

# Oil Market Report: June 2018

It is little surprise that previous Oil Market Reports have frequently delved into the world of Russian oil (eg; our [February 2014 report](#)). After all, Russia is a top 3 producer globally (along with Saudi and USA) and has also played a major part in starving global oil markets, by joining in with OPEC's recent production cuts. This time around, it was England's opening World Cup game against Tunisia in Volgograd (né Stalingrad) that once again highlighted Russia's intimate historical relationship with oil and how it continues to shape its future.

Prior to the Second World War, Stalingrad had become the main transshipment point for the Caucasian oil fields and was also Russia's oil refining capital. These key facts are largely overlooked when the subject of Stalingrad is discussed – such was the magnitude and significance of that particular World War II battle. But it is worth remembering that the battle only took place in the first place because Hitler's armies needed Stalingrad's oil, to literally fuel their continued existence in Russia. Equally the battle raged so ferociously and for so long, because the Russians themselves also required Stalingrad's oil capacity for their own war effort. 75 years on and Volgograd today continues to be the main route of oil from the Caucasus (Russian, Armenian, Georgian and Azerbaijani), but it now supplies a Russian oil sector that has changed significantly since the trauma of the Second World War.

In the post-war Soviet era, the oil industry was strictly controlled by the Communist Politburo. It was also used as a political and foreign policy tool, whereby favour was granted according to oil royalties and foreign states were either rewarded or punished by receiving (or not) Russian oil. Between 1950 and 1980, annual Soviet oil exports increased from 60m tonnes (1.1m bpd) to 185m tonnes (3.5m bpd) and this cemented global Soviet influence and provided backbone to robust Cold War behaviour. Furthermore, nothing in the USSR's industrial machine came close to oil in terms of importance or capability, as the USSR rapidly became an undisputed oil super power, producing 11.5m bpd by the mid 1980's.

Then came Perestroika and the 1990's transition to a free market. Multiple oil companies sprang up (Lukoil, Rosneft, Gazpromneft, Yukos), almost all of them being the result of dubious commercial auctions, whereby existing employees of the Soviet Oil Ministry (Minnefteprom - and associated oil companies) or the State Institute of Oil & Gas (Gubkin), bid at massively under-valued levels for chunks of the Soviet oil industry. These employees of course went on to become the oil oligarchs that we read about today (Gutseryev, Timchenko, Khordorkovsky, Abromovich, Berezovsky, Alekperov, Mikhelson etc, etc, etc), many of whom still dominate Russian and global oil markets.

Although market conditions for the new oligarchs were initially difficult (crude in the mid-90's sank to \$7 per barrel and production dropped to 6m bpd), such were the low prices paid by the oligarchs for Russia's oil assets, that it was simply a case of sitting tight until things improved. And improve they did, as production steadily increased along with prices. To produce crude in Russia, costs between \$20 and \$40 per barrel, which at current prices leaves producers with (roughly) \$30 of margin. Multiply that by 10m bpd and even today, we come to a profit figure of \$300m per day, shared between about 500 people! Now rewind 10 years, when production hit 12.5m bpd and prices were topping \$148 (with costs running at a similar, if not reduced level)... Well you can do the maths, but make sure you are sitting comfortably when you do so. Needless to say, such riches explain why Russian Oil Magnates routinely buy Georgian Mansions in Belgravia for £20m a pop...

It also explains why since 2005, President Putin has slowly muscled in on the action and it is now estimated that approximately 50% of Russian oil production comes under the direct (and sometimes indirect) control of the Kremlin. Those oligarchs that have played ball, have been rewarded with further exploration licenses (largely in the huge, untapped Eastern Siberian basin), whilst those that didn't, were either jailed (Khordorkovsky) or exiled (Berezovsky).

Oil and Gas today accounts for about 30% of Russia's GDP, 80% of its exports and almost all of its "hard currency" income (ie, US Dollars). So make no mistake that Russia remains first and foremost, a Petro-state. This over-reliance on one industry has often been at the expense of commercial development in other areas of the economy and has also led Russia to fail in future proofing its energy sector (it's fair to say that Russia wouldn't cope particularly well in a zero-carbon world!). Finally, it could be argued that it has created significant international and domestic tension, because unimaginable wealth has been placed in the hands of a tiny clique of people. But that wealth also allows you to get FIFA onside, host World Cup tournaments and build spanking new state of the art stadiums. On July 15th, we will see a golden trophy held high in recognition of the ultimate footballing achievement. Football Gold you might say, but lubricated by Black Gold...