Implications of the Aramco oil shock for our economy

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The attack on Saudi Aramco's crude oil processing facilities at Abqaiq and Khurais in Saudi Arabia on 14 September has plunged the world oil industry into an abyss of uncertainty, speculation and apprehension. It will be quite some time before normalcy is restored to a market which was already passing through turmoil, largely as a result of sanctions on Iran, Venezuela and internal strife in Libya and Nigeria.

Abqaiq is Saudi Arabia's largest crude processing facility, with installed capacity of 7 million barrels per day (mbpd) and utilized capacity of 5.7mbpd. Khurais is the second largest oil field in Saudi Arabia, with a capacity to produce around 1.5mbpd. The kingdom's usual crude oil production is about 9.8mbpd, of which about 7mbpd is exported. This attack has resulted in the suspension of 5.7mbpd of supply, which is above 5% of world oil supply.

In reaction to the disruption, oil prices swung violently in the first two days, pushing Brent futures up by as much as 19.5% to $71.95 per barrel and WTI futures by 15.5% to $63.34. It is reported that cargo of light crude oil bound for China will be delayed by about 10 days; also, that light crude oil nominated for September delivery may be swapped by heavier grades with no changes in volume. Further, Aramco promises to deliver the same grade and volume of cargo as nominated for October.

In the immediate term—the rest of this month and early October, that is—India may not fall short of supply from Aramco. Minor shipment disruptions can be compensated for by Indian refiners, who can either buy crude in the spot market or exercise their operational flexibility to do the needful. India therefore does not foresee an overall supply problem in the short run. Notably, India also maintains strategic reserves of 5.33 million metric tonne (mmt) to handle any immediate crisis.

The medium-to-long-term impact of the drone attack on Saudi oil facilities and its implications for India can be analysed under three different scenarios.

Let's consider them one by one.

First, business as usual: this scenario is predicated on the assumption that Aramco will repair its facilities within a short span of time. The oil major is reportedly bringing back on line previously shuttered oilfields and also drawing upon its oil reserves to cushion the blow. What cannot be compensated for by cranking up idle fields and siphoning reserves is being satisfied by substituting heavier grade oil.

In such a case, India is well positioned to tide over any supply disruption. Indian refiners maintain 65 days of crude storage and, when added to the strategic reserves, that takes the Indian crude coverage to 87 days. Second, India has diversified its crude oil import sources. Out of 227mmt crude oil that was imported in 2018-19, only 64% was sourced from the world's top five producers; Iraq (46.6mmt) topped the list, followed by Saudi Arabia (40.3mmt), Iran (23.9mmt), UAE (17.3mmt) and Nigeria (16.8mmt). The rest was imported from well diversified sources, including the US (6.4mmt).

Of the scenarios likely to unfold, we must hope for business as usual but brace for a flare-up in West Asia

During the first four months of 2019-20, India's share of crude oil imports from the Organization of the Petroleum Exporting Countries (Opec) fell to 78% of the total; the figure was 83.2% in the corresponding period last year. On the other hand, India's crude oil imports from the US rose 213% during that period.

As for global oil prices, a sluggish world economy and softening demand do not suggest a sustained escalation.

The second scenario would be one of low supply disruption and a global price ripple. Irrespective of developments on the economic fundamentals front, global crude oil prices are greatly influenced by sentiment, geopolitical diplomacy and speculation. Tensions in West Asia could result in price spikes and India remains sensitive to such volatility. The country expects to import around 1.6 billion barrels of crude oil this financial year, so a $1 price increase adds $1.6 billion to the import bill (₹11,500 crore at the current exchange rate). The Indian basket of crude oil price for the first five months of 2019-20 was ruling at $65.28 per barrel. India's current account deficit grew to $68 billion in 2018-19, from $49 billion in the previous year. It is further estimated that a $10 per barrel increase in the price of oil reduces gross domestic product (GDP) growth by 0.2-0.3 percentage points, and ups WPI inflation by about 1.7 percentage points. Given the US-China trade war, and a trade deficit estimated to widen on account of higher oil prices, India's macroeconomic balances could come under strain.

The third scenario could be on sustained tension and retaliatory action taken by Saudi Arabia, the US or a coalition. The attack itself was a symptom of an underlying geopolitical rivalry in West Asia. If the Saudi bloc, supported by the US, attempts to strike the forces behind the attack, the future that unfolds would be far more unpredictable than now. At the moment, world leaders are talking about forging a collective response to the crisis.

Indian policymakers, oil companies and fuel retailers need to keep a close watch on these developments and prepare an appropriate strategy to ensure smooth supplies, while also acting to protect the interests of price-sensitive Indian consumers.

These are the authors' personal views.

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