
Handbook of OPEC and the Global Energy Order

Past, Present and Future Challenges

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Chapter 20

OPEC and Russia: A happy pro forma marriage

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OPEC and Russia

A happy pro forma marriage

Mikhail Krutikhin and Indra Overland

Russia has long been a potential dream partner for the Organization of the Petroleum Exporting Countries (OPEC). Russia could greatly enhance the cartel's market power and has several allies among the OPEC member states. During the 2010s it seemed that the potential of the OPEC–Russia relationship was finally being realized as they grew closer. However, in this chapter we argue that the strengthened dialogue has little impact on physical oil output and the level of mutual commitment remains low. What they do share is an interest in the semblance of cooperation to push oil prices upward through impacting market psychology. This strategy is in line with the postmodern turn in Russian foreign policy, as proclaimed by Vladislav Surkov and others. It also has some important foreign policy side benefits for Russia, such as weakening its international isolation after the conflict in Ukraine and making it possible to simultaneously befriend various Middle Eastern countries that are at odds with each other. The OPEC–Russia dalliance is also convenient for a third party – the USA. Although the USA is still a net oil importer and its consumers dislike high oil prices, they benefit American oil companies and their employees and investors, especially in the shale oil sector. Arrangements between OPEC and Russia are thus not only a happy pro forma marriage but also a successful ménage à trois.

A match made in heaven?

There are several reasons why Russia might seem like a good candidate for cooperation with OPEC. First, like OPEC, the Russian government would like to see stable, high oil prices, as the petroleum industry is the backbone and main source of income for the Russian economy. Exports of crude oil, natural gas, and refined petroleum products account for 64.4 percent of total Russian exports.¹ Second, as the world's second largest oil exporter, Russia could give a powerful boost to OPEC's market power. Third, the Russian state seems to have a good basis for functioning as an OPEC member. The state's share in Russia's production of crude oil approaches 65 percent; it has a controlling interest in country's largest producer (Rosneft) and owns the fourth largest producer, Gazprom Neft (Overland et al., 2013). In addition, the Kremlin has considerable informal power to induce oil companies to do what it wants through the mechanisms of selective law enforcement, suspended punishment, and *kompromat*. *Kompromat* is compromising information about people held in store as a lever in future conflicts or as blackmail material and plays an important role in Russian society (Ledeneva, 2006, p. 60; see also Baekken, 2014; Lauth, 2000; Lauth, 2004).

However, experience shows that an alliance between Russia and OPEC is not easily achieved (Boué, 2004) and the current cooperation between OPEC and Russia may be more of an opportunistic dalliance than a genuine alliance. This interpretation is in line with the self-proclaimed ‘postmodern’ political strategies proposed by influential Kremlin advisor Vladislav Surkov, who argues that we live in a post-truth world and what matters is the semblances and impressions that can be created and how they can be used (Yaffa, 2015). From this perspective, the purpose of the seeming alliance between OPEC and Russia may be to drive up oil prices in the long term rather than to form a lasting bond.

Why it is difficult for Russia to join OPEC?

All member countries of OPEC have national oil companies that can either determine the policy for their governments or follow a policy dictated by the governments. By contrast, perhaps surprisingly, Russia has no formal mechanisms to regulate the volume of oil production, consumption, or export apart from its general tax regime – and changing the flow of oil with a tax amendment is not accomplished swiftly. Thus, the Russian government has few tools apart from the informal ones listed above to change the volume of production and export quickly and thus contribute to OPEC’s market management. This situation contrasts with even with non-OPEC member Norway. Although Norway is averse to mixing politics and business in its oil exports, even the Norwegian system leaves the door more ajar for government intervention than does the Russian system. Paragraph 4–4 of the Norwegian petroleum law states that the government can change the rate of oil production when this is justified by ‘important societal considerations’ (*vektige samfunnshensyn*).²

Despite the powerful informal levers that the Russian government seemingly has on the country’s oil companies, there is more to the decision-making hierarchy in Russia’s oil industry than meets the eye. The Ministry of Energy functions mainly as a lobbyist for the interest of oil companies in the Council of Ministers, where the companies’ main adversary is the Ministry of Finance. Consequently, it is normally the ministry that heeds the recommendations of the companies, rather than vice versa, and the ministry’s role in relations with OPEC is mostly limited to declarations, which often have little practical significance for the actual behavior of the Russian oil producers.

Certain technical specificities of Russian oil production further cloud its prospects for OPEC membership. Most Russian oil wells are located in northern areas with low temperatures where stopping the oil flow can lead to ice plugs that damage the wells and require costly maintenance. The high-water content of the wellhead fluid of many Russian oil wells, in which water flooding is the main method of enhancing oil recovery, increases the danger of plugs when a well is stopped. For many Russian upstream operators, it is therefore difficult simply to suspend ongoing work and wait for oil prices to rise.

Finally, Russia’s ability to regulate oil production and exports is also limited by the absence of any large storage facilities for crude oil, leaving little flexibility in the country’s oil exports. Once oil is pumped out of Russian oilfields, it has to keep flowing through the pipelines to consumers and tankers without too much delay.

In combination, the reasons listed here ensure that Russia is not as useful a partner for OPEC as might seem at first sight. This is also demonstrated by the history of their relations, to which we turn in the next section.

The history of relations between OPEC and the USSR

In the first years after the founding of OPEC in 1960, the Soviet Union regarded the organization as a possible addition to the ‘anti-imperialist’ camp, a counterweight to the Western petroleum monopolies, and an element in the national liberation movements of developing countries. Soviet leaders even believed that OPEC could potentially become a fully fledged socialist organization if only the ‘reactionary

monarchies' among the organization's member states could be overcome (Dasgupta, 1975, p. 357). Moscow hoped that its allies within the organization – particularly Algeria, Iraq, and Libya – might facilitate increased Soviet influence.

In the 1970s, the USSR considered becoming a member of OPEC, but this idea was never implemented.³ There were several reasons for this. If it were to become an OPEC member, the Soviet Union would want to play an important role in the organization, but the founding states did not want to be overshadowed or dominated by the Soviets. Moreover, the OPEC statute included requirements that were incompatible with the USSR's communist agenda, for example, a 'fair return' on capital for investors in the petroleum industry⁴ (OPEC, 2012). OPEC's most important member country, Saudi Arabia, had even broken off diplomatic relations with Moscow in 1938, accusing the Soviets of inciting revolution among Muslims. Diplomatic relations between the two countries were not resumed until 1992. Finally, as the Soviet oil and gas industry continued to develop, natural gas became increasingly important both in the internal Soviet energy system and as an export to other communist bloc countries and to Western Europe. OPEC is an oil cartel, not a gas cartel.

As a result of these factors, the idea of joining OPEC, or even cooperating with OPEC, lost its relevance. Instead, OPEC and the Soviet Union came to be seen as rivals rather than potential partners in many contexts (Stein, 1980; Dasgupta, 1975).

The post-Soviet track record

Post-Soviet Russia inherited a strained relationship with OPEC from the USSR (Mann, 2009). During the 1990s, Moscow was in any case more focused on improving its relations with the West than on courting OPEC (Elass and Jaffe, 2009). Russia did not become an observer in OPEC before the summer of 1998 when it started attending all the conferences of the organization in that capacity. The leading members of OPEC showed an interest in expanding cooperation with Russia and, in 1998/9, non-OPEC member Mexico and OPEC members Saudi Arabia and Venezuela allegedly jointly suggested forming an informal super-alliance of oil producers dubbed 'The Big 8'.⁵

Over the next 20 years, Russia agreed several times with OPEC to cut production, but never fulfilled its pledges (Elass and Jaffe, 2009). In 1998, Russia assured OPEC it would trim its oil production by 7 percent, but in fact left it unchanged.⁶ The promise had been dictated by the decline of global oil prices, which fell from USD 25 per barrel in early 1997 to USD 10 at the end of 1998. The decline had been provoked by OPEC's 1997 decision to boost daily oil production by 2.5 million barrels and by shrinking demand for oil because of the Asian financial crisis of 1997/8. In March 1999, OPEC plus Mexico, Norway, Oman, and Russia agreed on a production cut of 2.1 million barrels per day. Russia's share in that cut was supposed to be 100,000 barrels per day.⁷

Following that agreement, oil prices recovered: one barrel of Brent was sold for USD 23 at the end of 1999 but increased to USD 32 by March 2000. However, Russia broke its promises and increased its daily oil production from 6.17 million barrels to 6.18 million barrels in 1999 while other members of that temporary alliance either reduced their output (as Saudi Arabia did) or kept it at the same level (as Norway did).

By the summer of 2000, it became clear that Russia was not going to join OPEC and the Russian government said so officially. Russian officials and media claimed there had been 'oral' invitations, but this could not be confirmed⁸. Moscow-based experts argued that if the country joined OPEC it would still only be 'a minor partner' of the cartel and would be obligated to lower oil exports and abandon its work towards reviving oil production after the 1990s collapse.⁹

Within Russia at that time, there was no consensus on cooperation with OPEC. Some of the major Russian oil companies, such as Sibneft, Surgutneftegas, and Yukos, believed that low prices would help them defeat competitors and expand their share of international markets. By contrast, Bashneft, Lukoil,

and Tatneft, which were experiencing problems with reserves and upstream projects, wanted prices to be as high as possible.¹⁰

In the first quarter of 2002, the Russian government announced that it was reducing its oil production by 150,000 barrels per day under an agreement with OPEC to keep prices from plummeting¹¹ (Mann, 2009). By the end of the quarter, however, it became obvious that the majority of Russian oil companies were following their previous production plans and were paying little heed to the government's recommendations.¹² In the third quarter of that year, Russia's production grew at the fastest rate in the whole post-Soviet period. OPEC expressed displeasure with Russia's reluctance to honor its promises and only the growth of international oil prices due to other developments prevented further conflict.¹³ After that period of empty promises and 'misunderstandings', it is unclear whether OPEC and Russia have made any genuine mutual commitments or attempts at cooperation and coordination for purposes of *physical* oil market manipulation – regardless of their public declarations of unity.

Russia did not join OPEC in the organization's periodical production cuts, such as the October 2008 agreement to decrease daily production by 4.2 million barrels. Igor Sechin, deputy prime minister at the time, attended OPEC sessions and agreed to such cuts, but Russia continued raising its oil output. Relations between OPEC and Russia at the time were limited to regular exchanges of opinions at the annual sessions of the OPEC–Russia Energy Dialogue, which was formalized from December 2005 onwards, without any tangible results.¹⁴

OPEC had a weak basis for its displeasure with Russia. During the period 1999–2007, as oil prices trended upwards, most OPEC member states did all they could to boost their own oil output. Between May 2002 and December 2006, OPEC increased its overall production by 16 percent (Simoniya and Zhukova, 2008).

Cooperation after 2014

A new form of cooperation between Russia and OPEC started taking shape after the decline of oil prices in late 2014 under the weight of the shale revolution and the financial crisis. The approach of Saudi Arabia, OPEC's dominant member state, stunned the world when it unexpectedly decided not to draw down its output to help prices recover. Similarly, Russian companies continued their production programs as usual. By the end of 2016, however, the Saudis realized that low prices were not shutting down American shale operators and OPEC was forced to act. Russia and other producers were invited to join forces to stop prices from going lower.

Russia's new cooperation with OPEC was motivated by both political and economic considerations. The Russian leadership viewed international cooperation as a symbolic and practical countermeasure against the attempt by Western states to isolate Russia through sanctions (Fjaertoft and Overland, 2015).

Initially, when the Russian Ministry of Energy was negotiating possible cooperation with OPEC in the fall of 2016, the Kremlin was skeptical about the outcome of this initiative but allowed Energy Minister Alexander Novak to go ahead with a deal. The idea of production cuts made little sense in light of the same ministry's well-publicized expectations of production growth. Still, the prospects of seeing oil prices rise were highly attractive, as it could help save Russia's budget from some of the acute problems it was experiencing at the time due to the oil price collapse, sanctions, and inflation¹⁶ (Grigoriyev et al., 2015). And the financial effect of the cooperation was indeed significant.

It should have been relatively easy to achieve the production cuts agreed upon, as they were to be counted against a benchmark in October 2016 when Russia was producing at the record-breaking rate of 11.23 million barrels per day. The accord with OPEC called for a reduction of just 300,000 barrels per day from that high level.¹⁷ In practice, Russian oil production remained flat in 2016/17.

In late 2016, OPEC and Russia joined forces to confront the challenge of American shale oil production and the new alliance resulted in cooperation between 24 oil-producing countries that agreed to

restrict their production and keep prices from falling. The first tangible results of this cooperation became evident in the second half of 2017 when the surplus supply started to shrink; by January 2018, prices edged up above USD 71 per barrel for Brent, the highest level since December 2014.

Moscow played an important role in the OPEC+ deal, which helped enhance Russia's reputation in the Arab world and with some non-Arab oil-producing countries and also put a dent in the international isolation that Western countries were trying to impose on Russia in connection with the conflict in Ukraine (Fjaertoft and Overland, 2015). Furthermore, the cooperation with OPEC helped the Russian media maintain Vladimir Putin's image as an influential politician in the global arena – especially in the eyes of Russian voters, which is obviously what matters most to the Kremlin.

A happy pro forma marriage

In addition to reputational and diplomatic benefits for Moscow, cooperation with OPEC has had a considerable effect on the Russian economy through higher oil prices. In 2017, when the joint decision on production cuts was in effect and oil prices headed upward again, Russia received additional income of USD 117 million per day according to calculations by the International Energy Agency.¹⁸

The effect of the price hike on Russian budgetary revenues in 2017 was estimated by Minister of Energy Alexander Novak at 1.2 trillion rubles, or USD 20.6 billion at the average exchange rate of that year.¹⁹ Since the expenses of the federal budget in 2017 totaled 16.6 trillion rubles, the effect was equivalent to almost 14 percent of the government's expenditure. In December 2018, Novak stated that Russia had gained an extra USD 120 billion in 2017/18 thanks to its cooperation with OPEC.²⁰

This extra revenue enabled the Russian government to extend the life of one of its sovereign wealth funds, the Reserve Fund, which had been expected in 2016 to be depleted in early 2017. As result of the higher oil prices, the fund's life was prolonged until early 2018, by which time it had been fully spent and was merged into the National Welfare Fund, another sovereign wealth fund.

Oral interventions in the oil futures market aside, Russia's actual contribution to production cuts under the OPEC+ deal is dubious. Russia's oil output in 2017 amounted to 546.8 million tons (10.981 million barrels per day), just 0.1 percent less than in 2016 (see Figure 20.1). Since 2016 was a leap year, Russia's average daily oil production actually grew slightly from 10.965 million to 10.981 million barrels per day.²¹

In 2018, oil production in Russia accelerated, defying the Russian officials' declarations of solidarity with OPEC. During that year, Russia produced 555.84 million tons (11.45 million barrels) of crude oil per day, 1.6 percent more than the previous year.²² This means that rather than falling below the October 2016 benchmark, as Russia had promised, its production in fact increased by 0.3 percent against that benchmark (see Figure 20.1).

In theory, Russian oil companies should have been compelled by the government, which declared compliance with the OPEC+ deal, to slow down production and decelerate profit generation because the state takes the bulk of the gains from higher prices in the form of a progressive export tax on oil introduced in 2004. The tax rate is adjusted every two months, increases gradually when the oil price rises above USD 25 per barrel, and may reach 65 percent when the price of oil is high.

The limited number of large-scale oil producers in Russia (see Figure 20.2) and the power of informal administrative pressure in Russia means that the government expects to achieve a decrease in production without using fiscal measures or other formal tools. It boils down to a simple equation: the government boosts its revenues from the oil industry through seeming cooperation with OPEC that raises prices and thus taxes; the companies receive the part of the price increase that is left over after taxes, but they have to sacrifice some of their investment programs and marketing plans in order to stay on the safe side of the government.

Regardless of the short-term financial gains for the Russian government, Deputy Prime Minister Arkady Dvorkovich believed that the government-induced restriction of the oil industry's investment

plans might have a long-term negative effect on the economy. He warned that stagnating oil production would translate into lower GDP growth because the oil industry plays a vital part in the national economy.²⁴

The agreement with Russia was seemingly beneficial for the OPEC members, too, as it was associated with higher oil prices. Saudi Arabia alone, according to IEA statistical data, was earning an additional USD 100 million daily in 2017 thanks to the deal, and OPEC as a whole was taking in about USD 362 million of extra revenue per day (IEA, 2018).

It would be impossible to invite oil companies in the United States and some other countries to join OPEC's production cuts, the cooperation with Russia was decisive for OPEC's recent success in driving up oil prices. For some actors in the USA it was clearly helpful to have OPEC – 'morally' supported by Russia – doing the hard work to keep oil prices from falling too low. Although the USA is still a net oil importer and American oil consumers dislike high prices, the USA is also the world's largest oil producer, American oil companies and their owners and employees benefit from higher oil prices, and they constitute important interest groups. Especially the shale oil industry, in which many large-scale and risky financial bets have been made, benefited from higher oil prices brought on by the cooperation between OPEC and Russia.

The show must go on?

The Saudis and other OPEC members insist that the cooperation between OPEC and Russia to hold back production will continue for a long time. The OPEC/Non-OPEC Joint Ministerial Monitoring Committee in Muscat in January 2018 stated that producers should extend their cooperation beyond 2018 in order to assure 'stakeholders, investors, consumers, and the global community that this is something that is here to stay' and that producers 'are going to work together' within a longer time frame. Saudi energy minister Khaled al-Falih acknowledged, however, that the mechanism for long-term cooperation remains to be defined and that extending the cooperative framework would not necessarily mean sticking to current production targets.²⁵

OPEC was determined to continue playing along with Russia and reduce the likelihood of abrupt termination of the cooperation. By calling for cooperation beyond 2018, Saudi Arabia charted the route it desired for the market, in which OPEC+ plays a permanent role in managing market expectations and revenue maximization, rather than output maximization, is the main guiding principle.

Financial considerations

If the cooperation between OPEC and Russia evolves beyond the declarative level in the future, some Russian companies could in principle be forced, through government pressure, to curb their operational plans and limit activities to brownfield projects instead of investing in new exploration and development. However, such policies would accelerate the ongoing depletion of Russian reserves and national production might start falling at a quicker pace than expected.

If prices fall despite the OPEC+ accord, Russia will face a big challenge: a shrinking supply of hard currency from oil exports could force the government to alleviate the tax burden on the oil companies to enable them to develop new, higher-cost production. Otherwise, production will decline naturally due to the gradual depletion of existing fields. In any case, lower oil prices will translate into smaller revenues for the federal budget.

When income flows become dangerously small, Russia will have two options for its relations with OPEC: either to continue cooperation and hope that Saudi Arabia's market management scheme keeps prices at a reasonably comfortable level or to abandon OPEC+ and try to maximize the volume of oil

exports over prices. For the time being, the probability of Russia remaining in the OPEC+ alliance appears higher.

Off the record, officials at the Russian Ministry of Energy admit that negotiations about production cuts with OPEC members are often contentious and domestically controversial. Saudi representatives, they say, accuse Russia of being unable to meet the agreed cuts; the Russian delegations respond by pointing out the well-known fact that there is little discipline within the cartel and many OPEC member states fail to stick to their quotas.

In late 2017, the Russian government was considering gradual abandonment of the cooperation with OPEC. Opponents of the cooperation, including Rosneft CEO Igor Sechin, argued that the production cuts and the ensuing higher oil prices encouraged the USA and other oil producers to invest heavily in the development of shale and deep-water reserves, and that the OPEC+ agreement would therefore be counter-productive in the long term.²⁶ They also pointed out that Saudi Arabia itself seemed to be preparing to abandon attempts at boosting oil prices through production cuts. In February 2019, Igor Sechin came forth with a warning: cooperation with OPEC had become a strategic threat to Russia's oil industry.²⁷

By contrast, the Russian government officials and experts who advocated an extension of the agreement with OPEC believed that even a short period of higher oil prices would help the Russian oil industry and prevent the imminent decline of production due to lack of investment.

Conclusions

The continuation of the OPEC+ constellation has political side-benefits for Moscow. In the context of Western sanctions and attempted international isolation, any international organization prepared to engage with Russia is of interest to the Kremlin. Cooperation with OPEC, even without joining the organization as a member, is a way for the Russian government to show both foreign and domestic audiences that Russia continues to play a role in global affairs. Conversely, should the sanctions be weakened, the international relations incentive for Russia to cooperate with OPEC might also be weakened.

Apart from the sanctions, the Russian government regards OPEC+ as an opportunity to ally itself with some of the most important regimes in the Middle East as well as Venezuela and some African countries. Moscow also sees OPEC+ as a means to compete with the USA internationally. However, American oil companies are beneficiaries and even free riders on this effort when it succeeds in talking up the oil price.

The cooperation with OPEC is also regarded by the Kremlin as a way to reconcile some tensions in Russia's relations with countries in the Middle East as Russia seeks to establish good bilateral relations and even to strike alliances with regimes that are in conflict with each other. Iran and Saudi Arabia have long been at odds, but both countries are OPEC members and have to sit at the same table in Vienna to draw up plans of joint action in the oil markets. Russia, seeking to befriend everybody in the region – Iran, Iraq, Qatar, Saudi Arabia, Syria, Turkey, etc. – is often treated with suspicion by enemies of each of these countries (Freedman, 2010). The cooperation within the framework of OPEC+ may help Moscow to iron out some of these 'misunderstandings'. In practice, however, OPEC+ has not accomplished much in helping the Saudis understand why Russia is courting the Iranians, and the Iranians are wary of Russia's intentions to befriend the Saudis.

Today, Russia can hardly be regarded as an aspiring leader of decision-making in the world oil market, partly because of its international political isolation and partly because its oil production may be approaching a 20-year peak before declining again.²⁸ Russia's alliance with OPEC has lacked significant contributions in terms of production cuts and remains limited to speeches that have a largely short-term impact on the oil derivatives markets. The deterioration of OPEC as a cartel and its resulting loss of influence²⁹ make the OPEC+ alliance less significant (Mann, 2012). However, for the time being, this

alliance can still influence market psychology and provides side-benefits for Russian foreign policy; it is therefore likely to continue for some time.

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