

# Russia's dirty oil crisis is worse than almost anyone predicted



Bloomberg / London

After any normal voyage the tanker would quickly deliver its 700,000 barrels of Russian crude into a refinery for processing into gasoline, diesel and other petroleum products. But the Mendeleev Prospect is in limbo, the victim of Russia's unprecedented contaminated crude crisis that's been spreading chaos through the European oil market for a month.

The length and scope of the crisis has given it a political dimension. On Thursday, Polish Prime Minister Mateusz Morawiecki decided to get personally involved in finding a solution, but said talks were "very difficult, very tough."

Back in April, unusually high levels of the chemicals known as organic chlorides were discovered in the Russian crude flowing through the giant Druzhba pipeline, built in the 1960s to carry crude from the USSR to allied countries in Eastern Europe.

The chlorides can severely damage oil refineries and on April 24 Russia's state pipeline operator, Transneft PJSC, halted shipments. Moscow pledged to resolve the issue right away; four weeks later, the flow of Russian oil into Europe is little more than a trickle.

Druzhba usually supplies up to 1.5mn barrels a day of Russia's benchmark Urals blend into central Europe – more than the total production of Opec member Libya. The crude goes directly to refineries through two separate pipeline spurs and via tankers from the Ust-Luga export terminal in the Baltic.

Despite repeated pledges from Russian authorities to resume shipments in days, the crisis is proving bigger, longer and costlier than almost anyone expected and a solution could still be weeks away.

In Germany, one of the continent's biggest refineries – the Leuna plant owned by French oil giant Total SA – has shut down. Poland has been forced to tap the emergency petroleum reserves. And as far west as Rotterdam, Europe's petroleum hub, some refineries have been forced to run at lower rates.

The technical challenge of handling millions of barrels of tainted crude has been compounded by fights over who will pay the cost of the crisis. An emergency summit in Warsaw on Thursday made some progress, but didn't nail down a solution.

“So far the resumption of flows along Druzhba has been progressing very slowly,” Vienna-based consultant JBC Energy GmbH told clients. “Negotiations and payment arrangements here could well take some time, delaying the full resumption of flows.”

Then there's mystery of what's happening to Russia's crude oil while Druzhba is shut. According to official data, output has barely dropped over the last four weeks, falling from 11.23mn barrels a day in April to 11.15mn barrels a day so far in May. But the country is shipping roughly 1mn barrels a day less than normal, about a tenth of its output.

That's led oil traders to puzzle on how Russia's been able to maintain production, asking whether Russia has the millions of barrels of empty storage needed to hoard the crude that hasn't

flowed through Druzhba for four weeks.

Spokesmen for Transneft and Rosneft declined to comment.

As the weeks pass, the price tag soars. Speaking privately, more than a dozen oil traders and refining executives in London, Geneva and Moscow said the cost may reach \$1bn. The estimates are based on the volume of oil contaminated and the \$10-to-\$20-a-barrel discounts refiners are asking to take the tainted barrels. The traders and executives spoke on condition of anonymity to avoid upsetting their commercial relationship with Russia. "The Druzhba pipeline issue should cap Russian supply for the time being," said Ed Morse, head of commodities research at Citigroup in New York.

Although Moscow has yet to give its own estimate, Western traders also believe the problem will prove larger and take longer to resolve than many predict. Russian oil officials talk about 20mn barrels contaminated, but oil traders and refining executives believe the real number may be closer to 40mn.

The larger the amount, the bigger the problem: the polluted crude will need to be blended very slowly to bring the chloride levels down to acceptable levels, on a 1-dirty-to-10-clean barrels ratio most likely. That process may well take months, not weeks. So far, refiners in Poland have experimented with blending and struggled.

"The Russian crude can only be blended down over time, a process requiring hundreds of millions of barrels of clean crude," said Amrita Sen, chief oil analyst at consultant Energy Aspects in London. The second problem lies with who's responsible for the crisis – and the cost of clearing it up. The pipelines are run by Transneft, headed by Nikolay Tokarev, a former KGB pal of Vladimir Putin. Much of the oil is supplied by state oil company Rosneft PSJC, run by the Kremlin power-broker Igor Sechin.

Russian oil officials have pinpointed the contamination to a small, privately-owned terminal in the Samara region, about 1,000 kilometres (620 miles) from Moscow. Who owned the oil and why it was polluted remain a mystery.

The contamination with organic chloride, which is very unusual, comes at a time when the global oil market is already short of supply of crude of similar quality to Urals.

The combined impact of US sanctions on Iran and Venezuela, Opec+ production cuts, and lower-than-expected output in Mexico has reduced worldwide shipments of denser crude with high sulphur content. Premiums in the physical market for medium-heavy crude have surged to multi-year highs as a result. "This is a significant unplanned outage that is having spill-over effects," said Harry Tchilinguirian, head commodity strategist at BNP Paribas. "What you end up with is a further reduction in the availability of medium quality crude oil."

Russian officials and European oil executives are groping toward a solution. After Thursday's Warsaw meeting, Transneft said uncontaminated barrels can flow into Poland by June 10 if interested parties implement a restart plan yesterday. But PERN SA, its Polish counterpart, said claims for compensation from oil refiners must first be acknowledged if the deadline is to be met.

To be sure, the situation is slowly improving. Russia is resorting to Soviet-style mobilisation, marshalling thousands of rail cars to move crude from the north of the country into a terminal in the Black Sea where the polluted crude could be slowly blended with clean flows.

The southern branch of the Druzhba pipeline, which goes into the Czech Republic and Hungary has started to pump, although at rates about half their normal level of 300,000 barrels a day. Clean crude arrived on Thursday in Slovakia and it's expected to reach Hungary by Monday.

Ust-Luga is also receiving clean oil, but shipments remain patchy. The big problem is, however, the key northern branch of Druzhba going into Belarus, Poland and Germany, which remains closed, depriving the region of at least 700,000 barrels a day. So far, every plan to re-start the pipeline has failed. As an alternative, refiners in the region are getting oil via the Baltic ports of Gdansk in Poland or Rostock in Germany.

Until a proper solution is found, a crisis that started in a remote village in southern Russia will keep reverberating through the continent's oil market – and the costs will rise and rise.