FROM FACULTY'S TABLE

COVID-19 and ARAMCO

A BRIEF ANALYSIS

Photo: www.aramco.com

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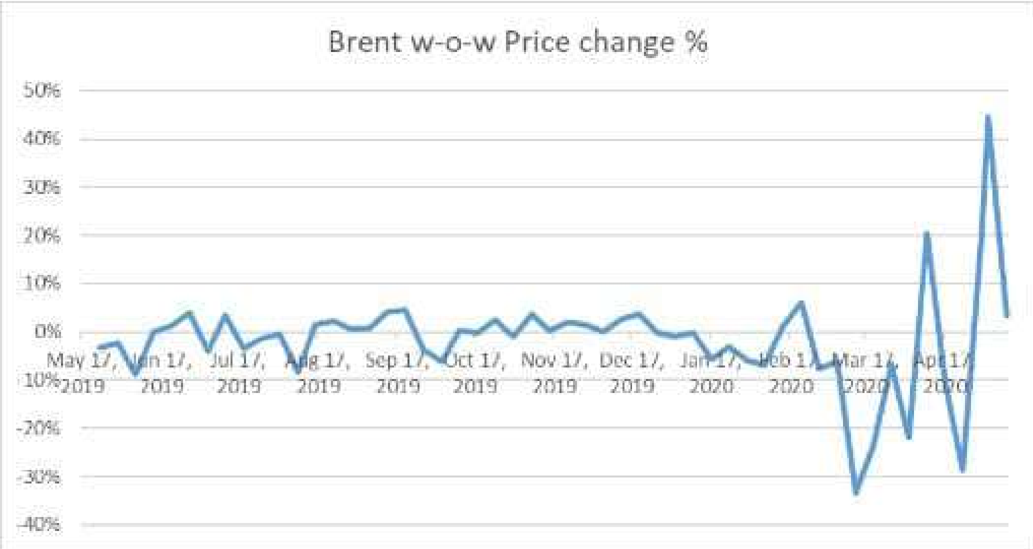
INTRODUCTION

The year 2020 is unparalleled in historical oil prices, crashing in April to -US$38 per barrel from a low of US$18 in a matter of hours. The increasing stockpiles and inadequate storage facilities forced oil producers *to pay* buyers to take barrels that were not storable. Oil producers faced a perfect storm of strategic price cutting stemming from rivalry between oil giants from the Kingdom of Saudi Arabia and Russia, and a global virus that forced lockdowns to contain the pandemic. Aramco, the Kingdom's 'national' oil company and the world's largest oil producer until recently, had to manage the severe oil price shock with policy changes that caused spillover effects on the nation.



Price changes week on week, for Brent Crude, from May 2019 to May 2020
Source: www.oilprice.com

Historically, oil has been a crucial commodity in almost every industry since the 1900s. The global move towards green, sustainable and renewable resources in addressing climate change was anticipated to spell the end of the 'black gold' era. But oil companies have managed to be ranked as sustainable due to a broader definition that covers the adherence to environmental guidelines, governance and social impact. There have been few substitutes to rival its versatility and cost. Going electric has not proven to be a worthy rival to oil in the short-term. According to the International Energy Agency (IEA), crude oil demand is expected to plateau by 2030, with 35% of vehicles going electric in 2040. It seems black gold has some time before it loses its lustre.

Aramco, the multinational Saudi Arabian oil company along with Shell and other oil giants have capitalized on the slow development of alternative energy sources.

The increasing price of oil after the 2008 financial crisis was also supportive, reaching peaks in 2016. The rally began to slow down towards the end of 2019, resulting in lower than average profits for Aramco. The recent oil price war with Russia and the COVID-19 pandemic further weakened Aramco's profits and capital spending.

In this brief opinion piece, we examine the apparent effects of COVID-19 on Saudi Aramco, the subsequent challenges facing the company and the nation, and potential solutions to reduce future losses.

BACKGROUND

Crude Oil Market

Crude oil is a finite, naturally occurring, unrefined fossil fuel comprising mainly of hydrocarbons. Refined oil can be produced as various petrochemicals, including gasoline and jet fuel. Dr. lling is the most common method of obtaining crude oil.

The oil industry is comprised of three phases: upstream, midstream and downstream (Beattie, 2020).

Technological advancements have popularized hydro-fracturing, allowing oil companies to extract from previously inaccessible shale reserves. The global economy is heavily reliant on oil with a slow change in favor of renewable energy resources. Saudi Arabia, Russia, and the United States are the largest producers of oil (U.S. Energy Information Administration, 2019).

The oil industry is comprised of three phases: upstream, midstream and downstream (Beattie, 2020). Upstream involves the exploration and production of oil, and downstream is the refinement and final sale of products. Midstream firms are the middlemen who transport oil from upstream companies to refinement facilities.

COVID-19

Several cases of pneumonia of unknown origin were reported in China in late December 2019. Shortly after, in early January of 2020 these cases were found to have been caused by a novel coronavirus now known officially as SARS -CoV-2 or COVID-19 (WHO, 2020). The highly infectious virus had approximately 12 million infected and caused 500,000 deaths globally, by July 2020 , and has forced governments to implement lockdowns and movement restrictions to curb the infection rate.

More than three billion people have been under some form of lockdown since February 2020 causing unprecedented economic damage to the global economy as a result of low consumer demand and supply chain disruptions.

SAUDI ARABIAN OIL INDUSTRY (ARAMCO)

Vast oil fields were discovered in Saudi Arabia, and 53 years later the Kingdom consolidated ownership of the oil company, now known as the Saudi Arabian Oil Company – Aramco (Saudi Aramco, 2020). Aramco is the leader of OPEC, a powerful oil cartel successfully influencing the price of oil through the control of production. The firm accounts for approximately 10% of daily oil production globally (Nehme, 2019), and was valued at US$1 trillion in 2020, one of the most profitable firms in the world. Saudi Arabia relies on oil export revenues for 90% of its export income (Forbes, 2018).

During the first quarter of 2020, Saudi Arabia was engaged in an oil price war with Russia. An agreement could not be reached and thus Saudi Arabia offered discounts to buyers in Asia and increased its daily oil production from 9.8 mbpdto 12.3 mbpd during the period (Sharufa, 2020).

ANALYSIS

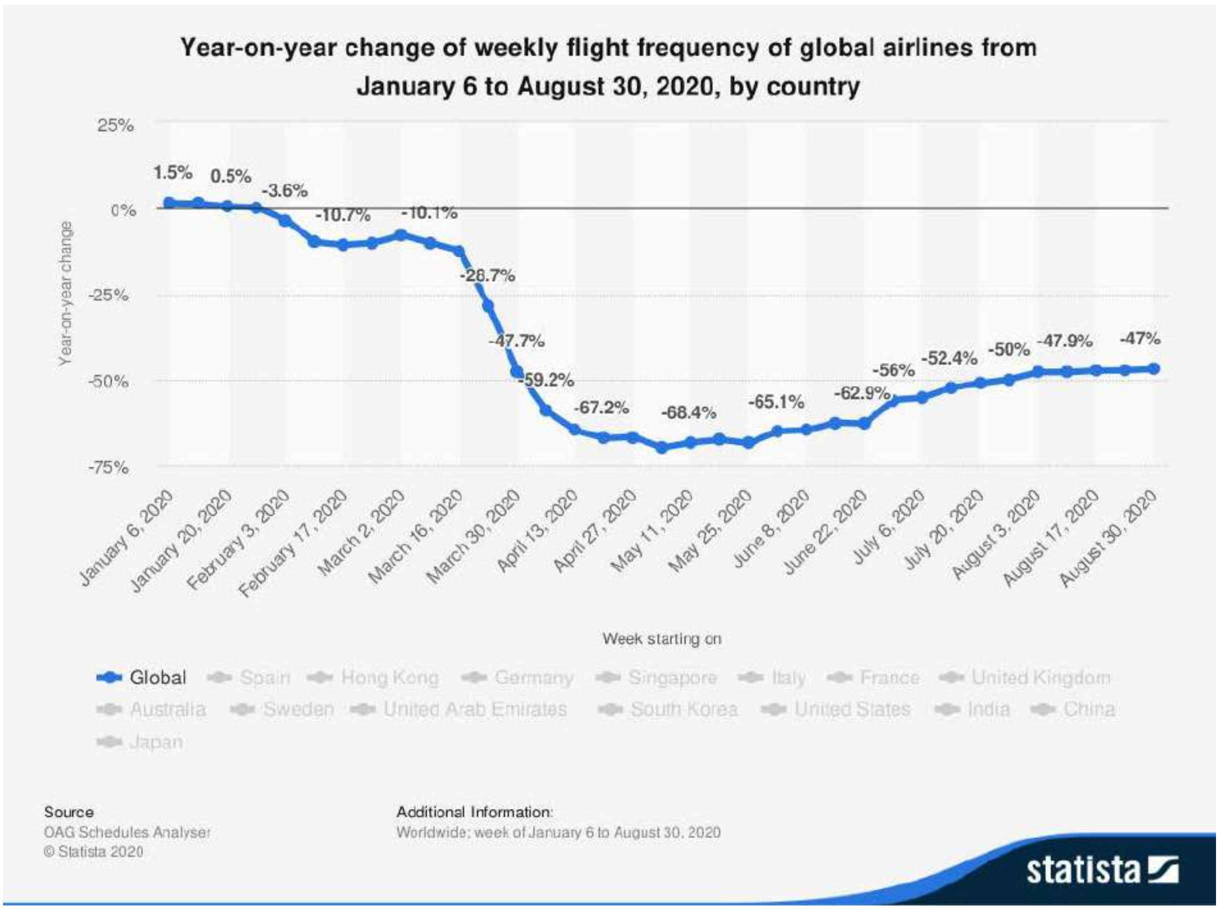
Demand, Supply, & Elasticities

Oil price is determined by demand and supply. Demand for oil varies with population, economic activity, and seasonal changes whilst supply is determined by current reserves, weather patterns, exploration, production costs and technology. West Texas Intermediate (WTI) and North Sea Brent are the two most recognized oil price benchmarks (Kurt, 2020).

Saudi Aramco's largest importer of oil is China, accounting for 47% of oil imports or US$40.1 billion in 2019 (Workman, 2019). As China was the first nation to grapple with the pandemic, they experienced the first decline in consumption.

With an approximate demand reduction of 3.2 mbpd, oil prices began to plunge in February (Yu, 2020). As global infection began to soar towards the end of February, global demand shrunk even further.

Travel restrictions significantly reduced the demand for oil, further impacting the oil price. Global flight frequency decreased by almost 70% by May 2020, prompting economists to predict a 2 to 3 mbpd fall in oil consumption, with short-term recovery unlikely (Sardana, 2020). Hence, future price expectations dropped to negative values. By July however, prices had recovered to above US$40 per barrel for WTI and Brent Crude as a result of an ease of travel restrictions and a reduction in production.



Due to limited alternatives for energy other than fossil fuels, demand for oil has been highly inelastic (Caldara et al., 2016). Saudi Arabian oil and their OPEC members have enjoyed the lowest costs of production and most control over oil supplies (Wall Street Journal, 2016). Oil extraction costs in Saudi Arabia are the some of the lowest in the world (US$10 per barrel), allowing for the Kingdom to prove significantly strong in a price war.

Recently, advances and government legislature in the U.S has increased hydrofracturing production and has reduced the price elasticity of Saudi oil.

In response to declining global demand due to the pandemic in March, Aramco reduced the price of its crude oil by giving discounts to major buyers, driving the oil price to down by more than 30%. Exacerbated by a disagreement within OPEC, and amidst the price war, Saudi Aramco increased production to a record 13 mbpd.

As consumers were more responsive to changes in Saudi oil prices, demand for futures contracts significantly increased. Coupled with the decrease in demand after the imposition of lockdowns, the oil surplus further reduced prices. Firms in the U.S could not accept deliveries purchased earlier in the year, hence the 'perfect storm'.

Source: WTI Crude Oil Prices, Macrotrends, 2020

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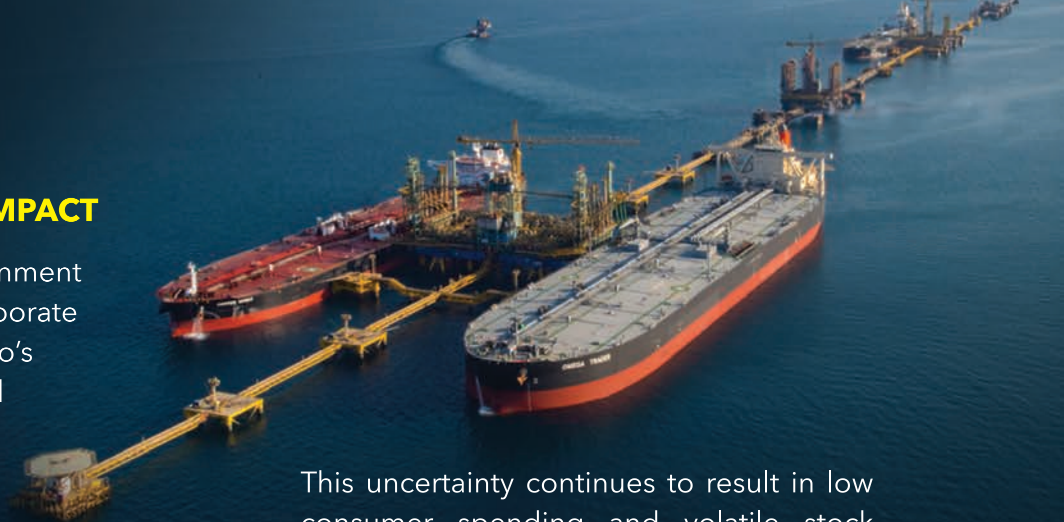
TAXATION, SURPLUS, & WELFARE

In Saudi Arabia, the lockdown had indirectly resulted in the imposition of higher levels of Value Added Tax (VAT) from July 2020; from 5% to 15% (Wolfers, 2020). It is not uncommon for countries to charge a VAT on the supply chain. However, Saudi Arabia has a tradition of limited to no taxes on income due to its enormous natural resources. In recent years, its dependence, and subsequent volatile oil prices has resulted in increasing budget deficits, with 2020 expected to expose a gap of 15% of GDP, compared to a 4.5% of GDP gap in 2019.

The new tax applies to almost all goods with limited exceptions. Consumer surpluses are likely to decrease, impacting their disposable income, prioritizing which goods they need and reducing travel. Secondly, gasoline also falls under the newly imposed tax rate. Three years ago, Aramco would have been buoyed by government subsidies which no longer exist.

Photo: www.aramco.com



CONSEQUENCES & IMPACT

The Saudi Arabian government applies a multitiered corporate taxation structure. Aramco's current tax rate is 50% (Al Arabiya, 2020) and if company contributions to the Kingdom fell below US$100 billion, the tax rate would increase to 85%.

This poses several issues for Aramco in the coming years, in terms of profitability and their stock performance. Aramco reported a 25% first quarter fall in profit in 2020- a direct result of the freefalling oil prices during the height of the pandemic. While oil prices have stabilized and a gradual increase is expected, company outlook and revenue may not recover immediately. Capital spending is a significant component of upstream oil company resources, including exploration, research and development. Aramco announced that it is revaluating capital spending and it is likely that resources spent on research and development would be reduced. Over the long-term, this may leave Aramco behind the curve of oil innovation and technology. Saudi Aramco's dividend policy is also expected to change, given lower profits.

The oil giant planned for a US$75 billion dividend in the 2020 fiscal year; however, the outlook is much lower than expected.

Although the firm is still aiming for US$75 billion, it is likely this will further drain their resources already being utilized because of the pandemic.

CHALLENGES

COVID-19 pandemic, global economy

As of July 2020, there is no clear end in sight for the COVID-19 pandemic.

This uncertainty continues to result in low consumer spending and volatile stock markets. Infection rates are falling and the search for a suitable vaccine is progressing; however, there is the possibility of a third wave in many countries as restrictions are eased. Governments have also organized stimulus packages to mitigate the impacts of the pandemic on local economies.

Despite the significant improvements since the beginning of the pandemic, global and local economies are not expected to recover immediately.

Consumer spending will take time to increase to levels seen before the pandemic. Saudi Arabia and its Gulf neighbors are predicted to enter a recession for the second half of 2020.

This may significantly impact already declined consumer spending. Cascading effects of the pandemic in the long run will likely pose challenges for oil price recovery, and by extension the profitability and state of Saudi Aramco.

Volatile Oil Prices

Oil price volatility is not new and is a consequence of different factors, for example, i. the slowdown in economic growth; ii. the decrease in Chinese oil demand; iii. the U.S shale oil strategy; iv. the drive towards sustainable and renewable energy sources; v. the incongruent approach of oil producing nations in refusing to reduce production; vi. political powerplay, instability and waging war on some major oil-producing nations under pretext.

Photo: www.aramco.com

These factors, amongst others, indicate that Saudi Arabia's long-term reliance on oil revenue is not sustainable and potentially harmful to a growing economy. Its strategy towards diversification is a positive move towards become a more robust and a more balanced economy.

However, if Aramco manages to sustain itself through the price war, decreased prices are expected to increase Aramco's oil market share and significantly reduce the strength of shale oil competition. Since shale oil producers have a significantly higher costs of production, the price war has shaken Wall Street and investment into shale oil production is expected to decrease (Consultancy, Rystad Energy predicts a 70% decline by 2021).

Tourism

Hajj & Umrah contribute 7% of Saudi Arabia's total GDP or around US$12 billion annually (Karam, 2019). It is therefore one of the largest non-oil income generators for the kingdom. Due to the pandemic, all visitation and tourism was restricted, incurring billions of dollars in losses. Furthermore, welfare among citizens may be impacted in areas heavily reliant on religious tourism. Derived demand for oil in the form of luxuries may face serious challenges until the pandemic is completely over. Demand for gasoline in travel between cities and tourist sites would also be impacted, resulting in further declines in oil prices.

POTENTIAL APPROACHES

Supporting healthcare systems

The main objective of healthcare systems and pharmaceutical companies is the management of infections and the search for a vaccine/treatment. Significant strain has been placed on healthcare systems in dealing with the pandemic globally. High initial infection rates incapacitate hospitals and dwindle supplies. PPE[1] is crucial during this pandemic. To ensure the least possible casualties, Aramco can assist in healthcare support/funding and financial packages to support their 76,000 employees (Saudi Aramco, 2020). With a better healthcare system, downtime is reduced and so the company remains more profitable.

Cutting Production

The forced and natural course of action to equilibrate the lower demand and oversupply (surplus) would be to reduce daily production of oil. Since demand cannot be controlled, Aramco can focus on supply. As the surplus decreases due to supply exceeding demand, the oil price will slowly increase. This also allows for demand to recover with a resultant increase in oil prices, mitigating losses and balancing revenues. In a positive move in mid-May, Aramco announced that they would cut daily oil production by as much as 1 mbpd to 7.5mbpd (Jalabi, 2020).

Political instability peaking during the Arab Uprising and the ongoing conflict between Saudi Arabia and Iran has also impacted production. An alleged Iranian attack on Aramco facilities in September 2019 resulted in a capacity cut of 2 to 3 mbpd for a few days. Production cuts may be unexpected as a result of conflict as well.

Coordination is also possible between Saudi and its OPEC members. This seems to be the current trajectory. Towards the end of May 2020, OPEC announced that they would further reduce production by 10mbpd (Saefong, 2020). The challenge with these organized cuts, while positive in raising the price and equilibrating supply and demand, places OPEC members at risk of losing to U.S. Shale oil.

1 Personal Protective Equipment

Shale oil production is increasing in the U.S, and if the difference decreases, the cartel will no longer have the control it once had on oil prices. In addition, members such as Iraq may pursue self-interest as they are facing severe budget deficits. Since production cuts are estimated to last for a month, a conservative and measured approach should rally oil prices for the second half of the year.

Diversification

Support for the National Transformation Program and the Saud Vision 2030 is expected to impact positively on Aramco over the long-term. This requires diversification into alternate vertical and horizontal industries including renewable energy resources. Aramco has made efforts to privatize through an initial private offering (IPO) in December 2019, after merging with Saudi Arabian Basic Industries Company (SABIC) earlier in the year.

Its recent support of Islamic finance by providing a fintech startup with US$25 million of funding is a further indication of diversification. However, more venture capital support is required for aspiring local entrepreneurs as well. The entrepreneurship centre established in 2011 (Wa'ed) has been encouraging and should continue its support for start-up development in the country through collaboration with fintech and entrepreneurship hives in the region.

COVID-19 has impacted the global economy and crippled rising consumer demand for goods and services

CONCLUSION

COVID-19 has impacted the global economy and crippled rising consumer demand for goods and services. Through derived and direct demand, oil prices slumped to their lowest in history.

The outlook is dire, yet positive signs of recovery are being witnessed in the oil market in the increase in consumer spending and the easing of travel/movement restrictions. Aramco has suffered a 20% loss in profits during the first quarter of 2020 and is expected to sustain further damage from the aftermath of the height of the pandemic in the second quarter.

Aramco would benefit from proactively managing the effects of lower consumer demand by cutting supplies, providing stimulus packages, and funding healthcare services. With all the uncertainties around the pandemic and economic recovery, there are improvements already which is reassuring to the company. If they do not, the spillover effects will be sustained, and recovery will be delayed. Oil prices do not only signify the price of the commodity, but also act as an indicator for economies, and play a key role in stock market stability. High oil prices can be detrimental for an economy, negative WTI prices more so. The subsequent impact of the fall in Aramco's profits will be felt throughout the nation, region, oil producing countries, and the world.

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