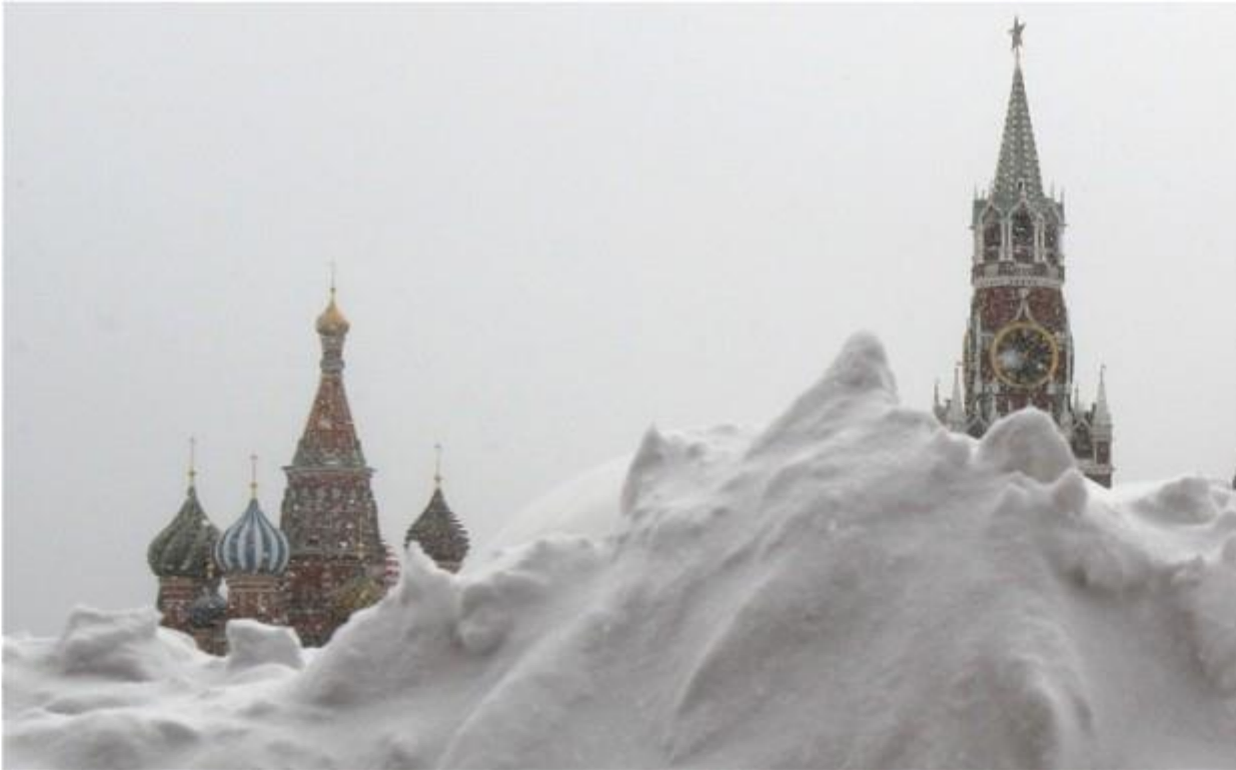
The Telegraph

Glimmers of hope for oil as Russia poised to slash output

RBC Capital Markets said the changes in Russia could pave the way for an implicit accord with Opec but huge hurdles remain



The oil-pipeline monopoly Transneft said Russian companies are likely to cut crude shipments by 6.4pc over the course of 2016 Photo: Reuters

By Ambrose Evans-Pritchard

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6 Comments

The first signs of a thaw are emerging for the battered oil market after Russia signalled a sharp fall in exports this year, a move that may offset the long-feared surge of supply from Iran.

The oil-pipeline monopoly Transneft said Russian companies are likely to cut crude shipments by 6.4pc over the course of 2016, based on applications submitted so far by Lukoil, Rosneft, Gazprom and other producers.

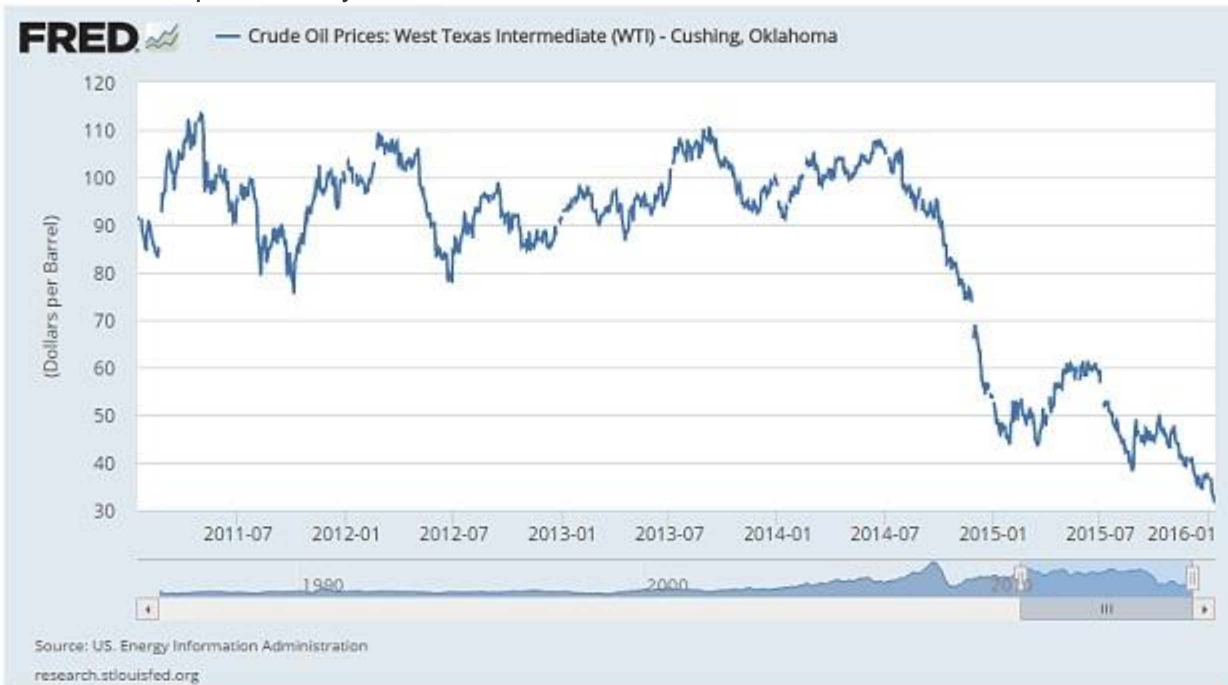
This amounts to a drop of 460,000 barrels a day (b/d), enough to eliminate a third of the excess supply flooding the world and potentially mark the bottom of the market. Russia is the world's biggest producer of oil, and has been exporting 7.3m b/d over recent months.

Transneft told journalists in Moscow that tax changes account for some of the fall but economic sanctions are also beginning to inflict serious damage. External credit is frozen and drillers cannot easily import equipment and supplies.

New projects have been frozen and output from the Soviet-era fields in western Siberia is depleting at an average rate of 8pc to 11pc each year. Russia's deputy finance minister, Maxim

Oreshkin, told news agency TASS that the oil price crash could lead to “hard and fast closures in coming months”.

What is unclear is whether the production cuts are purely driven by markets or whether it is in part a political move to pave the way for a deal with Saudi Arabia. Opec **stated in December** that it is too small to act alone and will not cut production unless non-Opec states join the effort to stabilize the market, a plea clearly directed at Russia.



Kremlin officials insist publicly that they cannot tell listed Russian companies what to do, and claim that Siberian weather makes it harder to switch supply on and off. Oil veterans say there are ways to cut quietly if president Vladimir Putin gives the order.

Helima Croft, from RBC Capital Markets, said the expected cuts could be the first steps towards an accord. “As the economic reality of lower oil prices begins to bite, perhaps Putin will push for a course correction and reach a deal with the Saudis. It would certainly upend the current conventional wisdom that Opec is down for the count," she said.

Russia has a strong incentive to strike a deal. Anton Siluanov, the finance minister, said the Kremlin is drawing up drastic plans to slash spending by 10pc, warning that the country’s reserve fund may run dry by the end of the year. “We have decided not to touch defence spending for now,” he said.

The budget deficit is running near 5pc of GDP at current oil prices, yet the country lacks an internal bond market and cannot borrow abroad.

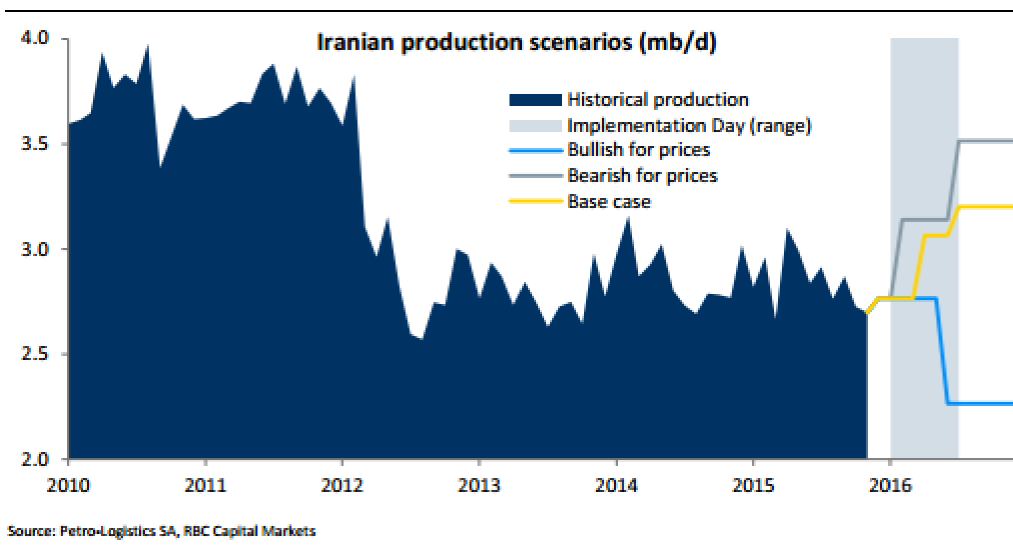
The oil markets have so far shrugged off the news from Moscow, focusing on the more immediate glut. Short positions on the derivatives markets remain extremely stretched, but this creates the conditions for a vicious "short squeeze" if sentiment turns.

Brent crude is hovering near 11-year lows at $30.50, while Saudi Arab light is trading in Asia at $24.57, and Basra heavy is down to $17.77. The cheapest West Canadian is selling at $16.30.

Markets are bracing for the certain decision to lift sanctions against Iran next week, a move that will open the way for a burst of Iranian supply by March.

David Fyfe, from the Swiss-based oil traders Gunvor, said Tehran is likely to tread carefully at first. “They don’t want to crater the market. We think they will work up to 500,000 b/d by the end of the year,” he said.

Figure 2: Iran may bring barrels back onto the market in a matter of weeks



While Iran has 30m to 40m barrels sitting in tankers offshore, this is mostly ultra-light or condensate. It is hard to sell quickly and will not have much effect on the crude price.

Mr Fyfe said the futures markets are pricing crude at $35 or lower through 2016, below the crucial cash cost in large parts of the world. “At this sort of level people are going to be scratching their heads asking whether they can really afford to keep producing,” he said.

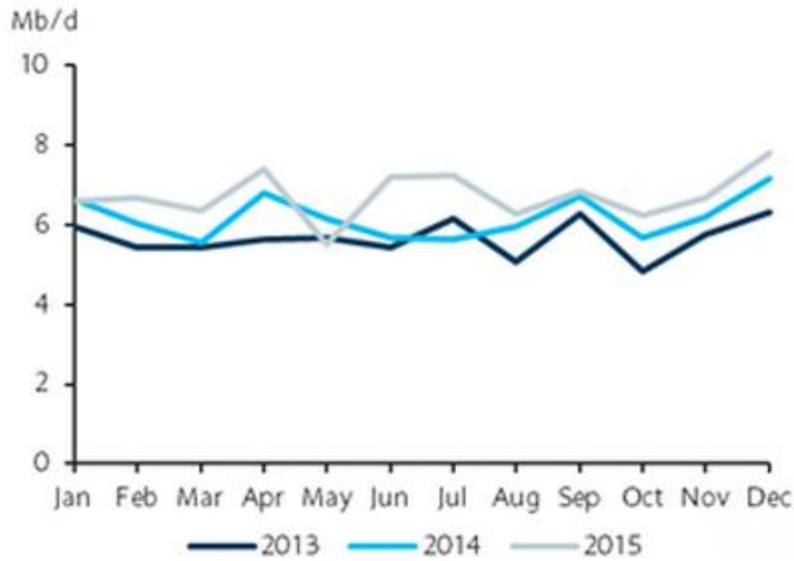
The paradox of the market is that although inventories are at record highs there is little spare production capacity by historical standards, creating the risk of a violent spike later once the glut has been digested and the Saudis have knocked out enough rivals.

“We’re heading toward a short supply situation unfortunately, “ said Harold Hamm, head of the US shale driller Continental Resources.

“That’s going to get very concerning in the latter part of the year,” he told the Wall Street Journal. Mr Hamm said prices will this jump later this year to $60.

Oil demand rose 1.7m b/d last year – the second highest pace in a decade - and is still rising more briskly than widely supposed. Chi Zhang from Barclays said China’s imports of crude surged to a record 7.8m b/d in December as the country continued to fill its strategic reserve.

Figure 1: Crude imports were strong y/y



Source: China Customs, Wind, Barclays Research

Ms Croft said the market is likely to tighten in the second half of the year despite the return of Iran, arguing that there are very few spots in the world other than Libya able to crank up output quickly "We remain of the view that many of the bearish macro factors appear overblown. Current market conditions are setting the market up for a supply shortfall for the coming years, which is not accurately priced into the forward curve," she said.