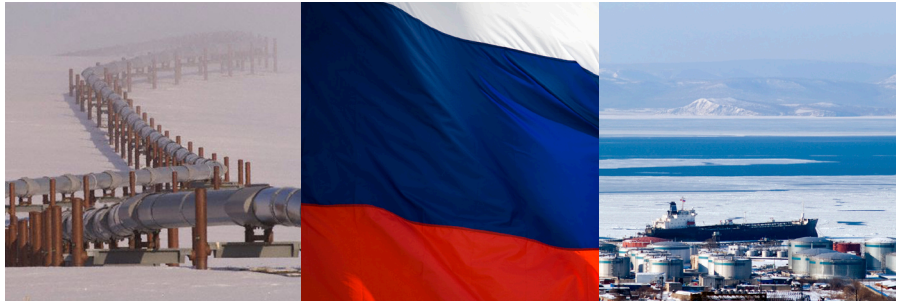
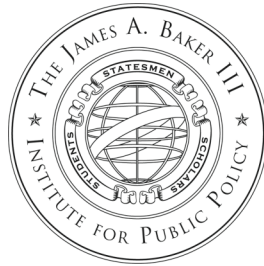


Russia and the Caspian States in the Global Energy Balance



The Future of the Russian Oil Industry

Amy Myers Jaffe and Martha Brill Olcott, Ph.D.



JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY
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THE FUTURE OF THE RUSSIAN OIL INDUSTRY

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**ABOUT THE STUDY:
RUSSIA AND THE CASPIAN STATES IN
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Russia's position as a major energy supplier has great significance not only for its foreign policy but for its relationships with major energy-consuming countries. The nature of Russia's future geopolitical role in world energy markets has become a major concern of international energy security with important implications for Europe, Japan, and the United States. Given a range of economic and geopolitical uncertainties, the fate of Russian and Caspian natural gas exports remains a major risk factor in global energy supply. For this study, researchers examined several scenarios for Russian and Caspian oil and natural gas production, possible export routes, and the geopolitics involved.

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Abstract

The fall in oil prices precipitated by the recent global financial crisis has made the fate of the Russian oil industry increasingly precarious, which in turn has made Russia's economic and political future quite uncertain. Much of the perceived success of the Putin government has been a direct result of the high oil and gas prices in the early 2000s, from which Russia gleaned enormous windfall and trade profits. Now, with oil prices at their lowest levels in years and with the depletion of hard currency reserves, Russia's economy is suffering. At the same time, Russia's relationships in the international community, particularly with the US and the EU, have become strained in part due to the 2008 conflicts with Ukraine over natural gas pricing that left much of Central Europe without heat during a record cold winter. The Russia-Georgia conflict also remains a significant point of contention. The potential costs of these political and economic difficulties include a greater likeliness for Europe to construct additional LNG terminals with alternative pipelines to bypass Russia and great declines in investor confidence in Russian industry. Under present conditions, lower oil prices and increasingly limited access to international credit markets will make it difficult for the Russian government to maintain current levels of oil production. This paper explores the possible political and economic consequences of various courses of action that Russia might take in addressing the crises at hand.

I. Introduction

This essay explores the possible impacts that the current global financial crisis may have on Russia's oil industry, on the Russian economy, and on Russia's position in the international community. When Vladimir Putin handed the presidential reins of state over to his protégé Dmitry Medvedev in March 2008 and moved from the Kremlin to the Russian White House, he could hardly have imagined that, in his first year as prime minister, he would confront an economic crisis that would threaten all he had sought to achieve during his eight years in office.

The current economic crisis poses a threat to everything that Putin has stood for since he came to national prominence in late 1999. Russia and Putin both were riding high when Putin decided to leave the Russian constitution unchanged and surrender the presidency according to schedule,

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even though Putin's popularity was generally so great that most ordinary Russian citizens would have been delighted to have him retain the post of president. Russia's "man-on-the-street" credited Putin and his restoration of a strong political center and a reassertion of Russia's international role with the improved standards of living that the country was experiencing.

Most Russian experts—and all of Putin's critics—believe that the source of Putin's success was the windfall profits that Russia achieved from unexpectedly high oil and natural gas prices. These were maximized by Russia's policy of keeping the domestic tax on crude oil exports high and garnering a low purchase price for Central Asian natural gas, which permitted sales of natural gas at a premium from Russia to the European market.

Now, as this essay discusses, Putin and Medvedev confront a very different set of economic realities than they did just over a year ago. Oil prices, while bouncing from their recent lows, are at their lowest average levels for many years and remain at least \$20–\$30 per barrel below even the most pessimistic planning scenarios for Russia's initial 2009 budget. Russia's hard currency contingency funds have been rapidly depleted, and foreign reserves spent down, through an unsuccessful effort to support the ruble and through government monies spent on selected corporate bailouts ordered by the Kremlin.

All this is occurring at a time of strained relations between Russia and the West. Lingering tensions between Russia and Georgia remain a flash point, and the United States and the European Union (EU) oppose Russia's "recognition" of the independence of South Ossetia and Abkhazia. The international community views these states as part of the Republic of Georgia and, therefore, has objected to Russia's close "military alliance," which includes the stationing of Russian troops in the territories. Russia's relationship with the EU, and to a lesser extent the United States, was still shaken by the nearly month-long crisis over natural gas prices between Russia and Ukraine. This literally left much of Central Europe without heat during a record cold winter and, worse yet, led to a shortage of fuel for industry and temporary shutdowns at a time when enterprises were trying to survive the effects of the global economic crisis. The gas cutoff demonstrated the need for a better-integrated EU energy market, one that allowed countries with energy surpluses to divert supplies to neighbors with temporary deficits. But generally, European

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public opinion focused on Russia's refusal to provide natural gas to Ukraine, despite Russia's major public relations effort to cast blame on Ukraine.

As we elaborate more fully below, these events have both short- and long-term implications. In the long run, the Georgia and Ukraine crises make the construction of additional liquefied natural gas (LNG) terminals in Europe and new pipeline routes that bypass Russia more likely, especially if the global downturn in economies proves short-lived. In 2008—after the Georgia invasion but before the Western financial crisis came to a peak—Russia had already begun to experience a downturn in investor confidence, especially in the natural resource sector, which was shaky given the problems that large companies such as BP, ExxonMobil, and Shell had in the previous year or two when contracts were renegotiated after the fact or export options were effectively blocked. Both instances were triggered by various bureaucratic excuses, such as purported environmental violations and allegations of uncontrolled cost overruns. The high cost overruns were particularly disturbing to Moscow as they pushed much of Russia's share of the revenue stream from ongoing production far into the future. In the aftermath of the Georgia conflict, Western investors became even more uncomfortable by the way some of Russia's own oligarchs and their companies, such as Mechel steel, were treated. The value of Russian oil company shares plummeted dramatically, and some began to question whether certain Russian companies would be able to service their debts.

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Share Prices Closing April 28, 2009

(\$/Share)	Closing Price	Change from April 21, 2009	12-month High	12-month Low	Market Cap (\$ million)
Locally Traded Shares					
Bashneft	8.1	-0.13	NA	NA	1,410.70
Gazprom	4.33	0.4	15.49	3.04	99,428.80
Lukoil	43.64	0.94	113.11	28.27	36,319.10
Rosneft	5	0	12.17	2.97	50,341.30
Megionneftegas	8.39	0.58	8.39	4.14	651.60
TNK-BP Holding	0.93	0.01	2.25	0.5	14,987.00
Gazprom Neft	2.62	0.09	8.11	1.46	12,872.60
Surgutneftegas	0.7	0.02	1.26	0.34	24,472.30
Surgutneftegas pref.	0.29	0.02	0.61	0.17	2,195.10
Tatneft	2.88	0.16	7.99	1.01	6,209.30
ADRs					
Gazprom	17.38	1.58	62.5	11.91	N/A
Lukoil	43.82	1.01	113	24.07	N/A
Gazprom Neft	13.25	0.72	40.2	7.42	N/A
Surgutneftegas	7.1	0.18	12.86	3.3	N/A
Tatneft	58.1	4.1	161.75	17	N/A
Indices					
RTS	803.17	27.93	2,487.92	498.2	

RTS prices are given for companies listed on the exchange. Market capitalization updated weekly.
Source: "Equities and Currencies." Nefte Compass. April 30, 2009. Copyright © 2009 Energy Intelligence Group, Inc.

Even the fate of companies enjoying Kremlin bailouts, as well as some not “rescued,” remains in doubt. For example, in April 2009, Siberian Services Co., a Russian domestic oil drilling firm that served clients such as Rosneft, defaulted on \$100 million worth of dollar-denominated bonds. According to *Bloomberg* news service, Russian borrowers (including many from the oil sector) have been struggling to refinance about \$100 billion in foreign debt that is maturing in 2009 in the face of the global credit crisis.¹ The costs of credit default swaps for Russian firms have risen substantially in recent months.

¹ Denis Magternovsky, “Siberian Services Defaults on \$100 Million of Bonds,” *Bloomberg*, April 7, 2009, <http://bloomberg.com/apps/news?pid=20601085&sid=ad3hGjWKoopQ&refer=europe>.

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It is in this risk-prone environment that we ask how lower oil prices and shrinking access to international credit markets might impact Russia's future oil production profile. Even as the global credit crisis eases, Western governments and banks may reconsider previous practices of unrestricted lending to Gazprom and other Russian companies, given the now-perceived level of higher political risk. At the same time, Gazprom successfully issued a 10-year Eurobond worth \$2.25 billion to refinance \$1.8 billion lent by Credit Suisse in 2007, and it sold Swiss franc notes in April, signaling that markets may still welcome Russian government borrowing. Lukoil Finance also recently paid in full a \$530 million six-month loan underwritten by a group of European banks. However, the fate of private Russian companies may be less auspicious on international capital markets, depending on whether the Kremlin will or won't bail them out.

Whether the Russian oil industry can service its debts, and whether and under what conditions the Russian government will step in, will play a major role in shaping the future of the Russian energy sector as well as determining future Russian oil production trends. Russia may have trouble maintaining its current level of oil production without major new investment and sector reforms, reorganization and rationalization of the sector, major adjustments in tax policies, and utility pricing. In this essay, the authors investigate the impact of the financial crisis on Russia's energy sector, the security of the Russian state, and the stability of the ruling regime, assessing which energy projects are likely to be preserved and funded internally and what future strategies might mean for Russia's position as a global player in the energy market.

II. Russia Reacts to the Crisis

The timing of the current global economic crisis caught Russian authorities somewhat by surprise. However, Russian officials were initially optimistic because the Kremlin had been using rising global oil prices to consolidate a \$700 billion-plus national wealth fund and had also all but eliminated the Russian Federation's sovereign debt.

At first, many in the Russian government were rather snide about the international global crisis, criticizing states that had failed to engage in enough public and institutional savings to protect themselves. Russia portrayed itself, in contrast to the West, as a responsible authority that had

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been smart enough to build up its financial reserves. But the weaknesses of Russia's petro-state economy became more apparent after plunging global oil prices left the Russians downgrading projected economic growth figures, to a point where no one is quite sure how much the GDP is likely to decline in 2009. The World Bank and Organisation for Economic Co-operation and Development (OECD) are projecting contraction in the Russian economy could be as high as 4 to 6 percent this year. While Russian fiscal planners have reworked the 2009 budget to reflect lower energy prices, the ability of Moscow to meet state commitments in 2010 remains uncertain.

Worse yet, the Russian stock market declined more than any other European exchange, and has underperformed exchanges in Asia as well. While some U.S. specialists, such as Brookings Institution economist Clifford Gaddy, caution that some of this was a normal cyclical downturn in an exchange that had overheated after a rapid recovery from the 1998 crisis, others are much less sanguine and see the crash as an almost insuperable blow to the young Russian exchange. There has also been a massive flight of capital from Russia; some is from foreign investors exiting the country, but even more is from Russians selling stocks at home to cover borrowing costs and trying to save assets being held abroad. BNP Bank Paribas estimates that international investors and Russian citizens have withdrawn or converted more than \$300 billion in Russian holdings since August 2008.²

The Russian government's initial program of supporting the ruble may have bought the government some breathing room with the public, but it did so at a very high cost to Russia's existing reserves. It is unclear whether the ruble program will have any lasting effect on the country's economic problems, including maintaining the price of the ruble against the U.S. dollar and euro. Devaluation has already occurred, and the government is in search of a strategy to support Russia's industries, which will now be at some new advantage in the export market, but will be paying more for all imported component parts and technology. Protectionist measures are unlikely to prove popular, as demonstrations in Vladivostok so clearly showed. The Russian government had to bring in troops from outside the region to put down the protests, as local

² Emma O'Brien, "Russia Not On Brink of Moody's Cut on Steadying the Ruble," *Bloomberg*, March 11, 2009, <http://bloomberg.com/apps/news?pid=20601087&sid=aP3atEWdhiZ4&refer=home>.

troops were unwilling to attack local civilians in what was a very popular local cause, the import trade of Asian automobiles.

It is also hard to know how to evaluate the long-term impact of the Russian government's decision to bail out some of Russia's biggest companies and oligarchs, such as the money loaned to Oleg Deripaska of Basic Element (which includes RUSAL) to keep shares from Russian corporations from being transferred to Western banks, when these companies were at risk of default. The Russian government has started to back away from endorsing the possibility of further bailouts, perhaps in part to preserve its own sovereign credit rating. But down the road, government acquisition of energy company debts might make the state more effective at setting a single national policy for all of Russia's strategic resources. This is at least the stated goal of Russia's policymakers, who maintain that they are not interested in achieving a permanent transfer of ownership. For now, at least, this policy has kept key sectors of the economy in continued operation, a critical issue at a point in time when medium-sized and even large enterprises are offering unpaid furloughs or shutting down entirely rather than restructuring. While in the long run this could push Russia toward needed reforms, growing social stress may make reforms harder to accomplish. The economic turmoil created by the global financial crisis has negatively impacted many of Russia's key energy companies, bringing the dual blows of a squeeze on credit and lower oil and natural gas revenues.

Four Russian companies—Gazprom, Rosneft, Lukoil, and TNK-BP—appealed to Medvedev in October 2008 for loans to refinance their foreign debts and allow them to continue to expand foreign investments. The call for help from Russia's oil giants signaled an end to their previous strategy of tapping internal revenue and international capital markets to fund expansion and opened the possibility for further consolidations in the Russian oil industry that would put the Kremlin even more firmly in control of the sector. According to the Russian investment bank Renaissance Capital, Russian oil and natural gas stock shares lost more than 23 percent between January and August 2008, with some firms losing more than 40 percent of their value. State-controlled and politically favored Rosneft was the least hit, as its shares only dropped 11 percent, whereas at one point Gazprom shares had lost roughly 70 percent of their value. More recently, analysts' expectations are that Gazprom and Rosneft will likely be able to access enough funds

to pay their own debt. Gazprom has \$7.3 billion of debt due this year and Rosneft has \$3.1 billion maturing in 2012, according to *Bloomberg* data.³ But other firms may have more difficulties paying back cash borrowed from state bank Vnesheconombank (VEB), which has lent about \$11 billion to companies struggling to refinance foreign debt. Such difficulties could lead to further nationalization. Putin has said that VEB will take shares in companies as collateral if they fail to repay the loans on time. So far, Rosneft is ahead of schedule paying back its loans to VEB but if metals prices do not begin to rise, smaller firms like RUSAL could well have difficulties.

III. Putin and the Energy Industry

During the second term of his presidency, Putin implemented a wave of consolidations in Russia's oil industry that were designed to reassert state control over this vital sector and subject privately owned firms and regional companies to the will of the Kremlin. This was accomplished through prosecutions of privately held firms that had tax problems with the state, as well as through the orchestration of strategic mergers intended to subordinate privately owned firms to Russia's two state-controlled energy giants—Rosneft and Gazprom. Behind Putin's plans for the energy sector were two stated major goals: the use of a state-directed strategic resource policy to foster economic development, and the use of energy wealth and global energy market power to regain Russia's status as a twenty-first-century-style global power. But Putin's critics have argued that the Russian leader had more sinister goals: to consolidate his own personal power and the power and wealth of his inner ruling circle.⁴ Prior to Putin's presidency, Russia's oil oligarchs were gaining in political importance and threatening the power of the Kremlin to control Russia's economic and foreign policy, not just in full, but also in substantial parts.⁵

While history and the public may never know the degree to which Putin has managed to enrich himself and his closest associates, it is nonetheless clear that he is a strong Russian nationalist

³ Ibid.

⁴ For a detailed analysis of this, see Boris Nemtsov, *Nezavisimyi Ekspertnyi Doklad*, "Putin I Gazprom," Moscow 2008.

⁵ See the Baker Institute's "The Energy Dimension in Russian Global Strategy" working paper by Martha Olcott, "Vladimir Putin and the Geopolitics of Oil," and Nodari Simonia, "Russian Energy Policy in East Siberia and the Far East," October 2004, available at <http://www.rice.edu/energy>.

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and a staunch advocate for the rebirth of the Russian land—currently stretching from the Baltic Sea to the Pacific Ocean—and for a renaissance of the Russian people. There is no question that this nationalist ideology and commitment to the greatness of Russia drove him to emphasize state supervision of the development of Russia’s strategic resources as the key to the country’s economic rebirth and its revival as a global superpower.

Russia’s energy interests are by their very nature central to its national security, economic health, and its terms of engagement on the international stage. In recent years, Russia has acted decisively to redress previous concerns that it had diminished control over its own energy export corridors—a “fact of life” in the 1990s and into the 2000s that fueled Russia’s national insecurity.⁶ It has commissioned new pipeline routes (the so-called Nord Stream and South Stream pipelines) aimed to bypass recalcitrant transit intermediaries and give Russia more direct access to European customers. It has also squeezed transit countries through financial and other means. In several cases, Russia has used energy supply cutoffs during commercial transit fee or trade disputes to reassert its interests in Belarus, Ukraine, Lithuania, and Georgia, although ironically Georgia and Russia signed an agreement reaffirming Russia as Georgia’s primary energy supplier in the aftermath of the Russian military incursion, at a time when normal diplomatic relations between the two countries had just been suspended. The events, while having commercial roots, also sent the message that Russia is willing to play hardball and cut off energy supplies to achieve its objectives.

Russia has also maintained its monopoly on the important energy transport corridors from Central Asia and the Caucasus. In recent years, Russia has used tax and other financial means to block temporarily expansion of the CPC pipeline from Kazakhstan through Russia to the Black Sea.⁷ But it was Russia’s military action in Georgia in August 2008 that reminded everyone of the potential vulnerability of the U.S.-backed Baku–Tbilisi–Ceyhan (BTC) pipeline and the Baku–Tbilisi–Erzurum (BTE) pipeline (which run from Azerbaijan to Turkey). Although there

⁶ Amy Myers Jaffe and Robert Manning, “Russia, Energy and the West,” *Survival* 43, no. 2 (Summer 2001) 133-152.

⁷ See Martha Olcott, “Russia, Central Asia and the Caspian—How Important is the Energy and Security Trade-off? Russia and the Caspian in the Global Energy Balance,” (working paper, James A. Baker III Institute for Public Policy, 2009), available at <http://www.bakerinstitute.org>.

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were few deliberate actions by the Russian military to interrupt of oil and natural gas transport along the BTC and BTE pipelines during the first days of fighting in the Georgian war, the operation of Georgia's ports was seriously disrupted, making apparent that the risk of accidental or deliberate damage at Russia's hands was not an abstract one.

Russian energy policy and industry consolidation in recent years has centered on building up the assets, size, and strength of the major Russian state energy entities Gazprom and Rosneft, protecting their potential contribution to the Russian economy and their power against foreign competitors. With the Gazprom takeover of major Russian oil firm Sibneft, for example, Russian government-controlled and -owned companies became responsible for about one-third of the country's total oil output. Gazprom has also weighed in on foreign oil investment in the Sakhalin Islands. Most notably, Russia has blocked ExxonMobil's plans to build a pipeline to export natural gas from its Sakhalin-1 field to China. Its budget proposal was disallowed by Russian authorities who said the natural gas must be sold for Russian domestic use.

The raiding of other firms to bolster Gazprom and Rosneft is interpreted by some to have political undertones, as Gazprom's ranks have included Kremlin insiders such as Medvedev, while the Rosneft faction has been led by Igor Sechin, Russia's deputy prime minister and a political heavyweight. The firms have exhibited competitive behaviors in the past and vigorously resisted a proposed merger in 2004. They still vie for merger-vulnerable assets, but Rosneft did agree to collaborate on the Daltransgas pipeline network early last year—a sign that Gazprom may be gaining an upper hand since Medvedev took office.

The outlook for Russia's large, privately held domestic firms, such as Lukoil and TNK-BP, is still uncertain. The conviction and imprisonment of former Yukos chairman Mikhail Khodorkovsky and his business partner Planton Lebedev—and the subsequent hemorrhaging within the Yukos oil and natural gas empire—signaled a significant move by Putin to assert the concept that the state must control the energy sector. It has subsequently persuaded other Russian oil giants from confronting the Kremlin head-on. At the end of 2007, seeing the handwriting on the wall, even successful Lukoil set up a joint exploration company with Gazprom Neft (the oil arm of Russian gas giant Gazprom), giving the state behemoth a majority 51 percent controlling

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stake in the new venture. The deal gave Gazprom Neft—which has already taken a 50 percent stake in producer Tomskneft—access to and influence over Lukoil’s hefty reserves. There has also been periodic speculation that either Gazprom or Rosneft might be interested in buying into BP-TNK, which currently has a large private Russian shareholder—Alfa Access Renova.⁸ Other firms rumored to be potential takeover targets are Russneft and Bashneft; at the time of publication, Rosneft was moving closer to gaining control of at least part of Russneft’s assets.

Ironically, while high oil prices gave the Kremlin the prestige and self-assurance to broaden its grip over the energy sector in recent years, now-falling oil prices are similarly strengthening the hand of the state if it wants to force a new round of consolidations. Some smaller Russian independents have been hard hit by low prices and the credit squeeze. Russian independent Sibir Energy appears to be in trouble from the growing indebtedness of its key Russian shareholder, Shalva Chigrinsky, who is reported to owe \$192 billion to state Sberbank, which extended a loan for real estate investments. Again, the problems may lead to a change in ownership structure for the firm, including a possible buy-in for Gazprom Neft.⁹ Already, Urals Energy is handing over ownership in its Duslisma field in East Siberia to Sberbank to cover debts to the state bank. In addition, Russneft shareholder Oleg Deripaska is looking at selling his shares in the Russian independent to pay back a \$3 billion loan to Sberbank.¹⁰ Russneft’s situation is complicated by its purchase of a 50 percent stake in West Siberian producer ZMB from Yukos in 2005, a transaction that Rosneft claims was illegal.¹¹

IV. The Global Crisis and Russian Oil and Natural Gas Production

Low oil prices, debt restructuring and consolidations, and ongoing financial market problems will likely mean that Russian oil production could fall significantly this year, following a less than stellar 2008, when Russian crude oil and condensate production fell for the first time in almost a decade. Russian production stood at 9.7 million barrels per day (bbl/d) in early 2009.

⁸ “Post Putin Russia to Bolster State Energy Role,” *Petroleum Intelligence Weekly*, January 7, 2008.

⁹ “Sibir Shares Suspended Due to Debt Error,” *International Oil Daily*, February 23, 2009.

¹⁰ “Russian Plans Fall Victim to the Downturn,” *Petroleum Intelligence Weekly*, January 29, 2009.

¹¹ “Hungary’s MOL Seen Receiving State-Controlled Russian Partner in ZMB—First Strike?” *Portfolio*, April 27, 2009, <http://www.portfolio.hu/en/cikkek.tdp?k=1&i=17479>.

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Surgutneftegas, Gazprom Neft, Slavneft, and Bashneft were already seeing production declines in 2008 (between 5 to 7 percent in the case of Surgutneftegas, Gazprom Neft, and Slavneft). TNK-BP saw a 1.2 percent drop in output in 2008 and is expecting a similar decline in 2009. Now most of the Russian majors are starting to announce spending cuts, despite the cash flow benefits of a drop in the ruble–U.S. dollar exchange rate, which reduces the costs of spending inside Russia. Gazprom Neft announced in mid-February that it is expecting its production to fall by 4.4 percent in 2009 as a result of spending cuts of about 20 percent. Lukoil is talking about cutting investment spending by 50 percent, to as low as \$4 to \$6 billion. TNK-BP has also been reported to be making spending cuts of \$500 million. The delay in the launch of its giant Vankor field in East Siberia will make it harder for Russia to post average production gains in 2008, and the field now is not expected online until well into 2009.

Analysts are projecting that spending cuts will translate into overall production declines. Russian output so far in early 2009 is down almost 1 percent from levels a year ago. Investment bank UBS is estimating that Russian production might decline by 2 percent this year, under an oil price scenario of \$60 a barrel. So far, such a price forecast for the year looks optimistic. Some analysts have projected even sharper declines of 5 percent or more, depending on oil price trends. Russia is already under pressure by falling oil prices to meet national budget priorities, so calls for new tax breaks for Russian oil producers will be difficult to afford. Crude oil export duties were reduced to \$13.77 a barrel in February 2009, down from \$16.25 a barrel in January the same year, although they were raised again in March. Speaking at Davos, Switzerland, in January, Putin said the government would support the country’s economic “champions”—including Gazprom, Rosneft, and Lukoil—to carry out investment projects and refinance debt.

It is not immediately clear what Putin’s strategy will mean for the long-term future of the Russian oil industry. A fall in Russian domestic production could easily translate into a loss of export oil to Europe, since the Kremlin is also actively using tax policy to try to encourage domestic oil refining. Officially, Russia’s refineries have nameplate-processing capacity at around 5.5 million bbl/d, but analysts believe fully usable capacity may be less.¹² Plants located deeper in the country’s heartland can face high shipping costs to get their refined products to

¹² “Europe Facing Slowdown in Russian Crude,” *Petroleum Intelligence Weekly*, February 18, 2008.

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market. Last year, Russia commissioned a new, high-quality, refined product pipeline to Primorsk port, allowing more refined products to be shipped from Bashkortostan. Rosneft is also planning to upgrade its Tuapse and Angarsk refineries, which could reduce the amount of West Siberian crude oil delivered to Europe.

There are also uncertainties involving future investments in older oil and gas fields as well as in greenfield projects. Much will depend upon how long the credit crunch continues, as well as the medium-term pattern of oil pricing. Lower prices and a long-term crisis could make eking out more production from older fields in West Siberia more attractive than starting expensive new greenfield projects in East Siberia or north of the permafrost line in the European part of Russia. Projects that the companies can largely do on their own, with little or no importation of foreign technology, will likely get priority over those that require large lines of credit from Western banks or new commitments from Western oil and natural gas companies. The latter are likely to continue to be nervous about going into Russia, where by law they cannot effectively make investments to take control of any corporate entity, but rather are restricted to minority stockholder status.

The financial crisis has also had another unexpected impact: It has dramatically augmented the potential importance of Asian markets for Russia. For the first time in modern memory, the Russian government was willing to both take a major loan from China and in exchange, to guarantee the timely delivery of large quantities of oil to China. In a deal concluded in February 2009, Russia offered guaranteed oil shipments in order to cover \$25 billion in loans from China Development Bank. The loans were divided \$15 billion to Rosneft and \$10 billion to state pipeline company Transneft. Moreover, the loans to Transneft effectively ensure that the Russian pipeline giant will feel compelled to complete the first stage of the East Siberian Pacific Ocean (ESPO) pipeline by the end of 2009.

An additional wild card remains in the policies surrounding domestic pricing and taxation, as well as the ultimate volumes of Caspian natural gas to move into Russia. Already sunken investments in the Sakhalin Islands mean those projects will likely move forward. Russia, though Gazprom continues to deny it, will have to seriously consider slowing down development of

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Yamal and neighboring fields, although there are indications that Shtokman will continue to adhere somewhat closely to the revised schedule issued in 2008. The key will be if Total and Statoil are satisfied with the project and will continue to share costs as planned. The natural gas could prove valuable to Russia, as the project has the flexibility to be developed either as LNG or partly as pipeline gas to Europe. The LNG portion of the project is a major boost to the city of Murmansk, home to Russia's only year-round port with unfettered access to the Atlantic. Russia also will not abandon the large East Siberian projects, as they are part of Moscow's strategic thinking about how the central government can hold this frontier region of Russia as its permanent territory throughout the twenty-first century. But depending on the length and depth of the financial crisis, these projects, too, could be slowed down, although almost none were on a terribly fast track as it was, given the uncertainties of the pace of growth in the Chinese market.

These dilemmas have not been changed by the crisis, and the last concern—how much natural gas production should stay in Russia to drive economic development and how much should be sold for export—has been made more difficult now due to the uncertain economic conditions within Russia itself. The timing of the resolution of the last issue is partly dependent upon the reform of the pricing structure of the Russian domestic utilities market, which is easy to reform in a low oil price environment because the differential between rate structures is less in actual terms. But speeding up the timetable for rate stabilization (the existing program has not been abandoned) is risky in a period of growing popular unrest. The Russian government also must think through whether it should keep the current tax structure, which is designed to discourage the export of crude oil and favor the sale of refined products. Medvedev had promised a review of the tax structure during his 2008 election campaign in order to stimulate investment in domestic production. But export taxes for crude oil have been raised (in real, and not percentage, terms) for the first half of 2009, indicating that the government feels it necessary to capture as much income from this sector as possible to fund the current federal budget.

Russian production plans will also be impacted by the pace of development of Central Asian reserves. While everyone is fighting over what pipelines should be developed to move these reserves, a prolonged period of low prices and tight credit will not only reduce funding opportunities for new pipelines, it could slow down the pace of development of Kazakhstan's

giant Kashagan field, or exploration as well as exploitation of the newly discovered fields in Turkmenistan. Until these fields come on line, there may not be enough natural gas to fill proposed new pipelines. Moreover, with credit tight, Moscow is likely to want to continue to pay a good commercial price for Caspian natural gas to meet its commitments in Europe, rather than spend far larger sums of money to develop its own greenfield projects.

V. The Impact of the Crisis in Russia Itself

The most difficult question of all may be to answer what the impact of the global economic crisis is on Russia and its foreign policy, as well as on the stability of the current regime and the incumbents in power. Many Western observers have been patiently waiting for the Russian Federation to implode, and have been doing so since the last days of the Soviet Union.

Russia's current economic turmoil makes it a far weaker adversary to challenge the leadership mantle in the oil market currently held by Saudi Arabia and its Gulf-Arab neighbors. And declining oil and natural gas demand in the West—the result of economic contraction—makes it far more difficult and costly for energy producers to cooperate to hold up prices. This weakens Russia's efforts to make oil producer bedfellows by offering to organize resource rent seeking alliances with like-minded producers. In a contracting market, energy-producing countries might feel more inclined to try to defend the market share they still possess and to stave off further losses in state revenue from falling prices. So while Russia still wields considerable market power from its sizable share of the European market, it will have to consider how best to utilize that influence during a global financial meltdown. The answer might not be the same as it has been for the past several years. So far, inside the Organization of the Petroleum Exporting Countries (OPEC), members are arguing that the group's interests would be best served by moderate prices, which could deter Western governments from implementing regulations and investments to stifle the demand for oil.¹³

The loss of income in the oil and natural gas sector creates serious strains for those in power in Moscow and threatens the stability of the system they hoped to create. One implication seems

¹³ Authors' interviews with representatives from OPEC member delegations, April and May 2009.

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fairly obvious. The drop in Russia's oil and gas income is likely to hinder the Kremlin's ambitions to use its natural resource wealth to regain some of its lost international prestige from the Soviet era.

On the one hand, the financial crisis has created new opportunities for Russia to realize its goal of creating a "single economic space" that reaches throughout the Caspian region, as well as in some of the new member states of the European Union. There is no shortage of businesses in these countries that now seek foreign investment.

On the other hand, Russia's business and political elite now face far more difficult choices. Russian corporations that seek to expand their influence beyond Russia's borders put their credit-worthiness at risk by increasing their international exposure. Similarly, the Russian government must decide how best to use its increasingly limited budgetary reserves. The Kremlin now confronts a choice much like Boris Yeltsin did in the mid-1990s: Should it use limited financial reserves almost entirely domestically to bolster the social welfare safety net for its citizens at home? Or should it sacrifice this increasingly politically important domestic spending to continue to fund a heightened security presence around Georgia and in the Collective Security Treaty Organization (CSTO) states?

No matter how great the Russian government's international ambitions may be, it seems safe to predict that its highest priority will have to be maintaining control at home. It is very difficult to predict how the Russian population will respond to a serious decline in lifestyle. If Russia implodes (i.e., goes through a period of political and social redefinition such as it did at the time of the collapse of the USSR), there will be serious consequences for the international oil and gas market in general, and for those dependent upon Russian natural gas in particular. Major political and economic unrest in Russia could eventually lead to a serious decline in Russian oil and natural gas production, just as it did in the early to mid-1990s. Political disorder would likely slow by years the start-up of badly needed new projects and could again call into question the ownership of existing assets on a much greater scale than has been the case at any time since 1992.

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The danger comes not from those whose lives have gotten worse since the collapse of the USSR, the mainstay of the surviving parts of the old Communist Party. The risk today comes from those whose lives have gotten better. Putin and Medvedev realize this, and it is one of the reasons that the Kremlin is not pushing back as regional governments and regional elites demand more responsibility (in a reallocation of *de facto* power more than *de jure* arrangements) in the economic direction of their regions. The regional elites create something of a buffer zone between the masses and the two edifices of power in Moscow—the Kremlin and the White House.

It is certainly possible that either political incumbent, or even both of them, could fall from power in a struggle to keep a centralized state intact. Putin became expendable when he took on the post of prime minister, as he is now formally responsible for the economic welfare of Russia (and thereby possibly to blame for any failures). By changing the terms of the constitution to allow for a longer term of the presidency after the next election, Medvedev, too, created the mechanism by which a behind-the-scenes group could encourage his early departure. With Stalin's death, the future of Russia (then the Soviet Union) became separated from the personality of the leader, creating a precedent for a different paradigm, and only the most misguided of Russian youth display nostalgia for the Georgian autocrat. Still, there is very strong support in Russia for the continuation of Russia *per se*, with a strong ruler at the helm, so the doomsayers who predict the downfall of the current regime are probably wrong.

Russians have been waiting for their country's rebirth since the last days of Soviet rule, and some would even say since the waning days of Romanov rule. Putin thought that he understood how this could be achieved. He dreamed about a state that is able to use oil and natural gas to play a dominant role on the global stage. High energy prices alone would never have been sufficient to do this. And now it is clearer in Moscow that high energy prices are harder to sustain than the regime might have supposed.

During Putin's first term as president, the Kremlin failed to stimulate economic reform when energy prices were relatively low. Similarly, it also did not find a formula for stimulating economic diversification and development during the later years of budget surplus. Now once

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again Russian authorities must try to stimulate reform during a time of many conflicting pressures. Maybe this balance will favor reform, as domestic energy prices are growing closer and closer to prevailing prices in Europe, a condition that many have felt was a prerequisite to stimulating the development of greenfield projects in all of the strategic sectors of the economy.

However, evidence drawn from recent Russian history is not a source of optimism, but rather suggests that Russia's international influence will wax and wane with the value of its strategic reserves. For now, with global energy markets facing oversupply, oil and natural gas demand in Europe—Russia's main market—is flagging. In this environment, Moscow will find it difficult to intimidate buyers with the threat of cutoffs. And lower commodity prices mean that Russia will find it slow going to accumulate the kind of wealth it would take to recast its economy for growth and also support an active foreign military agenda. With less money to fund badly needed oil and gas development projects and national infrastructure, all this casts doubt on whether Russia can remain an important global energy player when the global economy rebounds, let alone retain its superpower status.