Russia may cut off oil flow to the West

Contributed by Ambrose Evans-Pritchard, Telegraph
Friday, 29 August 2008

Fears are mounting that Russia may restrict oil deliveries to Western Europe over coming days, in response to the threat of EU sanctions and Nato naval actions in the Black Sea.

Any such move would be a dramatic escalation of the Georgia crisis and play havoc with the oil markets.

Reports have begun to circulate in Moscow that Russian oil companies are under orders from the Kremlin to prepare for a supply cut to Germany and Poland through the Druzhba (Friendship) pipeline. It is believed that executives from lead-producer LUKoil have been put on weekend alert.

"They have been told to be ready to cut off supplies as soon as Monday," claimed a high-level business source, speaking to The Daily Telegraph. Any move would be timed to coincide with an emergency EU summit in Brussels, where possible sanctions against Russia are on the agenda.

Any evidence that the Kremlin is planning to use the oil weapon to intimidate the West could inflame global energy markets. US crude prices jumped to $119 a barrel yesterday on reports of hurricane warnings in the Gulf of Mexico, before falling back slightly.

Global supplies remain tight despite the economic downturn engulfing North America, Europe and Japan. A supply cut at this delicate juncture could drive crude prices much higher, possibly to record levels of $150 or even $200 a barrel.

With US and European credit spreads already trading at levels of extreme stress, a fresh oil spike would rock financial markets. The Kremlin is undoubtedly aware that it exercises extraordinary leverage, if it strikes right now.

Such action would be seen as economic warfare but Russia has been infuriated by Nato meddling in its "backyard" and threats of punitive measures by the EU. Foreign minister Sergei Lavrov yesterday accused EU diplomats of a "sick imagination".

Armed with $580bn of foreign reserves (the world's third largest), Russia appears willing to risk its reputation as a reliable actor on the international stage in order to pursue geo-strategic ambitions.

"We are not afraid of anything, including the prospect of a Cold War," said President Dmitry Medvedev.

The Polish government said yesterday that Russian deliveries were still arriving smoothly. It was not aware of any move to limit supplies. The European Commission's energy directorate said it had received no warnings of retaliatory cuts.

Russia has repeatedly restricted oil and gas deliveries over recent years as a means of diplomatic pressure, though Moscow usually explains away the reduction by referring to technical upsets or pipeline maintenance.

Last month, deliveries to the Czech Republic through the Druzhba pipeline were cut after Prague signed an agreement with the US to install an anti-missile shield. Czech officials say supplies fell 40pc for July. The pipeline managers Transneft said the shortfall was due to "technical and commercial reasons".

Supplies were cut to Estonia in May 2007 following a dispute with Russia over the removal of Red Army memorials. It was blamed on a "repair operation". Latvia was cut off in 2005 and 2006 in a battle for control over the Ventspils terminals. "There are ways to camouflage it," said Vincent Sabathier, a senior fellow at the Centre for Strategic and International Studies in Washington.

"They never say, 'we're going to cut off your oil because we don't like your foreign policy'."

A senior LUKoil official in Moscow said he was unaware of any plans to curtail deliveries. The Kremlin declined to comment.

London-listed LUKoil is run by Russian billionaire Vagit Alekperov, who holds 20pc of the shares. LUKoil produces 2m barrels per day (b/d), or 2.5pc of world supply. It exports one fifth of its output to Germany and Poland.

Although Russia would lose much-needed revenue if it cut deliveries, the Kremlin might hope to recoup some of the money from higher prices. Indeed, it could enhance income for a while if the weapon was calibrated skilfully. Russia exports roughly 6.5m b/d, supplying the EU with 26pc of its total oil needs and 29pc of its gas.

A cut of just 1m b/d in global supply – and a veiled threat of more to come – would cause a major price spike.

It is unclear whether Saudi Arabia, Kuwait or other Opec producers have enough spare capacity to plug the shortfall. "Russia is behaving in a very erratic way," said James Woolsey, the former director of the CIA. "There is a risk that they might do something like cutting oil to hurt the world's democracies, if they get angry enough."

Mr Woolsey said the rapid move towards electric cars and other sources of power in the US and Europe means Russia's ability to use the oil weapon will soon be a diminishing asset. "Within a decade it will be very hard for Russia to push us around," he told The Daily Telegraph.

It is widely assumed that Russia would cut gas supplies rather than oil as a means of pressuring Europe. It is very hard to find alternative sources of gas. But gas cuts would not hurt the United States. Oil is a better weapon for striking at the broader Western world.

The price is global. The US economy could suffer serious damage from the immediate knock-on effects.

While the Russian state is rich, the corporate sector is heavily reliant on foreign investors. The internal bond market is tiny, with just $60bn worth of ruble issues.

Russian companies raise their funds on the world capital markets. Foreigners own half of the $1 trillion debt. Michael Ganske, Russia expert at Commerzbank, said the country was now facing a liquidity crunch. "Local investors are scared. They can see the foreigners leaving, so now they won't touch anything either. The impact on the capital markets is severe," he said.