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Russia and OPEC:

Uneasy Partners

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On Wednesday January 27th Russian Energy Minister Alexander Novak met with a group of Russian oil companies to discuss the domestic and global energy markets, following which he announced that Russia would be prepared to discuss an output cut of 3-5% at a meeting with OPEC in February. On the face of it this would seem to imply that Russia might reduce production by 300,000-500,000 b/d, and indeed the immediate reaction of the oil market suggested that some credibility had been given to the statement as the oil price surged by 8% in the immediate aftermath of the comments.[1] However, subsequent comments by other Russian and OPEC observers, combined with the history of Russia's relationship with OPEC, which has achieved little of substance, suggests that an agreement is a long way from being concluded and has limited chances of success. A more interesting conclusion is that Russia, perhaps not surprisingly, has revealed its growing economic and corporate desperation to see oil prices rise.

History does not suggest that compliance with any agreement is likely

Russia has a strong record of both encouraging OPEC to make cuts at times of low oil prices while also promising, but not delivering, reductions in exports itself. Figure 1 below highlights three previous periods of oil price decline when Russia and OPEC have tried to find a meeting of minds, but all have ended in no concrete action from Russia. In 1998, the oil price fell following an OPEC decision in 1997 to increase output that coincided with a drop in oil demand following the Asian and Russian financial crises.[2] The oil price fell from a high of $25/bbl in early 1997 to below $10/bbl in late 1998, prompting OPEC calls for production constraint from OPEC and non-OPEC producers.[3] Indeed in March 1999 OPEC and a group of four non-OPEC countries (Norway, Russia, Mexico and Oman) announced an overall reduction of 2.1 million b/d, of which the non-OPEC contribution was supposed to be 388,000 b/d.[4] Russia itself promised a 7% reduction in output (approximately 100,000 b/d), but in reality Russian production continued to rise consistently throughout the remainder of the year while any fluctuation in exports through the Transneft pipeline system was compensated by flows through alternative routes.[5]

By 2001 another crisis had emerged, with prices down from $36/bbl following the attack on the World Trade Centre in New York to a low of $20/bbl as the global economic downturn continued. OPEC promised an output cut of 1.5 million b/d, but again only if non-OPEC countries could find a further reduction, this time totalling 500,000 b/d. The OPEC call for support from other countries was this time largely targeted at Russia, where private companies such as Yukos and Sibneft had been driving a rapid growth in output since the 1998/99 economic crisis. Indeed overall Russian production had grown from a low of below 6 million b/d in January 1999 to just 7.3 million b/d in November 2001,[6] forcing OPEC to cede global market share. However, it was Norway, with production of 3.4 million b/d, that promised a cut of 100-200,000 b/d, while Russia, with output more than twice as high initially offered only 30,000 b/d. Subsequently Russian oil executives met with the then Prime Minister Mikhail Kasyanov, in March 2002, and agreed to a cut of 150,000 b/d, although it was unclear from what benchmark the cut was actually to be made.[7] Despite further promises from Deputy Prime Minister Viktor Khristenko, companies once again simply by-passed the official Transneft system and just got oil out of the countries via different routes – rail, barge and truck - with production and exports rising by around 300,000 b/d over the next six months.[8]

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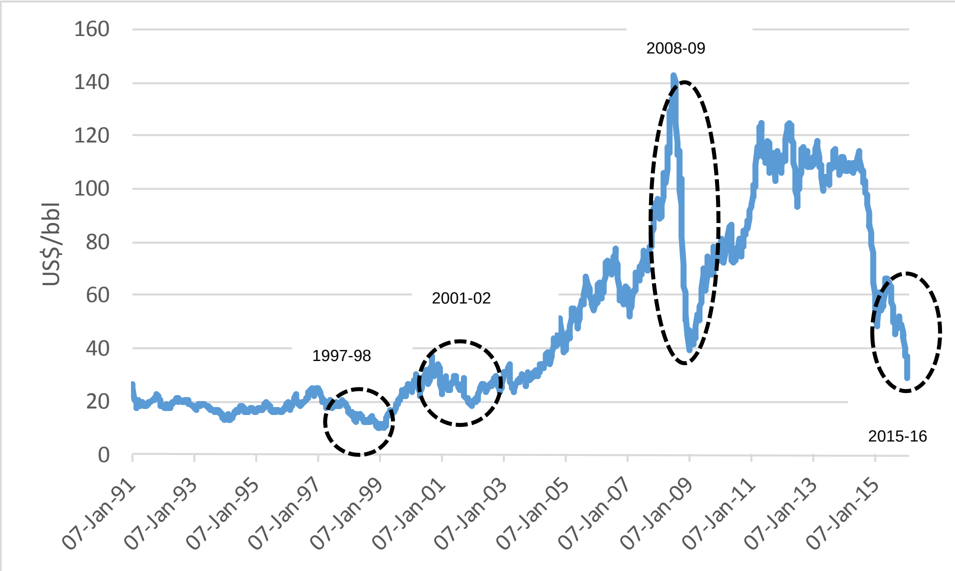
[1] Daily Telegraph, 28 Jan 2016, "Hopes of Saudi-Russian entente sends oil price rocketing"
[2] Economist, 4 March 1999, "the next shock?"
[3] For details, see Lajous, A. (2015), 'The Mexican, Saudi, and Venezuelan connection – a memoir ', Oxford Energy Forum, Issue 100, May.
[4] Elass, J. & Jaffe, A.M. (2009), p.16
[5] Wall Street Journal, 16 Nov 2001, "OPEC warns of $10-a-barrel price, insists other producers cut output"
[6] Data from Energy Intelligence Group
[7] Elass & Jaffe (2009), p.18
[8] Economist, 23 Nov 2001, "OPEC v Russia"

Figure 1: Timing of Russian conversations with OPEC



Source: Energy Intelligence Group

2008-09 saw the next sharp oil price plunge, from a high of $147/bbl to a low of $39/bbl in the space of only 6 months, catalysing more interaction between Russia and OPEC. Importantly, on this occasion it was Igor Sechin, then Deputy Prime Minister with responsibility for energy, who attended three consecutive OPEC meetings as an observer, consistently encouraging production constraint from OPEC but providing no promises of help from Russia. Indeed, he claimed that Russia had cut output and exports during 2009, but the reality was that overseas sales increased by 700,000 b/d, much to the exasperation of OPEC members.[9]

As a result, it is clear that Russia has historically adopted a consistent line that it is a price taker when it comes to the oil market, and has assumed that OPEC, and mainly Saudi Arabia, will always be the first to react and cut output to rebalance the market. It has presented a practical logic for this stance, with Russian companies arguing that their ability to adjust flows is limited by geography, as reducing output from wells in freezing Siberian temperatures risks creating fundamental and potentially irreversible damage.[10] However, it would also seem clear that the Russian government would much prefer to have OPEC reduce output and free ride on the price increase rather than have to organise a complex set of arrangements between numerous private companies itself.

This argument has been played out again over recent months, as Igor Sechin, now CEO of Russia's largest producer Rosneft, has again voiced his opposition to Russian production cuts (most recently in September 2015), using the practical problems as his reason while also citing the prevalence of private oil companies in the country as a barrier to government intervention.[11] In reality this is slightly disingenuous, as more than 50% of production is controlled by the state through its shareholdings in Rosneft itself, GazpromNeft and Bashneft, but nevertheless the potential for wells and pipes to freeze in winter if output is significantly reduced from specific wells remains a concern.

One alternative way in which Russia could contribute would be to slow the drilling of new wells, allowing the natural decline of fields in West Siberia to create a fall in output over time. As pointed out in a

[9] New York Times, 22 Oct 2009, "Russia oil surges after break with OPEC"
[10] Reuters, 28 Jan 2016, "Russian oil output cuts: where there's a will there's a way"
[11] Financial Times, 7 Sept 2015, "Rosneft chief Sechin damps talk of Russia-Saudi oil supply deal"

Vedomosti article on 29th January,[12] Russia drills around 3000 new wells every year, which contribute around 500,000 b/d of production – 5% of total current output. This would not produce the instant impact that OPEC might want, and could of course be subject to revision before it had been fully implemented, but the signal that it would send would be clear and potentially could support an increase in the oil price as its impact emerged.

However, the likelihood of this happening seems very low. A government instruction to halt drilling would be complex to impose and would have varying effects on different companies, depending on their specific investment plans for 2016. For example both GazpromNeft and Bashneft have recently made significant investments in new fields, with output having risen sharply in 2015 and set to continue in 2016, and both companies would therefore be very reluctant to limit output. Furthermore, any reduction in drilling activity would also have a dramatic impact on Russian service companies, just at a time when import substitution and the development of local activity is being encouraged.[13] The impact on economic activity would also be very negative at a time when another year of recession seems increasingly inevitable.[14]

Indeed the potential impact of any reduction in investment activity or oil revenues on the Russian economy highlights the dilemma which the Russian government faces. Its budget for 2016 was based on an oil price of $50 per barrel, and already anticipated a budget deficit of 3% of GDP, equivalent to $27 billion at the current exchange rate of around RR80=US$1.[15] At an oil price of $30 per barrel this deficit could expand to 4.5%, meaning that the majority of the Reserve Fund put aside for just such a circumstance could have been used by the end of 2016.[16] The Fund declined by more than $40 billion in 2015, with its total standing at 3760 billion roubles at the end of the year ($45.5 billion), leaving little room for another year with a significant budget deficit. Furthermore, with GDP forecast to decline by approximately 0.5% at an oil price of $50 per barrel but by perhaps 2% at $30,[17] the incentive for the Russian government to maintain investment in and revenues from the oil sector is obvious.

As a result, the Russian authorities have a fine line to tread, between wanting to encourage a higher oil price while not risking investment in the oil sector. As discussed above, one method that has been tried before, during the 1990s when oil transport capacity was more limited, is to allocate quotas in the state-owned Transneft pipeline system.[18] Two points need to be made about this strategy, though. First, it would create the risk of forcing oil companies to shut in wells that they might not then be able to re-open, thus curtailing reserve recovery permanently at some fields. Secondly, and perhaps more importantly, a quota system would be open to potential abuse either through the use of influence and political contacts (as was very much the case in the 1990s) or through the use of alternative export routes (again a classic 1990s tactic which often involved transporting crude to domestic refineries and then taking it into the export market as a quasi-refined product).

Furthermore, Russian oil companies are highly motivated to maintain exports for a number of reasons, and will continue to argue for the opportunity to sell their oil as the market allows. In particular, those with a high dollar-based debt level (for example Rosneft) need dollar revenues to make repayments.[19] Meanwhile all Russian companies benefit from maximising dollar income because the devaluation of the rouble over the past year has meant that export revenues are much more valuable in domestic terms, especially as the majority of operating expenses are based in roubles. Indeed currency

[12] Vedomosti, 29 Jan 2016, "Russia will sacrifice oil production"
[13] Reuters, 1 Oct 2015, "Russia's import substitution drive will take years"
[14] CNBC, 15 Jan 2016, "Russian Economy Ministry draft sees economy shrinking in 2016"
[15] The Moscow Times, 11 Dec 2015, "Russian budget deficit to reach $21bn in 2016 – Finance Ministry"
[16] CNBC, 27 Oct 2015, Russia's Reserve Fund could run empty in 2016"
[17] Macro Advisory, Jan 2016, "Preview 2016-2018"
[18] The Moscow Times, 11 Jan 1995, "What will replace scrapped oil export quotas"
[19] Financial Times, 25 Nov 2015, "Rosneft's $15bn financing beats sanctions"

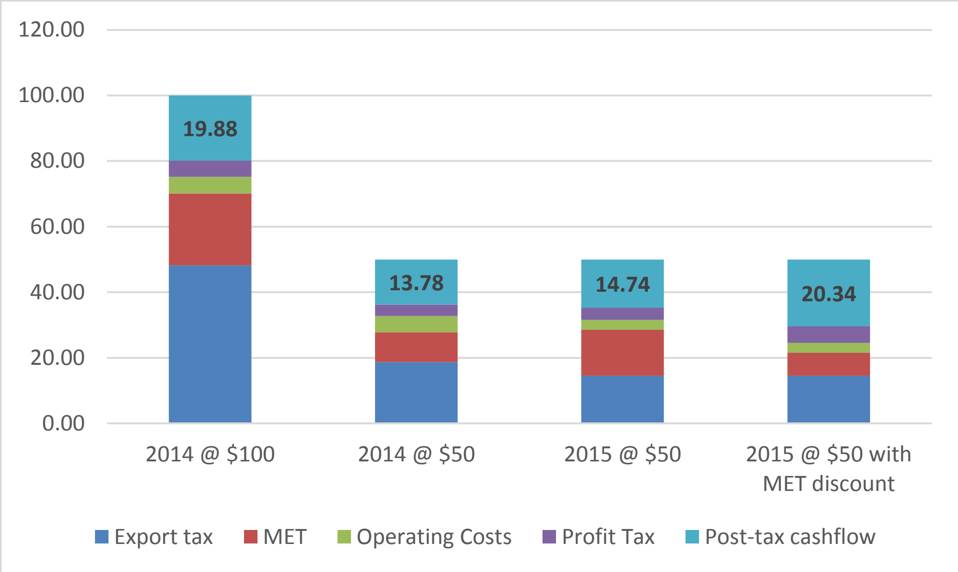
devaluation has benefitted Russian companies more than any other major oil producer, as Figure 2, reproduced from the Financial Times of January 21st, shows, with the effective domestic value of exported oil being over $60 per barrel because the rouble has fallen from US$1=RR35 to US$1=RR80 since mid-2014.

Figure 2: Comparison between oil prices in local currencies

Source: Financial Times, 21 Jan 2016

Furthermore, the tax system in Russia has provided significant protection to Russian oil companies, because the high level of the marginal rate above $25 per barrel has meant that the government has taken most of the cost of the falling oil price. As Figure 3 shows (reproduced from Henderson, 2015), the fall in the oil price from $100 to $50 per barrel could actually have seen corporate post-tax cashflow increase slightly for some operators in 2015 because of tax adjustments that were made between 2014 and 2015 for fields which qualified for a lower royalty (MET) tax (the final column). Even those fields which did not qualify saw cashflow decline by only 25% for a 50% fall in the oil price, demonstrating how the Russian budget has suffered much more dramatically than the Russian oil companies themselves.

Figure 3: Impact of lower oil price on Russian company cashflow (2014 and 2015)



Source: Henderson (2015)[20]

As a result, Russian oil companies have a much lower incentive than the Russian government to attempt an output reduction strategy to bolster the oil price. Indeed this conflict has been tacitly acknowledged by the Russian government already, in the immediate aftermath of last week's statements by the Energy Minister. Deputy Prime Minister Arkady Dvorkovich has since stated that "we take the position that our oil sector is, to a significant extent, private and is commercially minded, it is not under the control of the state…If prices are at a low level for an extended period of time, a correction in investment will become inevitable and that will lead to a certain reduction in output, but that will not be a deliberate act by the state."[21]

Furthermore, Energy Minister Novak has also conceded that although he promised that Russia would discuss output cuts at a meeting with OPEC members in February, this meeting has yet to be confirmed and indeed some key OPEC members, including Saudi Arabia, still seem to be unaware of its existence. Importantly, Novak's announcement also occurred following a meeting at which Igor Sechin, CEO of the company which produces 40% of Russia's oil and who has been a strong opponent of sanctions, was not present. Indeed a spokesperson for Rosneft has stated that "nothing new has happened" and described the market reaction by stating that "this frenzy is idiotic. It stems from the fact that people can't read."[22] In addition Novak himself has subsequently conceded that the idea had come up in a meeting with Venezuela, a country perhaps even more desperate to see a rebound in price than Russia. Finally, Novak acknowledged that Russia "would be prepared to participate in such a meeting [with OPEC] if it occurs," but added that "we're ready to discuss the issue of production cuts. This is not a decision. We're ready to consider the possibility. This should be a consensus. If there's a consensus it makes sense, if not, it does not."[23] This would appear to be a far more rational approach to take, given that OPEC itself has historically found it very difficult to reach agreement on production cuts, and given that Saudi Arabia has maintained a consistent line since November 2014 that any cut must be implemented by all, not a few, oil exporters.

[20] Henderson, J. (2015) "Key determinants for the future of Russian oil production and exports", WPM 58, Oxford Institute for Energy Studies
[21] Reuters, 29 Jan 2016, "Russia cautious on prospects for oil cut deal with OPEC"
[22] Financial Times, 29 Jan 2016, "Rosneft downplays talks of oil production cut"
[23] Reuters, 29 Jan 2016, "Russia cautious on prospects for oil cut deal with OPEC"

As a result, last week's comments about a Russian output cut in support of OPEC can be interpreted in perhaps one of two ways. A generous interpretation would be that the Energy Minister presented an over-enthusiastic conclusion from a meeting of oil companies who are naturally keen to see a higher oil price and wanted to encourage their government to discuss ways of achieving this. A less benign interpretation would be that Russian officials knew very well how the oil market would react to any talk of coordinated production cuts, and indeed have been proved right, even if the impact may be short-lived. In either case, though, there are many reasons to believe that, as in 1998, 2001 and 2009, Russia will do little of practical consequence to reduce oil output in support of OPEC.

The Saudi perspective

Given the history of Russia's consistent unwillingness to implement promises made to OPEC, it is hardly surprising that OPEC's most important member, Saudi Arabia, views any talk of a meeting to discuss cuts with suspicion and extreme caution. Indeed, it would go against historic Saudi oil policy to hold meetings without having previously agreed the likely outcome in advance and without almost absolute certainty that a positive outcome would be reached that could have a sizeable impact on oil market balances. Saudi officials are well aware that a meeting with no clear and constructive result is worse than no meeting at all.

Furthermore, the context of Saudi Arabia's overall policy towards oil market management needs to be borne in mind. It has been clear from the start of the current oil price fall (since November 2014) that Saudi Arabia will not cut its production individually, and that any output cut must be a collective effort in co-operation with both OPEC and non-OPEC producers.[24] Within OPEC the two key producers who need to be on board with this collective policy, and brought back gradually into the quota system, are Iran and Iraq. The key non-OPEC producer is Russia, which has continued to increase production throughout the past decade and a half, and has certainly shown no restraint during the period of weakness over the past 12-18 months.

The outlook for co-operation with Iraq and Iran may be complex, but at least the basis for negotiation is clear within an OPEC context. Furthermore, it seems likely that budget pressures in Iraq may force the country to scale back its ambitious growth plans, meaning that production performance in 2016 will not match that seen in 2015. While Iran's plans to restore production to pre-sanctions levels may also take longer than anticipated. What is more complicated, though, is understanding the Russian perspective, in particular because of the conflicting signals that the country has been sending. As has been outlined above, not only do the private companies in Russia have different motivations depending on their levels of recent investment, but ministers within the government also seem to have conflicting views. As a result Saudi Arabia is unclear who it should talk to, as although the perception is that the Russian government could mandate a cut if it wished (in particular if an order came from President Putin), the picture is confused by the fact that, for example, the head of the largest state-controlled oil company appears to be against any reduction in output.

Given this lack of clarity, Russia's history of promising cuts and then not delivering reinforces the lack of trust in any compromise that could be reached. Furthermore, it would be almost impossible for Saudi Arabia, or OPEC, to monitor any cut promised by Russia, or to enforce an agreement if it was not being honoured. Given all these facts it is perhaps not surprising that Saudi Arabia is reluctant to even acknowledge the Russian Energy Ministers comments at present. Indeed to do so would be to act in a way that should not be expected from Saudi Arabian officials, given their different negotiating strategy.

[24] For a more detailed discussion, see Fattouh, B. and Sen, A. (2015) 'Saudi Arabia Oil Policy: More than Meets the Eye?' *MEP 13*, Oxford: The Oxford Institute for Energy Studies.

Saudi Arabia preferred tactic, as evidenced over many years, is to hold negotiations behind closed doors and to avoid making any proposals public until they are fully agreed.[25] In particular Saudi Arabia has avoided the use of the media as a negotiating tactic, which makes it all the more unlikely that they would respond to the current Russian tactic of announcing a potential meeting to the press. Furthermore, it is highly unlikely that Russia would have received an offer from the Saudis, as it has claimed, because the Saudi strategy is already very clear – it expects the rest of OPEC and non-OPEC to come to it with concrete proposals of cuts before it will take any action. As a result, the only tactic that will work for Russia at present, if it is serious about co-operation, would be a private meeting with the Saudi leaders at which the offer of a significant cut is made, as again no formal meeting will take place unless an announcement of a substantial cut can be the outcome. At present, it would appear that Russia is some way from being able to make such an offer.

In the absence of any such private meeting with Russia or any of the other major producers, Saudi Arabia will continue its market share strategy, ensuring the long-term revenue maximisation for its 267 billion barrels of proved reserves.[26] Although low prices have taken longer than expected to cause a reaction among higher cost producers, it makes little sense for the Kingdom to step back from its strategy without a collective agreement while it has the financial and operational strength to outlast its competitors in the current price fall. However, having said this, one should not assume that Saudi Arabia will never change its oil policy regardless of the change in market conditions. If, for example, non-OPEC supply does decline sharply, perhaps because of a sharp decline in US shale output, and OPEC supply growth slows then the size of any cut needed to balance the market will reduce. In this circumstance, and given the high level of inventories, Saudi Arabia might decide to reduce output to speed the rebalancing process and absorb some of the crude stocks in the market.

One final point on Saudi relations with Russia should also be made. Not only is Saudi Arabia justifiably skeptical about Russia's willingness or ability to implement a production cut, but it is also very aware of Russia's competing political interests in the Middle East, in particular in relation to Syria and Iran. Indeed reports in the past few weeks that President Putin and his main spokesman have heavily criticized the Saudi leadership for their alleged involvement in 'targeting the stability and welfare of neighbouring nations'[27] is hardly conducive to reaching agreement over oil production cuts. Furthermore, Russia's increasing activities in co-operation with Iran also point to potential tension within any agreement with OPEC over the oil market, again highlighting the broad range of potential obstacles to any accord in the near term.

[25] For details, see Lajous, A. (2015), 'The Mexican, Saudi, and Venezuelan connection – a memoir ', Oxford Energy Forum, Issue 100, May.

[26] See for instance, Fattouh, B., R. Poudineh, and A. Sen (2015), 'The Dynamics of the Revenue Maximization-Market Share Trade-off: Saudi Arabia's Oil Policy in the 2014-2015 Price Fall', WPM 61, Oxford: The Oxford Institute for Energy Studies

[27] AWD News, 25 Jan 2016, "President Putin: Russia will bomb Saudi Arabia back to the Stone Age unless Riyadh desists from supporting terrorism"