ENERPO NEWSLETTER

Volume 1 Issue 6
23th October 2015

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Energy News Blog

Challenges Facing OPEC Members in Light of Lower Oil Prices – *Lina Nagell*

The Technical meeting between oil experts from OPEC members and 8 non-member oil producer states on Wednesday, 21st of October, did not reach an agreement to cut production. This comes as no surprise, taking into account that participants were in fact unable to agree on joint press releases at their two last meetings. Recent reports suggest that the meeting did result in an agreement to share information to better assess the market.

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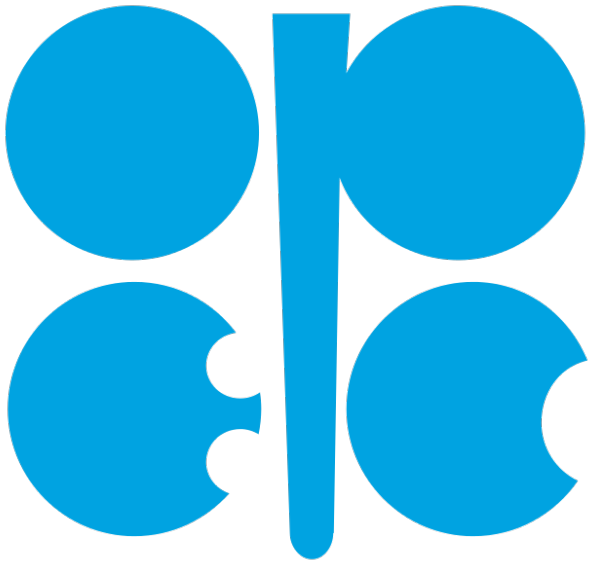

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Russia and the New Geopolitics of Oil – *Irina Mironova, Aaron Wood*

The changing structure of the global oil trade – which includes new roles for Russia and Saudi Arabia and the rise of non-state actors such as ISIS – has important implications for Russia's energy industry.

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Challenges Facing OPEC Members in Light of Lower Oil Prices

– Lina Nagell

Fragile five in dire straits

Since its creation at the Baghdad conference in the 1960s, OPEC's objectives and abilities to influence world oil prices have changed. From an influential yet uncoordinated actor where individual member states' interests far surpassed that of the cartel as a whole, OPEC rose to infamy during the 1970's oil crisis. Today we see a new OPEC, unwilling to jeopardize future market share for short-term gains. OPEC, with Saudi Arabia at its hem, decided to abandon the role of global swing producer of oil in November 2014 – facing oversupply due to the U.S. shale revolution. Oil prices has fallen dramatically since then, leaving some OPEC member states in dire straits.

The fragile five include Venezuela, Nigeria, Libya, Algeria and Iraq. Facing increasing public unrest as a result of decreased revenue resulting from lower oil prices, Venezuela was the instigator of the technical meeting of oil experts in Vienna. Raising its original call for price control of $70 per barrel to a whooping $88 per barrel (stated to be an equilibrium price by the nation), some participants claimed that the call was simply a PR stunt. Venezuela has been trying to influence OPEC to return to set prices for already some time. Along with other OPEC member states, Venezuela is one of the OPEC members dependent on high oil prices to cover necessary public expenditures needed to maintain their, to a large extent, authoritarian regime. In this sense OPEC's strategy to endure current losses to protect future market share, could pose an existential threat to some of its members. Observers are stating that not even oil producing giant Saudi Arabia is safe in the long run.

Saudi Arabia – no money no problem?

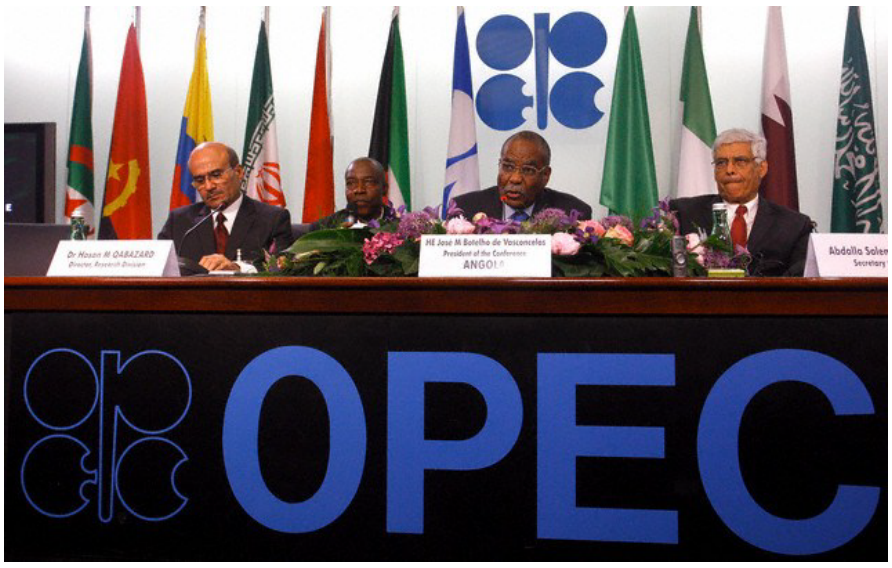
When Saudi Arabia became the key proponent of not introducing production quotas back in 2014, there was a strong belief that the country would be able to withstand the consequences of lower oil prices. However, today's situation demonstrates that Saudi Arabia miscalculated the extent to which oil prices would decrease. Aspects that were not accounted for include continuing drops in demand and the resilience of the U.S. shale industry. A recent IMF report suggests that Saudi Arabia needs a price per barrel of $100 to balance its budget while maintaining its current public expenditure levels.

The same report states that Saudi Arabia could in fact keep current levels of expenditure, financed largely through reserves, for maximum five years – estimating current debt at 20% of GDP. Other observers disagree and have a grim outlook on Saudi Arabia's ability to continue at current expenditure levels over 2-4 years, especially considering the kingdom's expenditures associated with wars in Yemen and Syria. There is no doubt that Saudi Arabia needs higher oil prices, and it needs to happen within a period of 2-4 years.

Get into the swing

With OPEC and Saudi Arabia out of the race, who could – if any, – take over the role as global swing producer of oil?

Observers pointing to the U.S. are not taking into account differences in market structure between U.S. and other oil producing nations where state companies dominate. Even if the U.S. export ban on oil were to be lifted, which is quite an if considering the White House's threat to veto, the U.S. market is characterized by many small producers. A large-scale coordination amongst them would be necessary, a development seen as unlikely. There is little evidence of such a desire amongst the small producers, antitrust laws put up to limit this kind of behaviour would also certainly constitute a major barrier.



Day Donaldson/ Flickr/ 2.0 Generic (CC BY 2.0)

The invitation of eight non-OPEC member states in the meeting on Wednesday, whereas five decided to participate, could suggest that OPEC is hoping to spread responsibility of production cuts among other oil producing nations. Statements made by Saudi Arabian Oil Minister al-Naimi and OPEC Secretary General Salem el-Badri, could support this claim. The two suggested that though production cuts could help increase prices, Saudi Arabia is not able to do it alone. This is supported by claims that Saudi Arabia is in fact no longer able to act as a swing producer due to its lacking ability to increase production notably in the short term. Venezuela recently called for Russia to cut production alongside OPEC, a proposal supported by Iran, albeit not Russia itself. In fact, Russian Deputy Minister Arkady Dvotkovich ruled out any production cuts, in September.

Light at the end of the tunnel?

Some observer's point to a light at the end of the tunnel; claiming that decreased activity in U.S. shale industry will lead to a drop in supply, followed by an increase in prices.
This is a short-term analysis. U.S. shale industry has shown a remarkable adaptability in the face of falling oil prices, and the industry is capable of starting and boosting production on relatively short notice. Nearly 30% of wells started in 2014 can in fact break even at $81 per barrel. Compared to some Middle Eastern producers with profitable onshore production at $10 per barrel, this is still not competitive, but the nature of the political regimes in many of these Middle Eastern oil producing countries, however, require a much higher oil price to stay afloat – closer to the price needed for U.S. shale industry to thrive**.** Taking into account that U.S. shale industry is constantly working to become more productive, some wells profitable at $30 per barrel, it is not unlikely that we will see massive increases in productivity in U.S. shale industry – especially as prices again start to rise. Keeping this is mind, OPEC and Saudi Arabia's strategy to outcompete U.S. shale seems less than bulletproof. Major oil producing countries might have to face the fact that the future entails a lower oil price than seen in a long time, which could have potentially devastating effects on the regimes within OPEC and around the world.

Russia and the New Geopolitics of Oil

– Irina Mironova, Aaron Wood

(This text was written for Russia Direct)

The changing structure of the global oil trade – which includes new roles for Russia and Saudi Arabia and the rise of non-state actors such as ISIS – has important implications for Russia's energy industry.

Russia's top energy companies, already grappling with the consequences of lower global oil prices over the past 18 months, now face additional challenges brought on by the shifting structure of the global oil trade. Most importantly, the rise of Saudi Arabia as a crude oil supplier to Europe is forcing Russia to accelerate its energy pivot to Asia.

As a result of increased tensions over Ukraine, European reprocessing plants have cut their purchases of Russian crude and started to replace it with oil from Saudi Arabia, setting the stage for increased competition between oil suppliers in their struggle for global market share.

Protecting market share is an important task, since crude oil trading has actually peaked, and room for crude suppliers is tightening. It is oil product markets that continue to expand and globalize.

In this context, the European market is especially important. The EU is the second largest producer of oil products after the U.S.: its refining capacity is about 15 million barrels per day, about 16 percent of total global capacity. After the economic crisis of 2008-2009, the European refinery industry has experienced difficulties, including weak demand for its output and growing competition from export-oriented refineries in the Middle East, Russia, the United States and India.

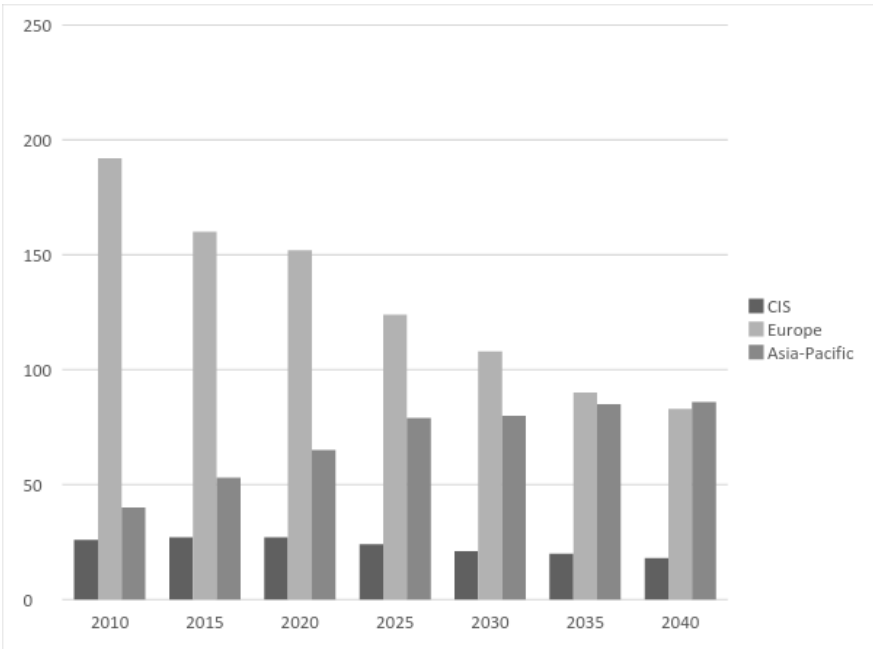
According to the 2015 oil market report by the International Energy Agency, "Just over 2 million barrels per day of refinery capacity has been permanently shuttered since 2008, largely in line with the decline in regional demand and throughputs over the same period." What this means is that the demand for crude that comes from the refineries in Europe is declining as well.

At the same time, there is a trend of lightening the quality of traded refinery feedstock worldwide, with medium and heavy grades increasingly refined closer to the wellhead rather than exported.

Russia's strategy in Europe since the end of the 1990s and up until 2010 was moving further downstream into the European refinery industry. Vertically integrated oil companies such as Lukoil, Rosneft, Gazprom Neft and Surgutneftegaz all were working on bringing their refining closer to the key consumers, thus acquiring assets in the European refinery industry. This meant the strategic choice of the European market as key for crude oil exports, as well as control in the European refining industry.

There are several major aspects, which have changed the basics of Russia's approach to this market. One of the factors is the aforementioned crisis in European refinery industry due to weak demand and increased competition of product supplies from refineries in other parts of the world (primarily Asia and the U.S., but also the Middle East). Another factor is the changed tax regime in Russia. The changes to the law came into force at the start of 2015, reducing crude oil export duties while increasing the mineral extraction tax. Export duties for diesel and other light products will be kept at 63 percent of those for crude. The main consequence is that refiners have an incentive to maximize their light-product output and exports. Naturally, this makes exports of crude for European refineries in particular less of a priority.

This should be understood in the context of the start of exports through the East Siberia – Pacific Ocean oil pipeline and further through the ports of the Far East to Asian buyers. It is part of Russia's pivot to the East.



Source: (ERI RAS & ACRF 2014)
Figure 1. Outlook of Russia's crude oil exports by destination, 2010-2040, million tonnes

In recent years, Saudi Arabia has faced a decreasing role in Asian markets as buyers there strived to diversify a market heavily dependent on crude oil from the Middle East via Russia. Now in an effort to keep market share, Saudi Arabia plans to ship more crude oil to Europe.

Recent reports show that light Saudi crude is a new favourite for energy importers in Europe, threatening the traditionally Russian dominated market. Low prices in addition to strained relations between Russia and the West are factors that have led companies like Shell and Total to make the switch.

There has long existed a desire for energy supply diversification in Europe, recently with Poland taking the lead by announcing a natural gas pipeline deal with Latvia, Lithuania and Estonia. An injection of Saudi oil into the European market would provide another much-desired avenue to achieve this goal.

The Polish port city of Gdansk has been slated as a possible storage hub, where Kingdom oil can be stockpiled for eventual shipment to refineries in Western and Mediterranean Europe. One possible customer is Germany. Ambassador to the Kingdom, Boris Ruge, stated in a recent interview that, "The exchange of the traditional range of goods — mechanical engineering and chemical products against crude oil and petrochemical products — continues to play an important role."

The moves are aggressive enough to have caused sufficient concern among Russian leadership. The head of Rosneft, Igor Sechin, claims that Saudi Arabia is price dumping in an effort to muscle Russia out of the market. Nikolaj Rubchenkov, a representative of Tatneft, urged the Russian Ministry of Energy to consider adding protective measures to safeguard Russian interests in Western markets to the government's energy strategy. Minister of Energy Alexander Novak has characterized the entry of Saudi Arabia into the current market as Russia's toughest competition.

The combination of concrete measures taken by European buyers and the amount of concern among top Russian executives strongly suggests that this move by Saudi Arabia has the potential to dramatically change the face of the European oil market. So long as Saudi Arabia keeps prices sufficiently low by discounts, high production, or both, Russian market share in Europe will continue to be threatened.

The emergence of the Islamic State of Iraq and the Greater Syria (ISIS) complicates the notion that the geopolitics of energy are traditionally set by sovereign states. ISIS enjoys a crude output of 34-40,000 barrels per day, banking an estimated USD 1.53 million per day. Reportedly some of this oil is sold and consumed by both rebels to the Assad governmentand the Assad government itself. This strange interdependence between enemies further complicates the already labyrinthine set of allegiances in the region.

What we are witnessing is, firstly, a change in the geography of the oil trade. Russia is turning to the East, winning market share from the Middle East. At the same time, Saudi Arabia is replacing Russia in the European gas market.

The factors that explain this development are rooted in the security of supply considerations of Asian oil importers, who have a historically high degree of dependence on Middle Eastern supplies and use Russian supplies as a way to diversify.

Moreover, the deteriorated relations between Russia and the West have had their impact on this process, with decreased participation of Russian companies in the European refinery business, as well as the smaller degree of involvement of international energy companies in Russia's modernizing refinery sector.

Secondly, the nature of the oil trade is changing as well. It is not the crude oil trade but refined products trade that has central meaning for the globalization of trade flows in the medium-term perspective. Therefore such players as Saudi Arabia and Russia are actually focusing on developing their own refinery capacities and taking over their positions in the products markets. Importantly, the end-markets for their output are located in Asia rather than the stagnating European market.

Thirdly, the recent developments in the Middle East, which has seen increased production from fields controlled by ISIS, signify a serious change – a birth of the new geopolitics of oil where non-state actors have increasing importance.

As a result, the notions of sovereignty over national resources, traditional trade barriers associated with national borders and trade legislations, and energy diplomacy all acquire a very different context.

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The Week in Review

ISIS Still Making Money from Oil Sales

The ISIS regime and its infrastructure has been a target of Western and now Russian airstrikes, but yet ISIS still produces about 34,000-40,000 barrels per day, sold for USD 20 to USD 40 per barrel, which brings the militants an earning of USD 1.5 million a day. The dilemma of US air strikes is that attacks on critical infrastructure could destabilize the life of 10 million people living in areas under ISIS control. "Everyone here needs diesel: for water, for farming, for hospitals, for offices. If diesel is cut off, there is no life here," says a businessman who works near Aleppo. "Isis knows this [oil] is a winning card."

Erika Solomon, Guy Chazan and Sam Jones, 2015. Isis Inc: how oil fuels the jihadi terrorists. Financial Times, 14 October 2015.

Inside Isis Inc: The Journey of a Barrel of Oil

Most of ISIS oil is being produced in the Deir Ezzor province in the East of Syria at 34,000- 40,000 barrels per day. The price of the oil varies between 25 and 45 USD per barrel and is being sold to independent buyers from Iraq and Syria, who line up with their oil tankers, sometime waiting for weeks at the entrance of the oil fields. At refineries, traders can make a profit of about USD 10 a barrel and then return quickly to the oil fields to buy more. Some even try taking the tankers of oil to other refineries in hopes of it making to the international market. There is even evidence that ISIS has been purchasing oil refineries and leaving the original owners in charge as a front man and splitting the profits with them. There are three markets at which oil is typically sold; ISIS controlled markets, where traders must prove they have paid zakat in order to purchase tax-free this oil, in ISIS controlled cities such as Mosul where the oil is sold at small petrol stations, and finally in rebel markets. In recent months, smuggling of ISIS has been declining because of low oil prices. When the prices were higher, smugglers used boats, makeshift pipelines made of rubber tubing and 25-50 liter jerry cans carried on horseback.

Erika Solomon, Robin Kwong and Steven Bernard, 2015. Inside Isis Inc: The journey of a barrel of oil. Financial Times, 14 October 2015.

Russian Billionaire Fridman Turns to Norway after Being Blocked by British government.

The Russian billionaire Mikhail Fridman has agreed to buy E.ON's oil and gas assets in the Norwegian North Sea for USD 1.6 billion. Fridman's LetterOne fund attempted to acquire the British fields as part of its takeover of RWE's DEA oil and gas business in March, but it was blocked by the government, as the West tightened sanctions against Russia. After the following announcement that Fridman had bought E.ON's Norwegian oil and gas assets, Norway's oil minister said he welcomed international investment and the application for approval of the deal. Although the reassurances given to Fridman do not signal any major improvement in relations between the West and Moscow, they showed that Russian investments have not been banned entirely. If approved, the deal is another step in Fridman's plan to create a serious oil and gas player. However, the deal still requires the European Commission approval, which E.On expects by the end of 2015.

Christoph Steitz, 2015. Russia's Fridman buys E.ON's Norway oil and gas assets. Reuters, 14 October 2015.

Expected Winner of Polish Elections Urges EU Climate Deal Renegotiation.

The likely winner of Poland's Oct. 25 parliamentary election wants to renegotiate a climate deal agreed last year by the European Union. This would enable the country to build more coal-based power stations. After the long lasting negotiations, the European Union agreed last year, to cut greenhouse gases by 40 percent by 2030. Poland is likely to meet resistance from its EU partners if it attempts to reopen the climate deal again. "The demand for electricity, if our economy develops fast, should increase at double the pace, so there should be many more power plants," the party leader Jaroslaw Kaczynski said. Kaczynski also argued that Poland should not have agreed to the deal and vetoed it instead. The party's energy point man Piotr Naimski told Reuters in August he hoped that any United Nations' climate deal to emerge later this year would be non-binding, which would enable Warsaw to renegotiate the current EU emissions laws.

Agnieszka Barteczko, 2015. Expected Polish election winner urges EU climate deal. Reuters, 13 October 2015.

US Increases Oil Trade with Africa as Shale Output Decreases

US oil refineries are turning back to old suppliers in Africa as the growth in shale production slows. The number of barrels of African crude shipped to the US is at its highest level in almost two years. African producers suffered strongly from the shale boom and the lower oil price could now help them to survive. The volumes of US oil imports from Africa are not expected to come to the levels of 2010, when Nigeria and Angola at times sent almost half of their oil exports to the US. However, it may contribute to tightening supplies in other regions. West African producers have often been forced to discount their high quality oil to win new customers in Asia and Europe over the past five years. More West African crude going to the US could mean less making its way to Asian refiners. India, China and others took more of these displaced barrels in recent years as US demand dried up.

Anjli Raval, 2015. US turns to west African oil as shale output slows. Financial Times, 13 October 2015

Developments in African Market

In recent weeks Africa seems to be increasing in importance. Tanzania is in the news in the past weeks: it is developing its natural gas market and an emerging transit state for Uganda's oil. Geopolitics of energy in East Africa evolves with financing that comes from China.

Fumbuka Ng'wanakilala, 2015. Tanzania launches project to pipe natural gas to capital. Reuters, 11 October 2015.
Paul Burkhardt, 2015. Uganda Looks at Tanzania in Search for Cheapest Oil Pipeline. Bloomberg Business, 13 October

Solar and Wind Catch Up With Coal, Natural Gas Across the Globe

A recent study done by the Rocky Mountain Institute, claims that in some parts of the United States, the price of utility-scale solar is actually lower than natural gas-fuelled plants. Bloomberg New Energy Finance expects in the US that after 2030, solar power will be able to compete with gas across the entire country. They also suggest that in other parts of the globe we may even see solar competitive with gas by 2020; examples are India, China and Europe.

Katherine Tweed, 2015. Solar and Wind Catch Up With Coal, Natural Gas Across the Globe. Greentechmedia, 15 October 2015.

Russia to Build Gas Pipeline in Pakistan

Russia and Pakistan recently signed a contract for RT Global Resources to build a 1,100 km pipeline that would supply 12.4 BCM annually which will connect the LNG terminals in Karachi with Lahore in the northeast of the country. Planned completion date for the pipeline is 2018 and will be commissioned by 2020. The pipeline will be owned and operated by RT Global Resources for 25 years and then be given to the Pakistani government.

Russia Today, 2015. Russia to build gas pipeline in Pakistan. 16 October 2015.

Ukraine Discuss Issue of Deliveries of Kazakh Oil Products

At a bilateral meeting of the Presidents of Ukraine, Petro Poroshenko, and Kazakhstan, Nursultan Nazarbayev, discussed a wide range of issues, including trade on fuel and energy. "We agreed on the sort of Kazakh coal to deliver to Ukrainian power stations." Nazarbayev said afterwards. Ukraine will continue to deliver equipment to Kazakhstan's power stations. As for supplies of Kazakh oil to the Ukrainian oil refineries, the problem that the pipeline goes through Russia still exists, the Kazakh president said. "Kazakhstan, Russia and Ukraine are the members of the WTO and must comply with the accepted obligations (...). Kazakhstan for Ukraine is window to Asia and Ukraine for Kazakhstan is window to Europe," President Poroshenko said. According to Nazarbayev, the trade turnover between Kazakhstan and Ukraine decreased more than twice. "Some would say that now it is difficult to develop business in the conditions of Russian aggression, annexation, but I want to assure you, it is not. Today is the best time to work together to start working. A war we will stop," Poroshenko said.

Kulpash Konyrova, 2015. Astana, Kiev discuss issue of deliveries of Kazakh oil products to Ukraine, The New Europe, 12 October 2015.

Japan to Take Inroad into Iran's Nuclear Energy

The foreign ministers of Japan, Fumio Kishida, and Iran, Mohammad Javad Zarif, agreed that Japan provides personnel and expertise to Tehran to help it develop nuclear energy sector. Japan has know-how on earthquake-preparedness at nuclear facilities based on its experience of the Fukushima nuclear disaster in 2011 and is willing to share this with Iran. According to a joint statement released after the ministerial meeting, Japan will dispatch nuclear experts to help it map out strategies to cope with a nuclear accident. The two ministers also signed a bilateral investment pact to entice Japanese companies to make inroads into the Iranian market.

Daisuke Kanda, 2015. Japan to provide expertise on nuclear energy to Iran. The Asahi Shimbun, 13 October 2015.

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