ENERPO NEWSLETTER

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Week in Review

- Henrik Vorloeper, Aaron Wood

Energy News Blog

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ENERPO Workshop: Drebentsov, BP's Chief Economist for Russia and the CIS

–John Collins

Amidst the vortex of uncertainty surrounding world hydro-carbon markets, Mr. Vladimir Drebenstov, the chief economist for BP in Russia and the CIS, arrived last Wednesday at the European University to give a presentation aptly entitled the Changing World of Oil and Gas, and included projections from the latest BP Energy Outlook. The presentation was multi-faceted, addressing many of the existential concerns which have brought oil and gas suppliers to their knees, not just in Russia, but on a global scale.

As we know, the extreme volatility and eventual collapse of prices since 2014 has been caused by a glut of supply on the international market in conjunction with slower growth in East Asia, still the world's fastest growing economic region. Yet Mr. Drebenstov added nuance to the simple argument that unconventional production in the US led to the divergence between global supply and demand by examining the actions of traditional oil market shapers, specifically Saudi Arabia, and their role in causing the current crunch. Geo-political developments post US global financial crisis, and especially since 2014, also were given due consideration in the presentation, particularly due to the reality that regional power (and thus energy supply) dynamics in the Middle East are "as capricious as the seasonal flows of the Euphrates", while Russian relations with the West have deteriorated to levels not seen since the collapse of the USSR.

The over-arching theme to the presentation was to look at recent trends in both oil and gas markets and then to use this information to draw informed conclusions about probable future trajectories in the energy field. As US unconventional production skyrocketed in the first two decades of the XXI century, their import dependency was significantly reduced. By 2015, US net imports were only a third of what they were in 2006 (Figure 1).

The corresponding fall in Brent crude price however, had no impact on Saudi production, which remained constant and then increased at the end of 2015/beginning of 2016 as illustrated in Figure 2. Indeed, OPEC production has significantly increased throughout the second half of 2015/beginning of 2016, led by a resurgent Iraq who will presumably be joined by a defiant Iran in the coming months. Furthermore, Russian production levels are at their highest in a quarter century, largely because small producers have followed their US counterparts in using lower costs and greater flexibility, when compared to the industry giants, to ramp up production.

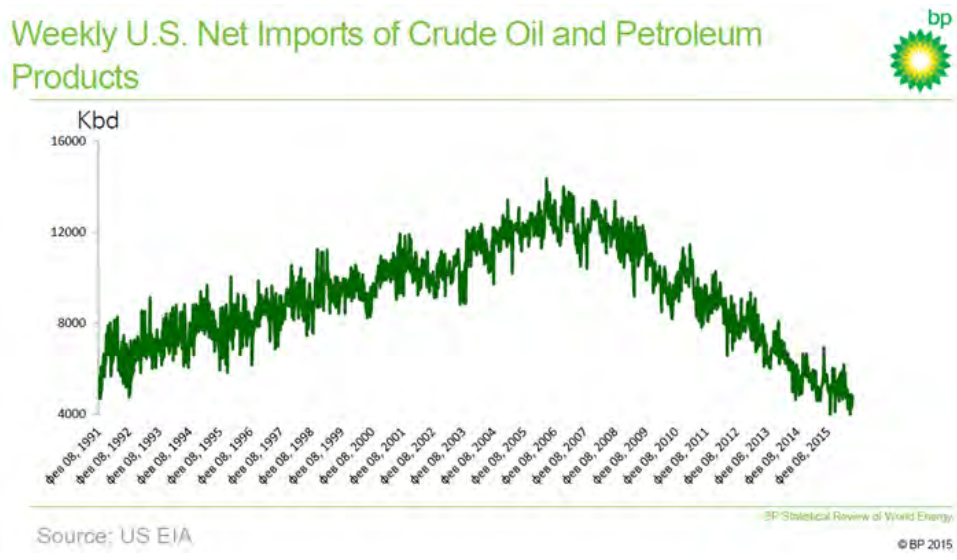

Figure 1: Weekly US net imports of crude oil and petroleum products. Source: BP

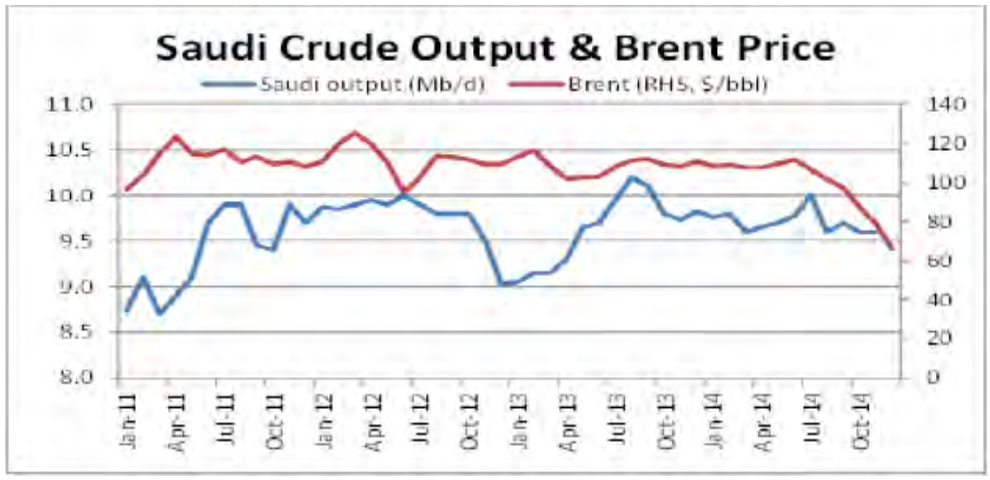

Figure 2: Saudi crude output and Brent price. Source: BP

Since the onset of the output freeze agreement with the Saudi's, Russia's independent producers, all small market enterprises not party to the deal, have accounted for the vast majority of additional Russian output as the agreement to freeze has faltered from all sides (Figure 3).

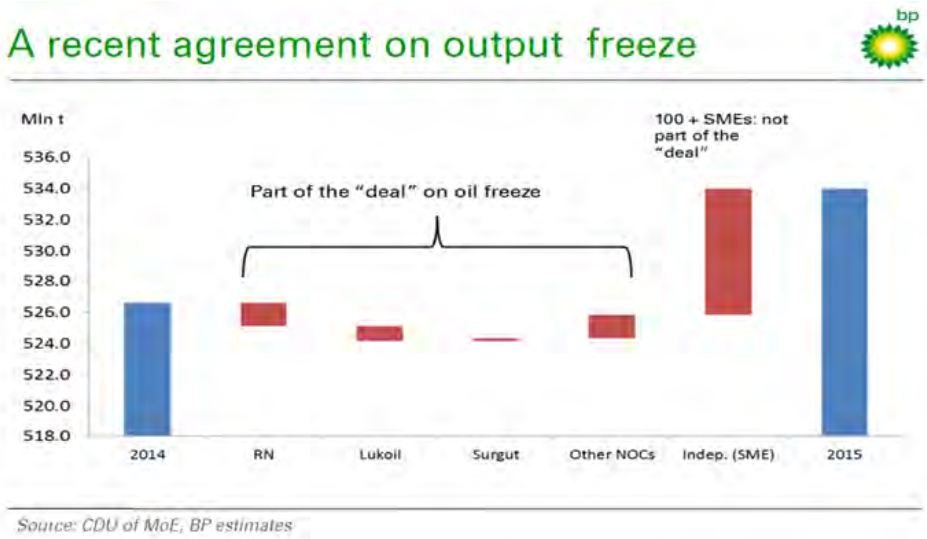

Figure 3: A recent agreement on output freeze. Source: BP

This confluence of factors has created a perfect storm in which crude prices will struggle to keep their heads over fifty dollars a barrel.

However, it would be doing BP's chief regional economist a disservice to speak only of recent trends in international oil markets when discussing his presentation, and certainly too narrow-sighted to not include natural gas in any conversation concerning world energy markets. Regarding gas, BP has made projections about the dramatic increase in the fuel's role in the international energy mix over the next twenty years, due largely to the dynamic processes associated with technological innovation and new forms of production/supply, as well as growing environmental concerns that see relatively low carbon-emitting natural gas as a viable alternative to coal (Figure 4). Indeed, while trends over the past couple years in the oil markets have had huge ramifications for prices of natural gas, as LNG supply proliferates, allowing for an ever expanding number of producers and the growing relevance of trading hubs and thus spot market pricing, we will see a gradual de-coupling of pricing structures in the two markets (though to what degree remains to be seen).

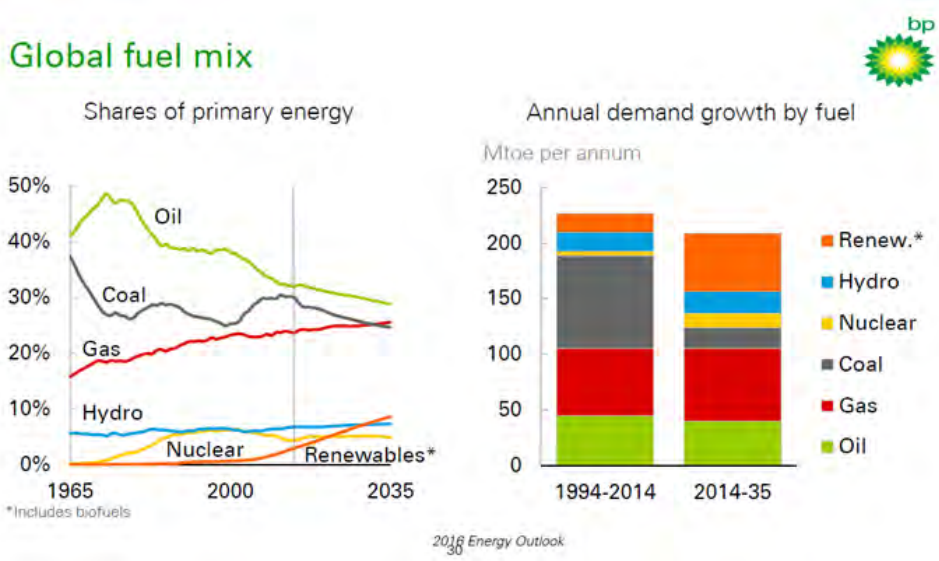

Figure 4: BP Outlook: Global fuel mix and Annual demand growth by fuel. Source: BP

In the long term, BP remains optimistic, as there is significant potential for economic growth and correspondingly higher levels of energy consumption across much of Eurasia, and even in other Non-OECD countries.

BP in particular remains unfazed by US sanctions because of their dearth of involvement in deep water and unconventional projects in Russia.

Mr. Drebenstov presents at the European University in St. Petersburg

Their rather large stake in Rosneft is perhaps a chink in their armor, due to Rosneft's somewhat alarming planned capital expenditure policies and investor concerns about whether they will be able to service their debt (especially as the major fields in Western Siberia turn from green to brown). Further problematizing future upstream projects for the oil giants is the fact that SME's and independent producers have a natural advantage in lower capital expenditures and thus lower abandonment costs. US independent producers also seem to be leading the way in terms of technological innovation, perhaps the most essential competitive advantage in any industry. Still, one has to agree with Mr. Drebenstov that over the long run of BP's twenty year forecast, market conditions will normalize, and greater access to capital along with the capacity to deploy that capital in the creation of huge upstream, mid-stream, and downstream infrastructure projects, will allow the industry's largest players, including BP, to create economies of scale in meeting the demand of China, India, and other developing non-OECD countries.

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Tax Changes in Russian Oil and Gas

–Zachary Waller

No matter where in the world you are, taxes are a complicated thing if you're a large business. Russia is no exception to this rule. With the fall in oil and natural gas prices (and subsequent decline in state tax revenue from the sector), the Russian Federation (specifically the Russian Ministry of Finance) has begun exploring potential changes to its tax regime for oil and gas production and export, changes that could have large implications for oil and gas companies working in Russia.

In order to understand what these changes could mean for oil and gas companies in Russia, let's first take a look at what taxes look like for companies right now.

Currently, oil and gas companies working in Russia are subject to a corporate income tax, a value added tax (VAT, with certain exceptions for the gas sector), a mineral resource extraction tax (MET), a subsurface use tax, and an export duty. While the corporate income tax (20%) and value added tax (18% on goods, works, and services) are relatively straightforward in how they are calculated, things get interesting when calculating MET and export duty (we will not look at the subsurface extraction tax as it can vary and is specified in each different license issued to oil and gas companies by the government).

According to the report by Vygon Consulting, MET for oil is currently calculated by taking a figure of 766 rubles per ton of oil and multiplying it by a coefficient K, where $K = (P_{Urals} - 15) * (P_{USD} / 261)$, P_{Urals} is the price of Urals oil and P_{USD} is the USD/RUB exchange rate. For gas, the calculation is even more complicated, as the tax is calculated by the formula $S = (S_i * E_{rf} * K_c) + C_{tr}$, where S_i is an initial fixed rate of 35 rubles per thousand cm3, E_{rf} is the value of a reference fuel, K_c is a coefficient expressing the complexity of the gas, and C_{tr} is the cost of transportation. Further complicating the MET on gas is the fact these variables can change depending on a multitude of factors, such as the oil price, USD/RUB exchange rate, domestic gas prices, and foreign gas prices (just to name a few).

Along with MET, export duty is the other interesting part of the Russian tax regime on oil and gas. When oil is priced below US$ 15 per barrel, the oil export duty is 0. When oil is between $15 and $20, the duty per barrel is calculated as $S = 0.35 * (P_{Urals} - \$15)$. For oil between $20 and $25, the formula is $S = \$1.75 + 0.45 * (P_{Urals} - \$20)$, and for oil above $25, the duty can be calculated as $S = \$4 + 0.42 * (P_{Urals} - \$25)$. For natural gas the calculation is much simpler: the export duty is 30% of the export price (with LNG as well as gas going to Belarus and Kazakhstan not being subject to export duty.)

What these various formulas do is create a situation where the Russian state stands to profit most from high oil prices, as companies see their shares of the pie go up only slightly when prices increase, while seeing them decline only slightly when prices fall.

Oil and gas play a huge role in the budget of the Russian government. For example, in 2014, revenues from MET and export tax on oil alone constituted 46% of the Russian government's revenue. With today's low oil prices, the Russian government has been losing more and more of its budget that used to come from oil and gas and has begun rethinking the specifics of its tax regime on oil and gas in order to take more rubles from the oil and gas trade and inject them into state coffers.

As part of the current tax regime, there are a number of fields receiving tax breaks, something the Ministry of Finance would like to end. Under the proposed changes, these tax breaks would be eliminated. However, others would come into play. For example, as a way to encourage development, greenfields would not pay MET until they become profitable.

The biggest change, however, comes to the MET itself. Under the Ministry's proposal, the MET on oil would be changed from its current formula to a 40% tax on all fields (except not-yet-profitable greenfields).

Oil Pump in Russia by Acodered - Own work, CC BY-SA 3.0

The Week in Review

Doha Meeting Turns Out to be a Farce Already

The high expectations set on the meeting between Saudi-Arabia and Russia to take place in April 2016 have already raised the hopes of those who have an interest in an oil production freeze – mainly smaller producers, who are hit hardest by low prices of oil. Amongst them are Venezuela and Nigeria. Unfortunately, according to an analysis by oilprice.com, they are likely to be disappointed. For Russia, the oil production freeze will likely not be significant since the country at the moment produces on the highest level since Soviet times. What matters is Saudi Arabia and Iran. Saudi Arabia stated clearly it would freeze production if all countries decide to freeze production as well. Iran announced that it would increase production, consequently reaping the benefits of lifted sanctions. If Saudi Arabia adheres to its warnings, the output freeze is unlikely to happen.

Rakesh Upadhyay, 2016. Are The Saudis And Russians Deliberately Sabotaging Doha? Oilprice.com, 06 April 2016.

Russia is Serious About Urals as a Global Benchmark

Trading of the Ural's oil export futures will commence at the end of 2016 and oil is expected to cost more than the currently recognized Brent price. One prerequisite is that oil output in Russia remains at a high level, although Urals production almost doubles production of Brent oil. The problem is that Urals is currently traded outside exchanges and mostly by long-term contracts. Thus only contract partners know the real price of Urals. Further, Urals oil quality differs greatly from Brent. If Urals will become a benchmark, the price will be transparent, but more importantly according to analysts, it will be fair. St. Petersburg International Mercantile Exchange, or SPIMEX, will then be the exchange on which Ural futures are traded. Delivery via the ports of Primorsk, Novorossiysk and Ust-Luga and the pipeline Druzhba justifies Urals to be a globally traded commodity, however, the local market development will influence the process. U.S. Dollar will be used for trade, transition to rubles depends on the political situation. ESPO brand could be the next global benchmark, provided that Asian markets are growing. The port Kozimo would become the main delivery point for global markets.

Donald Levit, 2016. Economic Calendar. Will Russian Urals Overtake Brent As The World's Oil Benchmark? Platt.com, 06 April 2016.

Angola Asks IMF for Help

Angola requested a loan from IMF of about US$ 1.5 bln as a consequence of low oil prices. The IMF said it will discuss the bid, but according to fund rules, Angola is eligible for only $500 million per year, unless a special waiver is made. Last time Angola asked the IMF for a loan was in 2009 for a similar sum, which it is still repaying. The move indicates the stresses put on oil producers especially in Africa as a result of falling oil prices. Angola is not the only country asking global lenders for help, but it is another one that following the same trend. Interestingly though is that Angola is the first developing world country that turns to IMF rather than World Bank. World Bank is known to require lower conditions of economic reform within the country. However, Angola has already a loan from World Bank. That only means, according to the analysis that things have gone worse in Angola. The IMF package for Angola is likely to be tougher than in 2009, although Luanda claims to work according to its commitments. Angola needs external funding this year of about $8 bln. Equally interesting is that Angola has not turned more towards China, despite Beijing being another big spender in Africa.

Shawn Donnan, Washington, 2016. Angola turns to IMF for bailout amid oil price fallout. Financial Times.com, 06 April 2016.

South Stream Not Yet Off the Table

When Russia abruptly cancelled its gas pipeline project South Stream, many countries in Southern Europe and the Balkans felt left alone, betrayed, and searching for new alternatives. Bulgaria decided for a strategy to push Russia further and thus not give up. The reasons behind Bulgaria's strategy are as such: first, Bulgaria receives 80% of its gas needs from Russia and has difficulties to find alternatives. Second, the only alternative has been Russia's follow up project, Turkish Stream, which has now been frozen for political reasons, but would have brought more Russian gas into the Balkans. However, another option could have been the Nord Stream project, which theoretically could connect Russian gas via Germany with the Balkans. Bulgaria did not send a protest note to the EU against the project, unlike most other Central European- and Balkan nations. Why the idea of South Stream could be revived is the consequence of a recent deal between Gazprom and the Italian company Edison and Greece's DEPA to build an interconnector pipeline between Greece and Italy to supply Russian gas. The agreement indicates that South Stream could be supplier of this.

Stephen Blank, Jamestown.org, 2016. Russia Remains Set On South Stream Pipeline Project. Oilprice.com, 24 March 2016.

Shell Continues Pulling Out of the Arctic

Shell signed its withdrawal on its application to win offshore extraction licenses on Norway's Arctic. As Shell has been a promising applicant and certainly important for Norway's strategy to maintain its foothold in the Arctic, the news indicates another chapter of the oil major's global struggle caused by low oil prices. Last year, Shell announced the abandoning of a promising project in the Alaskan Arctic, losing billions of US dollars in investments already made. Other companies have followed and the Arctic revolution is on hold, at least as long as oil prices are on a downward trend. Projects in the Arctic are too expensive and the current oil price does not guarantee the returns. However, Norway's Arctic has long been seen as relatively easy to explore, compared to other Arctic seas. The question for Norway is now, to whom the license will be granted. There are other bidders out there.

Stine Jacobsen, 2016. Shell pulls out of Arctic-focused exploration oil licensing round in Norway. Reuters, 04 April 2016.

Venezuela's Public Sector Employees Take a Break

The president of Venezuela, Nicolas Maduro, announced this week that public sector employees of the economically trouble nation will be observing Friday as a holiday for the next sixty days in a measure to save energy. Currently droughts are ailing the countries hydroelectric power stations. Employees involved in agriculture and food production are excluded however as the country is already struggling to meet domestic needs. The new holiday isn't necessarily received well however. Political opponents and regular Venezuelans alike have criticized the measure, concerned that the savings generated by Venezuelans taking off work will not be sufficient to rectify any problems and would inconvenience the Venezuelan public. Opposition politician Maria Corina Machado stated that "Just because Maduro doesn't work Monday to Friday, Saturday or Sunday, doesn't mean we Venezuelans are like that…What we want is to keep working, and for you, Maduro, to go." Luis Miguel Lopez who works for Chacao, a municipality that where the president has a low approval rating states, "This decree is illogical…People are going to be at home consuming energy all the same."

Ulmer, A., Kai, D., Chinea, E., 2016. Venezuela public sector workers to get Fridays off until drought ebbs. Reuters, 7 April, 2016.

Kazakhstan Files Against International Majors in Pricing Dispute

The recent prices glut means that more clashes are likely to abound between governments and international oil companies as state budgets dependent on resource rents come under more strain. The government of Kazakhstan has filed against BG Group and Eni for a hefty sum of US$ 1.6 bln. The dispute is over a formula of how profits would be split between the government of Kazakhstan and the companies taking part in the development of Karachaganak gas condensate field. This case has strained relations with foreign investors when last year representatives on a board of one of KazMunayGaz's subsidiaries upstream decided not to pay out dividends, contrary to the advice of independent directors.

Reuters, 2016. Kazakhstan Files Claim Against Karachaganak Partners. Upstream Online, 6 April, 2016.

Malta, Italy, Oil, and a Secret Deal for Refugee Relocation?

Strange news that Malta and Italy have struck a deal swapping oil exploration rights for refugee relocation hit the airwaves recently. Maltese opposition leader Simon Busuttil has claimed that the Maltese government has offered to drop its claim to the disputed territory in exchange for Italy taking on refugees who have landed in Malta. While the European Commission claims to know nothing about this issue, an Italian newspaper, Il Giornale, has reported on it as well. Very few refugees have landed in Malta since the beginning of troubles in Syria, which makes the situation all the more puzzling, while there are those who postulate that the de facto closing of the Aegean route of entry to Europe for refugees could lead to Libya, and therefore Italy and Malta, to be the next routes of entry. The de facto closing refers to a deal in which, in exchange for financial aid and some favors, Turkey will take back refugees who crossed from her borders through the Aegean and into Europe via Greece.

Burgess J., 2016. Did Italy and Malta Actually Agree to Swap Oil Rights for Refugees? Oilprice.com, 4 April, 2016.

TAPI Pipeline Developments

This week, shareholders in the project have signed on to own, construct, and operate the Turkmenistan-Afghanistan-Pakistan-India pipeline. The 1,800 km route will provide 33 bln cm3 of gas each year, and will cost over US$ 200 million. The majority of the pipeline's length will extend through Afghanistan and Pakistan. Leaders in the region have lauded the project, as an example of much need cooperation in cross-border projects in the volatile region. This is especially beneficial for Tajikistan as it will allow them to diversify their gas exports. Currently, Tajikistan only possesses export infrastructure to China. (Afghanistan is a major problem in the development of this project in addition to strained relations between India and Pakistan.)

National Gas Euopre, 2016. Shareholders Sign TAPI Investment Accord. Natural Gas Europe, 8 April, 2016.

Iran Gets Aggressive, Discounts Crude

Iranian NIOC will sell the Forozan blend of crude for almost US$ 2.50 less per barrel than the Oman or Dubai benchmark grades of oil. Analysts see this as a further move by the nation which, of course coming out from under a heavy sanctions regime, is scrambling to catch customers and regain market share in a world where crude goes for less than 50% below mid-2014 levels. This new measure makes the upcoming Doha talks on freezing output seem ever more doubtful, as Iran intends to increase production and continue discounting. Saudi Arabia has made clear that any halts in production would be done only in tandem with the Islamic Republic of Iran.

Cho, S., Cheong, S., Iran Steps Up Offense in Oil Market War with Price Discount. Bloomberg, 8 April, 2016.

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