

# Russia's Oil Potential: Prospects and Implications\*

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Since the late 1990s Russia's oil production has experienced a steady resurgence. As a result, Moscow has regained its status as a major oil producer, exporter, and a crucial player in global energy markets. This paper argues that this rising Russian role should neither be overestimated nor underestimated. It examines some of the main characteristics of the country's oil industry, notably the investment climate, production-sharing agreement regime, and pipeline capacity. The study also examines the Yukos scandal, which was escalated in late October 2003 with the arrest of the company chief executive Mikhail B. Khodorkovsky.

Despite these hurdles, Russia's rising production is likely to enhance global energy security. Moscow and other major oil producers share similar goal – stability of oil market and international economy. Today's energy market should not be analyzed in zero-sum terms. Major oil producers coordinate their policy with each other and with major consumers.

## Russia's Oil Potentials: Prospects and Implications

Since the late 1990s Russia's oil production has experienced a steady resurgence. By the early 2000s Moscow has regained its status as a major oil producer and exporter and a crucial player in global energy markets. Prior to the breakup of the Soviet Union, oil production peaked at 12.6 million barrel per day (b/d) in 1987<sup>1</sup>.

Such high production levels stemmed largely from the exploitation of tremendous new petroleum reserves discovered in Western Siberia. The political turmoil that accompanied the collapse of the Soviet Union was a major factor in the decline of production in the following decade. As the political situation normalized, oil industry stabilized and gradually, production started sky-

rocketing, rising from 6.1 million b/d in 1996 to 7.7 million b/d in 2002<sup>2</sup>. In addition to increasing stability of the Russian political system, the introduction of economic reform and the privatization of the oil sector have contributed to this dramatic turnaround. It is projected by many analysts that Russian oil production will continue its impressive rising for the next several years. According to a recent study by the United States Energy Information Administration, the Russian oil production is projected to reach 10.9 million barrels per day in 2025, 43 percent above 2002 levels<sup>3</sup>.

Since the collapse of the Soviet Union, Russian economy has been in a state of transition, from a state-run economy to a free-market one. A delicate process of restructuring and diversification is underway. Still, the Russian economy is heavily dependent on oil revenues. These revenues represent a substantial proportion of the country's gross domestic product (GDP) and export earnings, in 2002 energy accounted for almost 20 percent of Russia's GDP and 55 percent of export revenue. These figures indicate that Russia's economy is extremely sensitive to global energy price fluctuations. This sensitivity implies that a one dollar rise (drop) in the price of a barrel of Russia's Urals Blend benchmark leads to an increase (decline) in real GDP growth of about 0.5 percentage points and contributes to an estimated \$1 billion in extra earnings (losses)<sup>4</sup>.

The relatively high and stable oil prices since 1999 brought windfall in oil export revenues to the Russian economy and spurred a strong growth in the GDP and contributed to the overall economic recovery. Put differently, Russia's real GDP growth since 1999 has

\* This paper first appeared in the June 2004 issue of the OPEC Review (Vol. 23, No. 2) and has been reproduced here with the kind permission of the Organization of the Petroleum Exporting Countries, who owns the copyright.

<sup>1</sup> British Petroleum, BP Statistical Review of World Energy, London, various years.

<sup>2</sup> Ibid.

<sup>3</sup> Energy Information Administration, Annual Energy Outlook 2004, Washington DC: United States Government Printing Office, January 2004, p.3.

<sup>4</sup> Energy Information Administration, Russia: Oil and Natural Gas Exports, April 2002, on line at [www.eia.doe.gov](http://www.eia.doe.gov).

averaged an impressive 6.6 percent per year. This strong recovery after the 1998 crisis can be explained by favorable external conditions, in the form of high oil prices, as well as the effects of the sharp 1998-99 ruble devaluation. Not surprisingly, in May 2003, the Russian government released its energy strategy to 2020, which designates the energy sector as the engine of economic growth.

Equally important, Russia's influence over the world oil market has risen dramatically in proportion to its growing production. Since the early 2000s the European Union has negotiated energy agreements with Russia. Moscow is a major oil and gas supplier to several European countries. The European-Russian energy dialogue is focused on European investment in Russia's oil and gas sectors in return for steady and secure supplies. At the EU-Russia summit in May 2002, which marked the EU's decision to recognize Russia as a market economy, Moscow agreed to complete reforms in the energy sector, aimed at the gradual elimination of restrictions to trade, the liberalization of its energy markets, and the gradual implementation of market principles in its energy policies, particularly with regard to prices<sup>5</sup>.

Similarly, the United States has shown growing interest in establishing an energy partnership with Russia. In April 2002 Washington has given the Russian economy a free-market status and in October the same year a United States-Russian energy summit was held in Houston, which brought together representatives of government, business and academic circles from both countries<sup>6</sup>.

This summit was followed by another one in 2003 held in St. Petersburg in which the two sides pledged to further deepen their cooperation. Accordingly, US officials announced \$130 million in loan guarantees from its Overseas Private Investment Corporation to help build a new OAO LUKoil storage and loading terminal on the Baltic Sea<sup>7</sup>.

Another earlier sign of this energy cooperation between Washington and Moscow was LUKoil's acquisition of Getty Petroleum marketing Inc. and its 1,300 gasoline stations in November 2000. This step marked the first time that a Russian oil company had purchased

a publicly traded company listed on the New York Stock Exchange<sup>8</sup>.

This rising status of Russia as a significant player in the energy global markets has prompted some officials in several Western capitals and in Moscow itself to present Russia as a substitute for the Middle East. This study argues against this proposition. The argument here is two-fold. First, Russia's oil industry suffers from several drawbacks including limited proven reserves and high production costs (both in comparison to the Middle East). Most notably, Russia's oil potentials are restrained by inadequate domestic investment environment and insufficient transportation system. The arrest of Mikhail B. Khodorkovsky, the former CEO of Yukos, Russia's largest oil company, in October 2003 is a good illustration of the country's unstable investment environment and an indication of the problems foreign investors have to face in Russia.

Second, these drawbacks in Russia's oil sector aside, the contemporary global oil industry should not be addressed as one supplier replacing another one. Oil security can be defined as sustainable and reliable supplies at reasonable prices<sup>9</sup>.

In other words, global demand needs can accommodate supplies from multiple sources. The question is less about the source of oil and more about its availability. For the last several years major OPEC producers have sought to coordinate their production policy with non-OPEC producers, including Norway, Mexico, and Russia. Also, OPEC members have worked with major oil consumers to stabilize global markets and world economy. In short, this paper argues that the global oil environment should not be addressed in zero-sum terms (one producer against another or producers against consumers). Instead, major oil producers (including Russia and the Middle East) and oil consumers share mutual interest in the stability of global oil markets.

## Restraints on Russia's Oil Potential

Since the late 1990s Russia's oil sector has made significant strides. The impressive rise in production and export, however, should not be exaggerated and should be understood in the right context. Several characteristics of Russia's oil sector need to be underscored. First, the country has a limited pool of proven crude reserves. In 2003 Russia's proven reserves were estimated at 60.0 thousand million barrels, about 5.7 percent of total world reserves. Major Middle East producers hold much larger reserves – Saudi Arabia (261.8 thousand million or 25.0 percent), Iraq (112.5 thousand million or 10.7 percent), United Arab Emirates (97.8

<sup>5</sup> Richard Wright, "EU and Russia as One", *The Moscow Times*, May 6, 2003, on line at [www.themoscowtimes.com](http://www.themoscowtimes.com).

<sup>6</sup> Viktor Kaliuzhniy, "The International Oil and Gas Market and Russia", *International Affairs*, Vol.49, No.4, September 2003, pp.139-145, p.143.

<sup>7</sup> Maureen Lorenzetti, "Russian, US Interests Pledge Cooperation on Energy Sector", *Oil and Gas Journal*, Vol.101, No.38, October 6, 2003, pp.22-24, p.22.

<sup>8</sup> *Ibid*, p.24.

<sup>9</sup> Vahan Zonoyan, "Global Energy Security", *Middle East Economic Survey*, Vol.46, No.15, April 14, 2003, on line at [www.mees.com](http://www.mees.com).

thousand million or 9.3 percent), Kuwait (96.5 thousand million or 9.2 percent), and Iran (89.7 thousand million or 8.6 percent)<sup>10</sup>.

These relatively limited reserves are particularly alarming considering that Russia's rate of oil production is exceeding the rate at which new reserves are discovered by a significant margin<sup>11</sup>. Put differently, the depletion of existing oil fields in West Siberia has raised fears that Russia's current oil boom will be followed by a sharp decline in the next few years<sup>12</sup>. Finally, most of the unutilized Russia's oil reserves are located in geographically remote and geopolitically challenging fields.

Second, production costs are much higher in Russia than in the Middle East. The cost of production in Saudi Arabia, for example, is less than \$1.5 per barrel, compared to the global average of about \$5 per barrel. In Russia it varies from one region to another, but overall it is much higher than in the Middle East. This means that Russian firms cannot survive a prolonged period of weak oil prices. For example, if prices fall much below \$15 per barrel, the country's exports will be severely affected. Middle East producers, on the other hand, can still make profit at \$10 per barrel<sup>13</sup>. Third, given the structure of Russia's oil industry, the country does not have any spare capacity. In other words, in the early 2000s Russia's oil industry is dominated by private oil companies. Like any private entities, these Russian companies seek to maximize their profit by producing and exporting as much as they can with little concern about strategic objectives. On the other hand in some Middle Eastern producers, mainly Saudi Arabia, oil industry is dominated by the state. This means that production and export policies are driven by both commercial and strategic interests. The Saudi government deliberately maintains substantial idle capacity in order to ensure stability in global oil markets. This can be seen as an "insurance policy", against interruption of oil supplies. For long time whenever world economy was threatened by political or social upheavals in oil producing countries, the kingdom has not hesitated to use its spare capacity to restore stability and abort economic crisis. Most of the world's spare capacity is concentrated in Saudi Arabia.

### Foreign Investment in Russia's Oil Sector

Foreign investment has been an important component of the economic reform program which started in the early 1990s. Russian efforts to attract foreign investment, however, have been hesitant and ambiguous. As a result, Russian economy as a whole and the oil sector in particular has

received a very modest amount of direct foreign investment. This modest success in attracting foreign investment, which is largely un-proportional to the country's resources and economic potential, reflects both a strong cash flow resulting from high oil prices and the rivalry between three players with competing, and to some extent even conflicting, agendas – the Russian government, Russian oil firms, and international oil companies.

Like in other governments, officials in Moscow do not speak in one voice. Some members in the political establishment understand the need to integrate the country in the global economic system and to forge close energy cooperation with major oil and gas consumers particularly the European Union, the United States, Japan, and China. These ambitious efforts are restrained by the state-led economy model, which has not completely gone with the collapse of the Soviet Union.

In the early 2000s Russian oil industry is largely dominated by several private oil companies such as Yukos, LUKoil, and Surgutneftegas Tyumen. These companies are credited with the impressive rebound in Russian oil production since the late 1990s. Apart from the oil projects in Sakhalin, relatively little foreign investment in the Russian oil industry has been made<sup>14</sup>. In other words, the Russians themselves have been able to substantially increase their production and export. Consequently, they feel little need for foreign investment, particularly under the terms that the foreign oil companies desire.

International oil companies need long-term stability to implement capital-intensive projects. Their executives complain about problems with federal and local legal regulations and taxation policies. Despite these complaints the British Petroleum (BP) announced in February 2003 its intention to purchase a 50 percent stake in Russia's Tyumen Oil Company (TNK), as well as other assets held by TNK's shareholders.

The creation of TNK-BP marked the largest single foreign investment in Russia since the collapse of the Soviet Union.

Three interrelated conclusions can be drawn from this discussion of Russia's efforts to attract foreign investment. First, while Russia has attracted domestic and foreign

<sup>10</sup> All figures are from British Petroleum, BP Statistical Review of World Energy, London, 2003.

<sup>11</sup> Naturally different sources give different estimates. The trend, however, is constant – Russia has much limited reserves in comparison with the Middle East producers. For example see the United States Department of Interior, U.S. Geological Survey World Petroleum Assessment 2000: Description and Results at <http://pubs.usgs.gov/dds/dds-060>.

<sup>12</sup> Energy Information Administration, Country Profile: Russia, November 2002, on line at [www.eia.doe.gov](http://www.eia.doe.gov).

<sup>13</sup> Petroleum Economist, "Russian Roulette", Vol.68, No.12, December 2001, p.2.

<sup>14</sup> Douglas Stinemetz, "Russian Oil Sector Rebound Under Full Swing", Oil and Gas Journal, Vol.101, No.22, June 2, 2003, pp.20-31, p.24.

investment to rich opportunities in existing fields, its record with larger and riskier frontier projects is chequered<sup>15</sup>. Second, despite ambitious efforts to attract direct foreign investment by President Putin's administration, the volume still is modest. Data collected by the Central Bank from 1994 to 2002 puts Russia at the bottom of foreign direct investment rankings for 27 Eastern and Central European countries<sup>16</sup>. Third, the debate on foreign investment has focused on creating a stable and attractive production-sharing agreement (PSA) regime.

### Production-Sharing Agreement Regime

Currently the standard petroleum contract is the production-sharing agreement, where revenues from oil sales, after capital recovery and production costs, are split in accordance with an agreed-upon formula<sup>17</sup>. PSAs have been one of the most controversial issues in reforming Russia's oil sector and attracting foreign investment. The debate over PSAs has been shaped by political and fiscal stability in Russia on one hand, and the fluctuation of international oil prices on the other hand. In the aftermath of the collapse of the Soviet Union and in the midst of political and economic instability there was a strong need to attract foreign investment. Under these circumstances the Federal Law on the Subsurface was adopted in 1992. However, frequent changes in legal procedures and tax regulations made the law ineffective in attracting investments into the Russian energy sector. As a result, a new federal

law on PSAs was adopted early in 1996. Prior to the adoption of this law three PSAs were signed – Sakhalin-1, Sakhalin-2, and Kharyaga in the Timan Pechora Basin, in north-west European Russia<sup>18</sup>. ExxonMobil operates the first, Shell operates the second, and France's Total-FinaElf and Norway's Norsk Hydro hold the third.

Initially the PSAs were welcomed by officials in Moscow with the exception

of some nationalist and leftist opposition leaders who considered the PSAs as "selling out the motherland"<sup>19</sup>. Later they were joined by the representatives of newly privatized Russian oil companies. Expanding their financial resources and technological expertise, the new Russian oil elites felt little need for foreign investors and became increasingly confident in their ability to develop their country's oil potentials. The oil price collapse of 1998-99, sharply reduced these Russian companies' financial assets and renewed interest in PSAs. This situation was reversed since 1999 due to stable international oil prices at relatively higher level.

Finally in 2003 Russian oil companies succeeded in lobbying the Duma (lower house of parliament) to adopt a law which effectively scraps PSAs. The government and the oil companies maintain that the country's tax regime has become more predictable in recent years, enabling international majors to invest in Russia without tax exemptions like those involved in a PSA. Under the 2003 legislation, oil, gas or other natural resources must be offered first in open tenders and only then, if no purchasers are found, re-bid on PSA terms<sup>20</sup>. In other words, from mid-2003 the government will treat PSAs as a special regime to be applied selectively on a case-by-case basis. They are likely to be limited to complex and capital-intensive offshore projects<sup>21</sup>.

This waning interest in PSAs can be explained by the conflicting interests and perceptions of international oil companies, Russian firms, and the government in Moscow. The international companies see PSAs as a framework that can simplify taxation and protect against changes in Russian investment regulations. The Russian firms, on the other hand, consider international majors as competitors. Accordingly, creating a PSA regime would give more advantages to these international companies and weaken the competitive edge of Russian firms. Finally, the Russian government claims that PSAs reduce tax receipts from oil projects especially in the early years of production<sup>22</sup>.

Thus, the future of PSAs in Russia looks bleak. Despite international interest in Russia's integration in the global economy as illustrated by growing energy cooperation between Moscow on one side and Brussels and Washington on the other side, nationalist sentiments and increasingly assertive Russian firms have contributed to un-hospitable business environment. This mixed business environment is further complicated by fragile and un-ease alliance between the political elites and the business elites. The arrest of Mikhail B. Khodorkovsky, the CEO of Yukos, and Russia's largest oil company is a case-in point.

<sup>15</sup> Oil and Gas Journal, "Editorial: The Oil Superpowers", Vol.100, No.42, October 14, 2002, p.17.

<sup>16</sup> Alex Nicholson, "Foreign Capital Sinks to New Low", The Moscow Times, January 12, 2004, on line at [www.themoscowtimes.com](http://www.themoscowtimes.com).

<sup>17</sup> Helmut Merklein, "Who Needs Big Oil in Iraq: The Case for Going it Alone", Middle East Economic Survey; Vol.47, No.2, January 12, 2004, on line at [www.mees.com](http://www.mees.com).

<sup>18</sup> Isabel Gorst, "Russia: Back in Fashion", Petroleum Economist, Vol.70, No.4, April 2003, pp.28-30, p.30.

<sup>19</sup> Andrei Konoplyanik, "Would Russian Oil Companies Really Like to Have a PSA Regime in Russia?" Oil and Gas Journal, Vol.100, No.52, December 23, 2002, pp.20-26, p.20.

<sup>20</sup> Energy Economist, "Market Overview", No.260, June 2003, pp.25-29, p.26.

<sup>21</sup> Joseph McAllen, "Making Sense of Merger Mania", Petroleum Economist, Vol.70, No.6, June 2003, pp.32-33, p.33.

<sup>22</sup> Sam Fletcher, "CERA: Yukos CEO Claims BP Deal Proves PSAs not Necessary for Russian Investments", Oil and Gas Journal, Vol.101, No.7, February 17, 2003, pp. 34-36, p.34.

## Yukos Scandal

The arrest and detention of former OAO Yukos chief executive Mikhail Khodorkovsky on tax fraud and other charges sent a shiver through the business community, both in Russia and abroad. After several months of indirect confrontation between Russia's most powerful politician, President Vladimir Putin, and the country's richest man Mikhail Khodorkovsky, armed and masked officials boarded a private airplane in late October 2003 and arrested the oil magnate. Few days later, Russian prosecutors seized control of 44 percent of stock in Yukos. The seizure represented the first time that the government has taken back control of a large company privatized in the 1990s. The company claimed that the seizure would serve as precedent for authorities taking control of any former state assets that were privatized. Meanwhile, President Putin rejected these charges and confirmed that "There will be no generalizations, analogies or precedents, especially related to the results of privatization"<sup>23</sup>.

This unprecedented episode signaled a potential sea change in the Kremlin's relationship with big oil, or, more specifically, a potential collision between the siloviks and the oligarchs. The former are a group of Kremlin hawks who came from the KGB, the former Soviet internal intelligence service, and known for their deep mistrust in the West and free-market economy. Expressing the sentiments of this group, the Russian Defense Minister Sergei Ivanov said, "The state should take control of Russia's energy reserves"<sup>24</sup>.

He also accused domestic oil companies of under-investing in exploration of new oil. These feelings were echoed in the December 2003 Duma elections, in which pro-Western and pro-market political parties lost to nationalist factions. The oligarchs, on the other hand, are a class of powerful businessmen who acquired state assets cheap during the chaotic privatization of the early 1990s. The following two sections examine the reasons behind the arrest of the former Yukos CEO and the economic and political implications of this development.

The rivalry between Khodorkovsky and the Kremlin was played out in both policy and oil business. Capitalizing on his growing wealth the oil billionaire sought to accumulate political power. In the early 2000s Yukos spread its financial support among a variety of political parties and lawmakers that promoted the company's business interests. In addition to increasing his political assets in Moscow, Khodorkovsky consolidated his

business and political ties with the West, particularly the United States. Indeed, he cultivated contacts with the most influential politicians, diplomats and business leaders in Washington. In December 2001 Khodorkovsky launched the Open Russia Foundation, a philanthropic organization. Its mission statement says, "The founders believe that openness is the first principle of substantial and mutually enriching communication between the peoples of Russia and the West"<sup>25</sup>.

It is important to point out that the West too stood to gain from this relationship by promoting an increasingly powerful oil baron who was promising to help give Western companies access to Russian reserves and was lobbying for key projects while becoming a powerful statesman in his own right<sup>26</sup>.

Besides pursuing a political agenda independent from the Kremlin, the Yukos chief executive sought to promote his company's interests with little, if any, consultation with the Russian authority. In early 2003 Yukos surpassed LUKoil as Russia's top producer and a few months later Yukos announced a merger agreement with Sibneft, another major Russian oil company. This takeover, which was derailed following the Khodorkovsky's arrest, would have created Russia's oil supermajor and turned him into a truly major global player. Furthermore, Khodorkovsky was negotiating a sale of his Yukos shares to ExxonMobil. President Putin felt that there was little Kremlin involvement in this huge deal<sup>27</sup>. Finally, the oil tycoon lobbied intensely for a privately owned pipeline to export oil to the United States. The state-owned Transneft controls all major pipelines, which gives the Russian government a significant leverage in determining both the direction and volume of oil exports. A privately-owned pipeline would have challenged this state monopoly.

In the aftermath of Khodorkovsky's arrest several government and energy executives played down the controversial incident reiterating the state's commitment to economic reform and the privatization of the energy sector. Despite these official assurances, the Yukos scandal has several financial and strategic implications. First, the case has raised questions about the "rule of law" and Russia's economic and political course. Particu-

<sup>23</sup> Peter Baker and Susan B. Glasser, "Russia Seizes in YukosSibneft Oil Company", Washington Post, October 30, 2003, on line at [www.washingtonpost.com](http://www.washingtonpost.com).

<sup>24</sup> Mark Berniker, "Energy Executives Stand Firm on Russia Opportunities", Oil and Gas Journal, Vol.101, No.45, November 24, 2003, pp.42-44, p.44.

<sup>25</sup> See the foundation website at [www.openrussiafoundation.com](http://www.openrussiafoundation.com).

<sup>26</sup> Catherine Belton, "Kremlin Playing Oil Game for Keeps", The Moscow Times, December 29, 2003, on line at [www.themoscowtimes.com](http://www.themoscowtimes.com).

<sup>27</sup> Timothy L. O'Brien and Erin E. Arvedlund, "Putin vs. the Jailed Tycoon: Defining Russia's New Rules", New York Times, January 2, 2004, on line at [www.nytimes.com](http://www.nytimes.com).

larly alarming is President Putin's warning that the Yukos affair might not be an isolated case. The president threatened action against other oligarchs if they did not toe the line. Furthermore, in December 2003 the Russian leader gave the first indications of how the state intends to redirect oil revenues without crippling the industry. He said he wanted to push for increased taxation on wind-fall profits and to improve the state's "administration" over private business so that each and every citizen can share their wealth<sup>28</sup>.

Second, the case is likely to have negative impact on the inflow of capital, both domestic and foreign, to Russia. As U.S. Treasury Secretary John Snow put it, "Capital is coward. It won't go places where it feels threatened"<sup>29</sup>. Not surprising, two major credit ratings agencies have voiced concern about the risks of operating in the Russian market. In late 2003 the credit rating agency Moody's put Yukos on "negative watch", saying that the potential impact on the financial creditors of Yukos is unpredictable. Similarly, Standard & Poor's said that it may revise its rating for Russia, if there is considerable capital flight or a downturn in the economy stemming from the crisis<sup>30</sup>.

A downgrade in Russia's credit rating could cost both the government and private Russian oil companies dearly in future borrowing costs.

Third, given the close ties Khodorkovsky had established with several members in the business and political establishment in Washington, his arrest was seen as a disturbing development in the United States. In late October 2003 the Department of State said that the seizure of Yukos assets belonging to Khodorkovsky "raised serious questions" about Russia commitment to free market and an independent judiciary<sup>31</sup>. Similarly, several members in the U.S. Congress called for the continued enforcement of discriminatory trading restrictions imposed on Russia under the Jack-

son-Vanik amendment, which the U.S. has been promising to lift for years.

Finally, the jailing of Khodorkovsky and the freezing of shares in Yukos should be seen as an indicator that there is still political risk in investing in Russia. The rules of the game can be reversed at any moment. Economic considera-

tions and property rights can become hostage to the political struggle. The country's long history of authoritarian traditions under both the czars and the communists are still lingering. At least in the near future international oil companies are likely to be reluctant in making huge investments in Russian oil sector similar to the one the BP signed with TNK early in 2003. At the end, the Yukos scandal underscores the Russian government's dilemma – how to continue the efficiencies of entrepreneurs, while retaining some of the old communist suspicions of capitalists. This dilemma is further complicated by the inadequacy of the country's pipeline infrastructure.

## Pipeline Diplomacy

Russia has an extensive domestic oil pipeline system, with links to nearly all of the former Soviet republics, but the country's ability to export its oil to markets beyond the borders of the former Soviet Union is limited. This reflects the close economic ties Russia had with fellow socialist republics during the Soviet era. The breakup of the Soviet Union meant that Russia needed to expand its oil exports to Western markets in order to earn badly-needed hard currency. At the same time the weak economies of former Soviet republics and Soviet satellites in Eastern Europe were hardly able to afford the market-priced Russian oil. Thus since the early 1990s constructing pipeline routes outside the former Soviet Union has become crucial for Russia's oil industry and export. The expansion of Russia's pipeline capacity has not kept pace with the country's rising production particularly since the late 1990s. Put differently, the biggest factor preventing the rapid development of Russian energy exports is its transportation network, including pipelines and cargo terminals.

Russia's pipelines are exclusively under state-owned monopoly Transneft. The insufficient Transneft system has left oil producers with three major options: to export oil via rail and river barge to external markets; to export petroleum products instead of crude; to sell their oil in the domestic market<sup>32</sup>. All these options come at much greater cost than shipment via pipeline. As a result, the Russian government and firms have been working to expand the country's pipeline capacity. In the early 2000s Russia has three major crude export outlets – through the Baltic Sea, the Black Sea, and the Druzhba (Friendship) pipeline system. Three major pipeline systems are also under serious consideration, one to China, another to Japan, and a third one in Murmansk on the Barents Sea

<sup>28</sup> Catherine Belton, "Kremlin Reloading after Shot at Yukos", The Moscow Times, December 30, 2003, on line at [www.themoscowtimes.com](http://www.themoscowtimes.com).

<sup>29</sup> Jeremy Bransten, "Russia: Foreign Investors Look to Kremlin for Signal on Future Business Climate", Radio Free Europe, November 4, 2003, on line at [www.rferl.org](http://www.rferl.org).

<sup>30</sup> Sam Fletcher and Mark Berniker, "Kremlin Moves to: Curb Fallout from Yukos Debacle, but Questions Linger", Oil and Gas Journal, Vol.101, No.44, November 17, 2003, pp.22-32, p.23.

<sup>31</sup> Mark Berniker, "Putin Seizes Yukos Shares; Yukos Names New CEO", Oil and Gas Journal, Vol.101, No.43, November 10, 2003, p.40.

<sup>32</sup> Russian domestic prices are typically just over half of the world market price.

(to the United States). A brief description of each of these six pipeline systems is in order.

Russia's main export pipeline to Europe is the Druzhba system. This system was constructed to support Soviet Union's allies in Eastern and Central Europe, exchanging cheap oil for political support. It traverses Belarus before splitting into northern and southern routes. The northern Druzhba line runs from Russia via Belarus to Poland and on to eastern Germany, while the southern Druzhba line cuts across northern Ukraine and on to Hungary, Slovakia, and the Czech Republic<sup>33</sup>. Because of shrinking oil demand in Eastern Europe the pipeline, particularly the southern route, is substantially underutilized.

Until the Soviet Union fell apart, the terminal at Ventspils, on the Latvian coast, was the main northern outlet for Russian oil exports. However, relations between Moscow and Riga became strained in the 1990s, partly because of disagreement over the high pipeline-transit and port-loading fees charged by Latvia<sup>34</sup>. As an alternative to Ventspils Transneft built its own outlet – the Baltic Pipeline System (BPS), which came online in December 2001. The BPS carries oil from Russia's West Siberian and Timan-Pechora oil provinces to the port of Primorsk in the Russian Gulf of Finland<sup>35</sup>. It gives Russia a direct outlet to northern European markets, allowing the country to reduce its dependence on transit routes through Estonia, Latvia, and Lithuania.

Novorossiysk is Russia's largest oil port in the Black Sea. A major problem facing the Black Sea ports is harsh winter weather, with strong winds often closing the main loading terminal of Novorossiysk. With only limited storage-tank capacity, delays are frequent during the winter<sup>36</sup>. Another important outlet on the Black Sea is the Caspian Pipeline Consortium (CPC). It was commissioned in March 2001 and after several delays became operational in October the same year. The Tengiz field in Kazakhstan is the main source of oil for the pipeline, but Russian producers also have the ability to export their crude via the pipeline.

In the first post-Soviet decade Russian oil companies have focused on establishing and consolidating their ties with the European markets. Since the late 1990s, however, there has been a growing interest in other regions particularly Asia and more recent the United States. Asia has been the fastest-growing energy market in the world for many years and is projected to maintain its high growth of consumption and dependence on foreign suppliers. In short, Asian markets have been proven too important for Russian energy strategists to neglect. In the early 2000s Russian officials have expressed

their desire to raise crude exports to the Asian-Pacific region tenfold by 2020 as the country plans to tap oil fields in eastern Siberia and the Far East. For a number of years officials and executives in Moscow have split over the most appropriate route to export their oil to Asia. Essentially, two big projects have been under serious consideration. Both of them initiate from the Russian city of Angarsk in East Siberia. Oil is supposed to be shipped to either China, the Angarsk – Daqing option, or to Japan, the Angarsk – Nakhodka option.

The proposed pipeline to China would extend 1,550 miles and would cost approximately \$2.5 billion. Yukos has been promoting the scheme for some time and is willing to help finance it. In May 2003 Yukos signed a framework deal with China National Petroleum Corporation (CNPC) to supply oil to China<sup>37</sup>. Signing of the Yukos/CNPC deal coincided with the visit by China's President Hu Jintao to Russia. Construction of a pipeline was highlighted in a declaration signed by the Russian and Chinese presidents in Moscow, which also called for the two countries to expand their energy cooperation. The same cooperation goals were repeated later in the year when the Russian prime minister visited Beijing.

Despite these public statements the Russian government has been reluctant to give final endorsement to the Angarsk-Daqing option. The reason is competition from the Angarsk – Nakhodka project. This proposed pipeline would extend to the Russian Pacific port of Nakhodka, about 2,410 miles and is estimated to cost about \$10 billion<sup>38</sup>. It is noteworthy that if this pipeline is built, it would be one of the longest in the world and would traverse a very harsh terrain. This makes many analysts

mistrust official estimates and argue that the project is more likely to cost \$8 billion<sup>39</sup>. These are the main disadvantages. On the positive side, Japan has offered Russia some \$5 billion in low-interest loans to help finance the project. Furthermore, this option would provide access to a wider range of Asia-Pacific markets than a system that stops in eastern China.

<sup>33</sup> Energy Information Administration, Russia: Oil and Natural Gas Export Pipelines, November 2002, on line at [www.eia.doe.gov](http://www.eia.doe.gov).

<sup>34</sup> Isabel Gorst, "Crude Exports Set to Grow", *Petroleum Economist*, Vol.70, No.8, August 2003, p.25.

<sup>35</sup> Energy Information Administration, Country Profile: Russia, September 2003, on line at [www.eia.doe.gov](http://www.eia.doe.gov).

<sup>36</sup> Stephen O'Sullivan, "Russia: Pipeline Politics", *Petroleum Economist*, Vol.70, No.11, November 2003, pp.26-27, p.27.

<sup>37</sup> *Petroleum Economist*, "Russia: No Decision on Chinese Crude Export Line until 2004", Vol.70, No.11, November 2003, p.38.

<sup>38</sup> *The Moscow Times*, "Price of Japan Pipeline Estimated at \$10 B.", January 29, 2004 on line at [www.themoscowtimes.com](http://www.themoscowtimes.com).

<sup>39</sup> Eugene Khartukov and Ellen Starostina, "Russia's New Pipelines Will Debottleneck Exports, Production", *Oil and Gas Journal*, Vol.101, No.38, October 6, 2003, pp.62-73, p.71.

A government proposal in May 2003 to lay the line to Nakhodka with a branch south to Daqing sounded like a compromise. But, based on current estimates, there is not enough oil in eastern Siberia to justify construction of two export lines. Yukos officials have suggested that one way of finding more oil to transport east might be to hook up Kazakhstan's oilfields with Russian pipelines across eastern Siberia<sup>40</sup>.

Finally the idea for a new pipeline and deepwater tanker terminal, designed to carry oil from Russia's West Siberian Basin and Timan Pechora basin to Murmansk on the Barents Sea was first suggested during a summit in May 2002 between Presidents George Bush and Vladimir Putin. Environmental concerns are among the long list of arguments being used by Russia's oil majors to persuade the government to approve the project. In addition to allowing exporters to bypass the Straits of Denmark, Murmansk would have several advantages over the Baltic oil outlets. The port is ice-free all year round and, unlike any existing Russian oil terminal, Murmansk would lie in waters deep enough to accommodate super tankers. This would enable Russian producers to sell large volumes to the United States.

Two conclusions can be drawn from this brief discussion of Russia's current and proposed pipeline capacity. First, most Russia's pipeline systems are operating at their full capacity. These pipeline routes have not expanded at the same rate like the country's production. Accordingly, they represent a major hurdle to expand export. Despite some expansions in export routes, several major schemes will take some time to be completed and operational. Second, the state-owned monopoly Transneft controls all major pipeline systems. This gives the government significant leverage over the country private oil companies. This state monopoly is increasingly under pressure to be privatized.

### Concluding Remarks: Russia in the Global Oil Market

The discussion of the hurdles that confront the expansion of Russia's oil production and export, particularly the investment climate and the transportation system, suggests that Russia should not be seen as a substitute to Middle Eastern producers. Furthermore, the international business environment in the early 2000s is more about cooperation and less about confrontation. Oil producers and consumers share common interest – stability of energy market and international economy. An example of this spirit of cooperation was a joint Organization of Petroleum Exporting Countries (OPEC)/International Energy Agency (IEA) workshop on oil investment Prospects held at the OPEC Secretariat in Vienna, Austria in June 2003<sup>41</sup>.

In closing three observations on Russia's role in the global oil market need to be underscored. First, despite the rapid surge in Russia's oil production the country's main energy assets and competitive edge lie in natural gas not oil. Russia has the seventh largest proven oil reserves in the world after Saudi Arabia, Iraq, the United Arab Emirates, Kuwait, Iran, and Venezuela. Meanwhile, Russia holds the world's largest proven natural gas reserves. Moreover, the Russian natural gas company Gazprom is the world's largest.

Second, at the time of this writing (January 2004) Russia's oil supplies are confined to Europe, with little amount going to East Asia or to the United States. In other words, Russia is a regional player not a global one. At least for the near future Europe will remain the dominant outlet for Russian oil and gas.

Third, naturally Russia, as a major oil producer and exporter, competes with other producers. Without playing down or minimizing the rivalry between major oil producers, it is noteworthy to highlight their mutual interests. Russian government and oil companies share vital interests with other major oil producers in preventing oil prices from collapse and keeping prices at "reasonable level". Although some analysts believe that Moscow has no leverage over the country's private oil companies and as a result, these companies will resent and resist any unwarranted state intervention into their plans. Others argue that Moscow already has an automatic supply restriction mechanism – state-owned monopoly Transneft<sup>42</sup>.

The fact that the Russian government has refrained from sanctioning significant capacity expansions on the Transneft system in recent years signals a desire not to glut the global market. In addition, the Russian government exercises some leverage over production levels by its control over issuing licenses to oil companies. Thus, it can be argued, Russia is already cooperating with OPEC, in an indirect but nonetheless effective fashion. Obviously the two sides are more likely to cooperate when prices are low and to compete when prices are high. □

<sup>40</sup> Isabel Gorst, "Russia: Energy Strategy: Eastern Promise", *Petroleum Economist*, Vol.70, No.7, July 2003, pp.10-11, p.11.

<sup>41</sup> The proceedings of this workshop are available in "Special Issue: Joint OPEC/IEA Workshop on Oil Investment Prospects", *OPEC Review*, Vol.27, No.3, September 2003.

<sup>42</sup> Juan Carlos Boue, "Will Russia Play Ball With OPEC?" *OIES Monthly Comment*, January 2004, on line at [www.oxfordenergy.org](http://www.oxfordenergy.org).