

Priming Russia's Economic Engine: A Review of 2005 Events in Russia's Oil and Gas Sectors

By *Victor Eriksen, General Manager, Harvest Natural Resources (Russia)*

Accounting for the majority of exports and some 12 percent of GDP, the oil and gas sectors in Russia witnessed a number of significant events during 2005.

Russia is the largest non-OPEC producer, second only to Saudi Arabia, with approximately 9.5 million barrels per day of output in 2005, of which just over half is exported to world markets. Owing to perceptions of world oil supply constraints due to demand growth, political instability, fears of terrorist attacks, accidents in the industry, futures traders/funds and the impact of severe weather in the Gulf of Mexico, prices have never been higher and Russia's contribution to world oil and gas supply has never been under greater scrutiny than in 2005.

According to statistics and most industry analysts, after a period of strong production growth for the past several years averaging roughly 8 percent per annum, most indicators point to a slowdown in production outputs for 2005 and coming years. This is occurring at a time when the world is looking to those countries which have the capacity to increase production and exports. Russia is one of those few stable producers, therefore playing a crucial role in the world's energy markets.

Production Plateau

Why the slowdown and potential decline? The much-publicized Yukos affair and sale of Yuganskneftegas, the failed Rosneft/Gazprom merger, lack of development spending by the industry, barriers to entry of new players, a slow commitment to improve infrastructure, the regressive taxes on oil sales above \$25 per barrel and rising operating costs are all factors.

In Russia, active consolidation of oil and gas assets has been evident among the Russian majors

in recent years, although there have been some notable recent entrants such as Russneft. The trend towards domestic M&A activity has in some ways stifled competition and not allowed optimal development of the assets acquired. Whilst traditional producing areas such as West Siberia and the Volga-Urals have provided most of Russian production, the Russian majors have begun to realize that without additional acquisitions or exploration, production increases are becoming increasingly difficult by secondary recovery techniques alone. There is a need for the adoption of policies to stimulate a platform for sustained development, provide confidence to the industry and encourage exploration in order to expand other potential areas of growth.

As producing regions expand away from developed areas, so too do the costs and need for additional infrastructure. Along with expanding production, the need for additional export capacity has been recognized. Existing pipelines and export facilities by most estimates are probably not capable of meeting export requirements without expansion. Several planned export pipelines did not receive official approvals during the year, but are vital to the development of remote regions and to supply expanding markets.

Major Events

In commercial terms, the headline industry event for 2005 was Gazprom's acquisition of Sibneft. Whilst many saw this as an attempt by the Russian government to gain additional control over the oil and gas industries, such an acquisition on reasonable market terms was generally positively interpreted. Gazprom itself is not without its own difficulties, since the gas industry, like its counter-

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Gazprom, as Russia's biggest gas producer, holder of around a quarter of world gas reserves and supplier of much of Europe's gas, is now realizing that development of additional gas assets and infrastructure is a priority in order to stem declining production from traditional producing areas. Positively for the market, this creates an opportunity for smaller, independent producers, for example Novatek, to supplement supply and make much needed investment.

In September Gazprom announced the much anticipated short list of potential contenders for development of the Shtokman field in the Barents Sea. Projects of this size require technical expertise of the highest standards and huge amounts of financial resources. Considering continued high energy prices, the Russian oil and gas industry has expanded and allowed local companies to develop their competitiveness by adopting new technologies, upgrading equipment and

training specialists. Nevertheless, foreign firms will still play an important role in development of the industry.

Legislative Notes

On the legislative front, the much anticipated Subsoil Law appears to have missed enactment in 2005, the first reading having been delayed until late in the year. Of particular concern to many in the industry were proposals to limit foreign firms from bidding on "strategic" oil and gas blocks, although a definition of what this meant has not been officially published.

Where to from here? The industry must do better in 2006 – opportunities abound. Increased investment, encouragement and entry of new players, and stable and sensible subsoil laws promoting development should all positively affect the markets in the coming year. □