
THE MARKET MATH BEHIND THE SAUDI-RUSSIA ROMANCE

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If it feels like Russia is just cropping up all over the place these days, you are no doubt focused on oil. No? Well, anyway, Russia's role in the global oil market has become even more important than usual. And BP's latest annual review of energy statistics, released on Tuesday, helps show why. Russia, and the Soviet Union before it, has long been a big oil producer:

The Great Bear

Even during the chaotic collapse in the 1990s, Russia and the broader former Soviet Union have always been big oil producers

The big development of the past year, however, has been the apparent marriage of that market power with OPEC's, in what some have dubbed the Vienna Group. Russia, along with several other non-OPEC oil producers, announced in November they would join with the bulk of OPEC's members in cutting oil supply to drain the glut of inventories weighing on prices. That agreement was reaffirmed, and extended, last month in Vienna at a meeting that was notable chiefly for the unusually chummy body language between the energy ministers of Russia and Saudi Arabia. The OPEC kingpin has a good reason to cozy up to Moscow: The oil cartel's power is nothing like what it was back in its heyday of the 1970s. Sure, as BP's data show, OPEC produced almost 43 percent of the world's oil last year, its highest since 2012 and in line with the past decade or so:

Still Here

OPEC's market share isn't at 1970s levels, but is still roughly where it was a few years ago when oil traded in triple digits

Source: BP Statistical Review of World Energy

What counts, though, isn't just market share but market concentration: How many big players really dominate the market? For that, I'll use the Herfindahl-Hirschman Index. This is a measure of market concentration used by competition regulators in assessing the impact of mergers. The higher the score, the more concentrated the market. The Department of Justice generally regards a market scoring 1500 to 2500 as moderately concentrated, while anything above 2500 is highly concentrated. Using BP's data, I've calculated HHI scores for oil production, using country market shares. In the chart below, I show three scenarios: A free-for-all where every country competes with the other; one where OPEC functions as one; and one where the Vienna Group functions as one (even though it didn't exist until late 2016):

Power Lines

In theory, OPEC and, especially, the Vienna Group would keep the global oil market moderately to highly concentrated

Source: BP Statistical Review of World Energy, Bloomberg Gadfly analysis

Note: HHI measures concentration of global oil production by country.

Clearly, the market's concentration is nothing like what it was in the 1970s. That decade's shocks prompted more supplies from outside OPEC. Absent cartels, the market would be pretty competitive, scoring below 1000 consistently since 1984. Indeed, that uptick in concentration you can see on the "Free-for-all" line since 2009 is misleading, because roughly four-fifths of it is due to the rebound in U.S. production. America's oil patch is competitive within itself, rather than state-directed; if we could drill down to the company level, the score would be even lower. If OPEC could act as one, it would keep the market much more concentrated. But its own divisions mean it effectively can't. Why else does the wider Vienna Group even exist? But it is hard to see why that even-more-disparate group is built to last. WHAT RUSSIA OFFERS OPEC Credibility As Saudi Arabia looks around, it can see that large members of OPEC such as Nigeria and Libya are unreliable partners due to civil unrest -- hence, they're exempt from the cuts -- and Venezuela may not be far behind. Iran, also exempt, isn't a rock-solid long-term partner for more fundamental reasons, while Iraq has a distressing habit of talking about how much more oil it would like to produce. When it comes down to it, the core of OPEC is Saudi Arabia and the other Gulf states: Kuwait, the UAE, and Qatar. And here's where Russia plays such a vital role. Because, even if you add in Oman -- part of the Vienna Group -- to the core Gulf producers, that doesn't shift the overall structure of the oil market much. Add in Moscow, though, and you have a grouping that has less cats to herd than either OPEC or the Vienna Group but still takes us back toward a moderately concentrated oil market:

Note: HHI score measures concentration of global oil production by country. Gulf core consists of Kuwait, Oman, Qatar, Saudi Arabia, and the UAE.

If Saudi Arabia can coordinate with its neighbors on the Arabian peninsula and keep Russia involved, it wouldn't mark a return to the glory days of the cartel. But it would inject a modicum of discipline into supply relative to a free-for-all, and reduce dependence on OPEC's less reliable or friendly members. Russia's cut of a few hundred thousand barrels a day isn't that big, but the country's broader heft in global oil supply lends a vital commodity: credibility. Up to a point, that is. As I wrote here, Russia's hybrid model of state and private enterprise in its oil industry complicates efforts at maintaining supply cuts for long. And that's before you get into the geopolitical divide between Riyadh and Moscow (then again, the geopolitical order is up for grabs in a way it hasn't been for decades, so who knows what surprises are in store). For now, with attempts at coordination being undermined by the competitive chaos of U.S. shale, Saudi Arabia needs all the help it can get. Russia, seeing an opportunity to help itself and knowing it has leverage, is happy to intervene. For now, anyway.

Kaynak/Source: