ENERPO NEWSLETTER

Volume 2 Issue 1
11th February 2016

Week in Review

- Lina Nagell, Henrik Vorloeper

Energy News Blog

Russian Prirazlomnaya oil rig in the Pechora Sea
By Krichevsky CC BY-SA 4.0

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Energy News Blog

Oil Prices Troublesome for Russia

– Irina Mironova

The topic of this issue is the Low Oil Price. Low oil prices in principle is not a new phenomenon in the international oil markets, and falls occur regularly. The oil prices are currently at a very low level (around US$ 30/bbl as of the beginning of February 2016), and as can be seen from Figure 1, the trends currently are different from what we observed in 2008-2009. During the previous crisis period, the price has started to recover in the beginning of 2009(Year 2), while currently it remains within the low range.

The Monitoring Team reports on the implications of the low oil prices worldwide, and Glenda Pavon-Suriel in her Energy News Blog outlines the implications for Saudi Arabia, the largest producer within the OPEC.

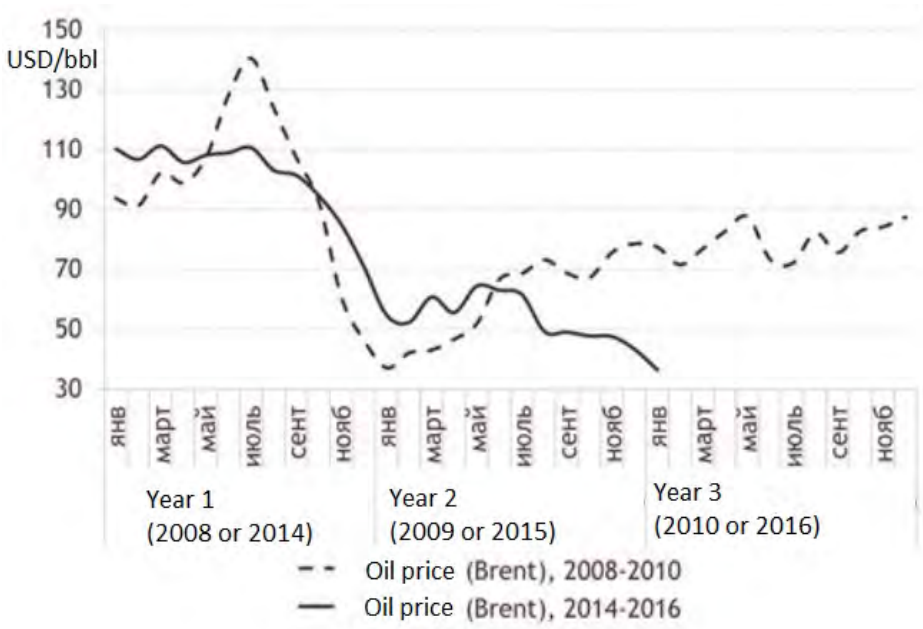

Figure 1. Oil price dynamics in 2008-2010 and 2014-2015. Source: ACRF 2016

What does this situation mean for Russia? The Analytical Center of the Government of the Russian Federation regularly publishes reports on Russia's energy sector and the economy in general, and in their January 2016 issue, they study how the situation in Russia has evolved throughout 2015. The findings are quite striking.

According to the preliminary data from Rosstat, the GDP has shrunk by 3.7% throughout 2015. The outlook for 2016 is not favourable either: considering the fall of oil price below $30/bbl in January 2016, the GDP is likely to shrink by another 1% in the coming year. Figure 2 demonstrates why prices in external energy markets, especially oil prices, are so important for the Russian economy.

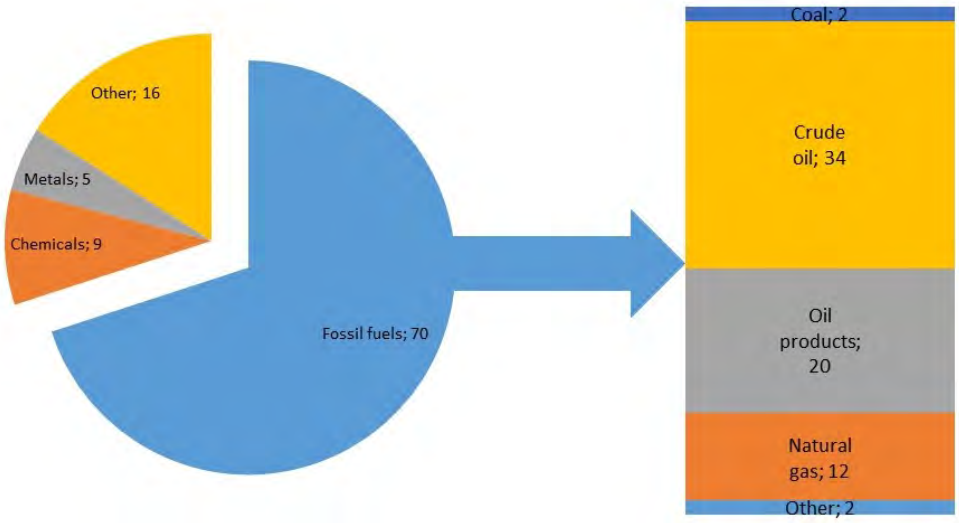

Figure 2. Structure of Russia's exports by value (%% in 2012). Source: Russian Gas Matrix 2014, p. 7, based on RF Customs Statistical Yearbook 2012

Low oil prices have led to decreasing inflation rates in developed countries – on average, inflation was at 0.2% in 2015, a level unseen since the crisis of 2008. This was not the case in Russia: what we experienced here is a 15.5% increase in prices compared to 2014. The prices were unsurprisingly strongly affected by the fall in the oil price and the devaluation of the rouble.

Against this background of recession and high inflation, real incomes in Russia have shrunk. The trade turnover in real terms has decreased by 10% in 2015, while the Kommersant Radio reports that Russians actually spent more than they earned last year. Therefore, the main mechanism of coping with unfavorable external conditions in the energy markets is actually the fall of real income of regular Russian population.

An interesting year looms ahead of Russia.

The Kingdom in Flux: OPEC's Prominent Producer Reacts to Price Gluts

–Glenda Pavon-Suriel

With oil prices at record lows, Saudi Arabia is waging different strategies in order to raise the revenue necessary to meet their obligations and maintain their position as the largest OPEC producer. Despite surpluses causing continued declines in oil prices Saudi Arabia, the largest of the OPEC producers, shows no indication of cutting production. The OPEC giant has cut subsidies, announced plans to raise taxes, and is pulling revenue from savings in order to stay afloat, all of which could have the country facing difficult economic times sooner rather than later.

Saudi Arabia, which relies almost entirely on revenues from oil production, is running on budget deficits in order to meet financial obligations. With crude oil prices around just US$ 30 per barrel, the Saudi government has been tapping into their foreign currency reserves. These reserves declined by about $1 billion in 2015 alone- from $720 billion early in the year to $620 billion in December, according to Michael McDonald of oilprice.com. If the price of oil doesn't increase, McDonald claims that the country may be out of foreign currency reserves in less than three years.

Despite this startling outlook, Riyadh refuses to cut production in order to balance some of the market oversupply. This is a long-term strategy in the hopes that demand for oil will stay high and to maintain their position as the world's largest OPEC producer. Saudi Arabia is concerned about other energy sources, primarily unconventional shale oil. With some of the lowest production costs per barrel, the Saudis hope that low oil prices will put North American shale oil producers out of business says John Schoen, a journalist with CNBC.com. Shale oil, which relies on expensive technologies, is only profitable for producers when crude oil is above $50 per barrel. Riyadh is counting on low oil prices as a potential way to forestall a decline in demand. The hope is that if demand stays high, the adoption of alternative forms of energy will be delayed. "The Kingdom is concerned about the rest of the world switching to other energy sources, and sees low oil prices as a way to delay the adoption of substitute forms of energy" states McDonald.

Essentially Saudi Arabia's strategy to secure their position as the OPEC giant should become a short-term strategy. Riyadh is only delaying the inevitable and they may have overestimated how long they can withstand low oil prices. The Saudis need to consider that even if they manage to force North American shale producers out of market share, shale oil technology isn't going anywhere, and neither is its threat to conventional oil producers.

By U.S. Department of State from United States - President and First Lady Obama, With Saudi King Salman, Shake Hands With Members of the Saudi Royal Family

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The Week in Review

Long Term Implications of Energy Industry Cutbacks

Oil prices below US$ 30 per barrel in January 2016 and rising stockpiles of oil have led to unprecedented cutbacks in activity and spending of energy companies worldwide. As a result costs for companies have come down, stemming partly from currency depreciation in oil producing nations and partly from cutbacks in service companies. The later has the potential to promote efficiency through more challenging competition. For example, Russian firms reduced costs by 20% because of the falling ruble, whereas U.S. tight oil producers could negotiate 30% cost reductions in average. The world average stands at 20% reductions. However, despite cost reductions, oil prices remain below the average break even prices, so that it becomes more difficult to suggest if cut backs remain cyclical or will have a structural impact on the energy markets for the coming years.

Amrita Sen and Virendra Chauhan, 2016. Oil producers retool for lower prices. Financial Times, 01 February 2016.

Major Oil Companies Report Great Losses, Companies with Activity in the North Sea Especially Hit

This week some of the world's biggest oil companies unveiled some of their worst-ever results, clearly showing the effects of the drops in oil price. BP suffered a loss of US$ 5.2bn in 2015, ExxonMobil announced a 58% drop in profits and a 25% reduction in capital spending for the next year. Royal Dutch Shell reported a decline of 56% in earnings in Q4 of 2015 compared to Q4 2014. Companies active in the North Sea are particularly affected, as it is one of the world's most expensive oilfields. Facing challenging times many of the companies have taken up debt to keep themselves funded, while the total debt at companies with North Sea operations was just over $90bn five years ago, today it has increased to $133bn. This is also shown by the example of Statoil's reported loss this week, estimated at a 44% decline in Q4 2015 compared to Q4 2014. Energy consultants at Wood Mackenzie stated that oil companies were likely to halt output at 140 offshore UK fields during the next five years, even if crude rebounded from $35 to $85 a barrel. Taking into consideration the $1m cost associated with halting extraction in the North Sea, there are many concerns facing oil companies operating in the fields.

Kiran Stacey, 2016. North Sea oil companies in danger amid debt spillage. The Financial Times, February 5, 2016.

Christopher Adams, Kiran Stacey and Chris Tighe, 2016. Collapse in crude brings North Sea fields near end of production. Financial Times, February 2, 2016.

Holly Ellyatt, 2016. Shell, Statoil earnings decline as oil price rags. CNBC, 4 February 2016.

Middle East Prepares for a Post-Oil Era

As oil prices remain at a low level, petroleum exporting countries in the Middle East are looking to reform their economies so to better weather the shock of lower oil revenues towards their highly oil-dependent economies. Diversification strategies to move away from oil-dependency has been put in place in the UAE, involving diversifying the source of energy and income. Six Gulf oil-producing countries (Saudi Arabia, Kuwait, Bahrain, Oman, Qatar and UAE) are planning to introduce a sales tax for the first time in facing the lower price level. Long standing fuel subsidies, specifically in the UAE, have also been removed.

Holly Ellyatt, 2016. Middle East prepares for a post-oil era. CNBC, 22 January, 2016.

Oil Prices Lower than China's Growth

Despite the lowest economic growth in China for decades, the low oil prices of January 2016 tempted the Chinese market to increase its oil imports to the highest since 2011, from sources including Africa, Russia and the North Sea. However, as it appears that China has become a "price taker", since slowing demand from China has been seen as one of the main driver for low prices, demand in China might only partially be driven by prices below US$ 30 per barrel. First, China increased its storage capacities, which needs to be filled preferably when prices are low. Second, China's economy is still growing and as a rather long-term trend, China has increased its refining capacity for gasoline to meet the demand in its automobile sector.

Rupert Rowling, 2016. China Can't Resist $30 Oil, Bloomberg Business, 01 February 2016.

Oil Prices Rallied After News of Increased Crude Inventory Levels, could This Mean That Oil Has Bottomed?

The Energy Information Administration released data on February 3rd showing that crude oil inventories rose by 7.8 million barrels the week before, more than the forecasted 4.8 million. Despite oil prices initially dipping and stocks tumbling, crude prices were spiking higher with stocks following around mid-afternoon. The rally in oil after news that inventories are at record highs is counterintuitive, and could suggest that the oil price has indeed bottomed. This analysis was put forward by Rich Barry, a Floor Governor of the New York Stock Exchange. Other analysts argue that although the increased oil inventory came as a surprise, a sizable increase that possibly exceeds forecasts has been expected for some time. Another point is the forecasted decline in the shale oil supply, which would offset the half million barrels Iran is expected to bring to the market.

Akin Oyedele, 2016. One trader has an interesting theory about why we might be seeing a bottom in oil prices. Business Insider, 3 February, 2016.

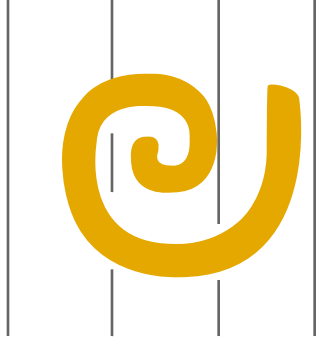
The Week, 2016. Oil price may be sub-$30 at the end of the year. The Week, 5 February, 2016.

Haifa Oil Refineries, By Hanay - Own work, CC BY-SA 3.0,

Oil Prices May Rise by 50% in 2016

Analysts project that oil prices could climb by US$ 15 per barrel in 2016, which is the median value of 17 different estimates. The increase will be spurred by the following two reasons: Shale production will decline in the U.S., while the average non-OPEC output will decline, mainly as a result of Russian output reductions. While the price thusly increases, analysts provide three explanations how prices could balance between $46 to $48 per barrel. First, Iran will re-enter the market while OPEC does not seem to significantly change its production rate. Second, shale production will decline, but balance and third, global demand for oil will increase.

Ben Sharples, 2016. Oil Prices Could Jump 50% by the End of 2016. Bloomberg Business, 3 February 2016.



Russia: Germany Will Agree to Build Nord Stream II Pipeline

The construction of the Nord Stream II pipeline (NS 2), between Russia and Germany has become politically controversial in recent months. The project faces opposition from several directions including Central European "gas-transit" states, the European Commission and members of the German government. Up until now, Germany has been a proponent of the project, but likely due to concerns of losing income from transit fees, German officials ask Russia now to guarantee gas deliveries to Eastern Europe.

Kenneth Rapoza, 2016, Despite Loud Opposition, Russia Believes Germany Will Agree To Build Nord-Stream 2 Pipeline. Forbes, 31 January 2016.

Oligarchs May Pay 500-800 Billion Roubles for Russia's Privatization

Driven by the economic crisis, Russia wants to sell stakes in some of the largest state-owned companies (Rosneft, Bashneft, Sovkomflot, VTB, etc.). The sale is aimed to prevent state-budget deficits and can bring up to Rb 800bn (US$ 9.99bn). The deal comes with some risk. First, foreign participation might be limited because of Russia's history of disputed property rights. Second, sanctions and low oil prices put the industry into a downturn, in which investment is risky. Third, experienced investors suggest that the state does not want to lose control over its assets and therefore lures oligarchs that are loyal to the Kremlin, who are willing to pay a premium on shares.

Reporting by Margarita Papchenkova, Olga Popova, Zlata Garasyuta, Darya Korsunskaya, Lidia Kelly in Moscow and Karin Strohecker in London; Writing by Margarita Papchenkova and Lidia Kelly; editing by Philippa Fletcher. Russian oligarchs most likely buyers in Putin's new privatisation plan. Reuters, 3 February 2016.

Gazprom's Strategic Changes

As LNG from the U.S. is expected to hit the market later in 2016, investors believe that Gazprom may adopt a strategy, very similar to that what OPEC does in oil markets: lower the price of gas. Even though this would certainly not be in interest of Russia's economy, a low gas price would make LNG from the U.S. unprofitable for European markets and secure Gazprom's market share. A European gas price war could have consequences for the global price structure not only for gas but coal as well. According to Gazprom, the company has still 100bln cubic meters of gas available, which could compensate for losses caused by lower prices. Gas prices in Europe have fallen in the last year (by 50% on the spot market and contracted prices are following the low oil prices). Gazprom cannot do much against the price drop, but it can fight a "price war" and take advantage of its already existing market share.

Jack Farchy, 2016. Global gas market braced for price war. Financial Times, 3 February 2016.

Shell- BG Merger Set to Take Place on the 15th of February, just as Sector Tanks Due to Price Mechanisms Based on Falling Oil Price

Shell is set to massively increase its exposure to the LNG market. BG, former international exploration and production arm of British Gas, will become a part of Shell on the 15th of February in a US$ 35bn merger. BG ramped up its LNG shipments by nearly 60% in 2015, only to see earnings from that side of its business plunge by 67%. Problems facing LNG companies is prices based on long-term supply contracts indexed after oil prices. Shell is already the biggest LNG provider among the large international oil companies, with its output set to rise by a third with the BG takeover.

Terry Macalister, 2016. Shell Massively expands natural gas business- just as sector sinks. The Guardian, February 5, 2016.

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