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Russia, OPEC face shale gas challenge

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On 3 June, Brent crude fell below $100 a barrel for the first time in a month despite OPEC's decision before the weekend to maintain production, concerned by weak global economic growth.

The Organization of Petroleum Exporting Countries is facing its biggest ever challenge with the projected huge growth of shale gas and non-conventional oil coming at a time when it the oil cartel is struggling to maintain an internal consensus, Moscow-based analyst Chris Weafer, who is establishing a macro-political research consultancy in Moscow covering Russia and CIS, told New Europe on 3 June.

At the OPEC meeting on 31 May in Vienna, Nigeria's Petroleum Minister Diezani Alison-Madueke said a committee will consider the effect of shale oil on the global market for OPEC crude in the not-too-distant future.

Weafer noted that up to now there was a sense, in both Russia and within OPEC, that the US shale gas and non-conventional oil projects were not a real threat. Moscow and cartel members believed that volumes would not grow to the extent projected. The oil industry has faced many extreme projections, both of supply surges and supply decline, over the past fifty years, Weafer said, pointing out that none have, so far, materialised.

"'This time is different' remain the four most expensive words in the English language. But the growth in US output has already exceeded projections and, along with the expected output from Canadian Sands and from Mexico and Brazil, the US is now clearly on course to cut its oil purchases from any OPEC member country by 2020 or shortly afterwards," the Moscow-based analyst said. "That's now the stark reality facing OPEC and other major exporters including Russia. After several years of denial they now have to start planning for that different energy world," he added.

On 31 May, OPEC members agreed, as expected, to retain the cartel's 30 million barrels per day output target through the rest of the year.

Weafer explained that the fact that OPEC did not cut production is not a reflection of its lack of concern over the growth in shale gas and non-conventional oil, but more a reflection of the fact that there is no internal consensus over how to react.

“The smaller OPEC producers, and especially Iraq as its looks to rebuild its economy after the lengthy war, want Saudi Arabia and the other wealthy Gulf producers to take the hit and cut production to balance the growing competition. But the problem for Saudi Arabia is that even if it wanted to do that it cannot,” Weafer said, noting that one of the consequences of the Arab-Spring has been a huge increase in Riyadh’s social and defence spending. Saudi’s budget now needs the money almost as much as Iraq and Russia’s budgets do.

To some extent OPEC can defer the issue when it meets again on 4 December or into next year as the average price of Brent has been well above $100 per barrel for the past 12 months so there are surpluses to live off, he said.

Weafer predicted that the Iranian nuclear issue is also likely to return as a risk prop later in 2013. But from 2014, assuming the growth in US and Canadian production continues and assuming that Russia will not slow its production by even one barrel, then the realty facing OPEC will be stark indeed, Weafer said, confident that Russia, which needs the oil revenues, will not decrease its production.

Asked how the drop in oil prices is affecting Russia, he said the price of oil is more of a budget and confidence issue than a factor in GDP growth. The budget balances someplace just above $100 per oil barrel Brent so that Russia's finances have been in good shape for several years, he said, adding that the country has a very low sovereign debt load, which less than 10% of GDP, and financial reserves are the fourth largest in the world. “So, down to about $80 per oil barrel Brent should not be a major concern for the economy as the resulting budget deficit can easily be covered with a modest increase in sovereign debt. Below $80 per oil barrel I believe that we would see some spending cuts and/or higher taxes and that would of course put downward pressure on growth,” Weafer said.

The Russian government has failed to persuade both domestic and foreign investors to boost spending because of a failure to deliver a convincing long-term plan to expand and diversify the economy and a failure to deal with persisting negative issues such as corruption and a perceived poor rule of law, Weafer said. “So, if on top of that current situation, the price of oil were to fall sharply, then the knee-jerk reaction would be a faster slowdown in investment and much slower economic growth,” he said.

The Moscow-based analyst noted that the optimistic side of that story is that while high oil prices helped balance the budget and led to economic complacency in Russia, a sharply lower oil price might spurn greater efforts towards reform in order to boost investment and diversification. “We did see this in Russia through the first half of 2009 when Brent was much lower than the budget required. But all those plans evaporated as Brent climbed steadily back above $100 per oil barrel,” Weafer told New Europe.

Asked if shale gas is really a big threat for Russia and Gazprom, Weafer said it has already caused damage to the Russian gas giant in that the big increase in US shale gas production has led to a huge increase in US coal exports. “Those cheap coal imports into Europe have severely cut demand for Gazprom gas. The competition from cheap coal has also put considerable pressure on Gazprom to change its take-or-pay contracts to more short term contracts,” he said.

Gazprom still expects the gas market of the European Union to recover and grow considerably over the next decade. Weafer cited Gazprom Deputy CEO Alexander Medvedev as saying last week that he expects exports to Europe to increase by 80 billion cubic metres (from 139 billion cubic metres in 2012) to 220 billion cubic metres by 2020 and by a massive 200 billion cubic metres (to 340 billion cubic metres) by 2030. “Those forecasts do suggest that Gazprom is still hoping that shale gas is a relatively short lived phenomenon,” Weafer said.