

Prospects for Russia's Oil Industry

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Introduction

Russia has the world's largest natural gas reserves, the second largest coal reserves and the eighth largest oil reserves. Increases in oil production in recent years have been attributed to the privatization of the Russian oil industry, which helped focus incentives. The collapse of the ruble and the increase in world oil prices also played a part (EIA 2005).

Several factors are coming together to make it appear that Russia's energy industry has bright prospects for the foreseeable future. China's rapid rate of economic growth has greatly increased its energy needs, and therefore the demand for energy. This increase in demand has put upward pressure on worldwide oil prices. The same could be said for India, the world's second largest country in terms of population, which has also experienced rapid economic growth in recent years. Turmoil in the Middle East, which increases uncertainty in international energy markets, has also helped caused oil prices to reach record levels. Both of these factors – rapid economic growth by the world's two most populous countries and turmoil in the Middle East — appear to be long-term.

China is expected to continue to have rapid economic growth and the situation in the Middle East is not expected to get better any time soon. Some Arab members of OPEC may decide to punish America for its unwavering support for Israel by cutting back on its oil shipments to the USA, like it did in 1973. The turmoil could also lead to the disruption of oil shipments even if some oil producing Arab countries do not decide to punish the USA by cutting back on oil production. However, such embargoes have proven to be only partially effective, at best (Hufbauer et al 1990a, b). Professor Morris

Adelman of the Massachusetts Institute of Technology has correctly pointed out that "if the Arabs don't sell us oil, somebody else will." (Economist 2003). That somebody could be Russia.

China

China's economic growth in recent years has been phenomenal. In some years it has been higher than ten percent. China now has one of the largest economies in the world. At some point in the not too distant future it could have the world's largest economy, and with that the largest demand for energy. China's oil imports doubled between 2000 and 2004 and jumped almost 40 percent in the first half of 2004 alone. It is now the second largest oil consumer, behind the USA. It accounted for about one-third of the increase in world oil consumption in 2004 (Forney 2004).

Industrial demand is driving up the price of oil, but so is the increase in automobiles. The number of autos on the road in China increased by 2.5 million in 2004 (Forney 2004). Similar annual increases are expected in the future.

Another statistic worth mentioning is China energy use. The World Bank's World Development Indicators includes a category for energy use, measured in kg of oil equivalent per capita. Table 1 shows the figures for China.

As can be seen, the trend, although erratic, is definitely upward. Another measure of energy use is electric power consumption, measured in kwh per capita. Table 2 shows recent statistics for China.

President Putin has been talking to the Chinese about a number of oil and gas joint ventures between the two countries, including the construc-

tion of a pipeline from Russia's oil fields to China's distribution network. However, Japan has also been talking to the Chinese about pipelines and joint ventures (Forney 2004). Although China was once energy independent, that is no longer the case. Most of its main oil fields have been or will soon be depleted and its demands for energy are outstripping its ability to supply its domestic demand. It has tried unsuccessfully to obtain drilling rights in a number of countries in Central Asia and the Middle East, which makes Russian oil all the more attractive.

China has run into difficulties trying to exploit its own oil and gas reserves. In 2004 a consortium consisting of Shell and some other major producers pulled out of a 4,400 km gas pipeline joint venture stretching from the western deserts of China to Shanghai due to lack of profitability, a move that embarrassed the Chinese. China was unsuccessful in finding partners to participate in an oil pipeline of similar length, which was another embarrassment. It was also unable to find any foreign firms willing to drill in the Tarim Basin, an onshore region in China that is considered to have large untapped reserves. Part of the unattractiveness of this venture is because of the perceived low quality of the oil and the high transportation costs that would be involved in getting it to market. Even if new sources of oil were discovered tomorrow, it would take years to bring the new oil to market (Forney 2004). Thus, Russian oil has the opportunity to fill the gap and supply China with the oil it needs for the next several years, at least. In the meantime, oil prices will continue to creep up, which will make the Chinese market even more profitable.

The Middle East

The situation in the Middle East is not expected to get better any time soon. U.S. Middle East foreign policy will continue to be interventionist and its support for Israel will continue to be unwavering. Both of these factors will put upward pressure on oil prices for the foreseeable future.

But the current Middle East situation is different in several ways from the situation that existed in the 1970s, when Saudi Arabia and a few other Arab countries decided to cut off oil sales to the United States. The main problem – U.S. unwavering support for Israel – still exists, but there are now at least two additional factors that could adversely affect oil prices. The continued U.S. occupation of Iraq has angered the Arab world, so Arabs now have two reasons to be angry at the United States instead of one.

The other factor is the rise of militant Islam. During the 1970s the Arab OPEC nations at least considered the effect that an oil embargo would have

Table 1. **Energy Use – China** (kg of oil equivalent per capita)

| Year | Per Capita kg Oil Equivalent |
|------|------------------------------|
| 2003 | ... |
| 2002 | 959.5 |
| 2001 | 894.4 |
| 2000 | 903.2 |
| 1999 | 890.2 |

Source: World Bank, World Development Indicators.

Table 2. **Electric Power Consumption – China** (kwh per capita)

| Year | Electric Power Consumption | Growth Rate % |
|------|----------------------------|---------------|
| 2003 | ... | |
| 2002 | 987.1 | 10.5 |
| 2001 | 893.4 | 8.0 |
| 2000 | 827.0 | 9.1 |
| 1999 | 757.7 | |

Source: World Bank, World Development Indicators.

on their own bottom lines. Cutting off sales to the United States could be bad for business, unless the increase in worldwide oil prices could somehow offset the lost sales to the United States. But Islamic fundamentalists are not concerned with the bottom line. If the militant Islamic leaders decide to disrupt oil markets, they really are not concerned with the effect it might have on Arab economies. In fact, major economic disruptions might actually help them to advance their goals, one of which is to overthrow existing Arab regimes, which they consider to be corrupt and insufficiently Islamic. Thus, the present set of factors could lead to a situation that is even worse than the situation that existed in the 1970s, from the perspective of oil prices.

An Arab embargo or other cutback on the flow of Middle Eastern oil could lead to a chain of events that would increase oil prices even further, if history is any guide. During the Arab oil embargo of the 1970s, the United States government adopted a series of counterproductive economic policies that caused oil prices to rise even higher than would have been the case if oil prices had been left alone to seek their market level.

The Nixon administration imposed price controls on oil, which prevented the market from adjusting to the market clearing price. As a result, there were shortages and long lines at the gas pumps. U.S. domestic oil companies did not have any incentive to increase production because they could not pass on the full costs, so the shortage continued. Congress exacerbated the situation by trying to ration and allocate oil to various industrial sectors and geographic locations and by passing price regulations that made a distinction between new oil and old oil, a policy that is especially irrational for a fungible commodity like oil.

There is no evidence to suggest that American politicians and bureaucrats are any more intelligent now than they were then, so there is a high probability that the U.S. government will adopt counterproductive economic policies to deal with future oil crises. The Russian oil industry stands to gain from these blunders, but can only do so if it positions itself to supply the increases in demand that are sure to result.

Other positive benefits can come from such positioning. Rapidly increasing energy prices can lead to regional recessions, or even to a worldwide re-

cession. A well positioned Russian oil industry can reduce the depth of such recessions by supplying at least some of the needed oil, thus helping not only the Russian economy but also the economies of Russia's trading partners. However, the effect of this added production will have only a limited effect, since Russian oil reserves account for only about 5 percent of the world's total, compared to 25 percent for Saudi Arabia and about two-thirds if one adds the reserves of four of Saudi Arabia's neighbors to the Saudi total (Economist 2003).

Table 3. **Top World Oil Producers, 2004** (millions of barrels per day)

| Rank | Producers | Total Oil Production | % of Total |
|-------------------------|----------------------|----------------------|------------|
| 1 | Saudi Arabia | 10.37 | 17.0 |
| 2 | Russia | 9.27 | 15.2 |
| 3 | United States | 8.69 | 14.3 |
| 4 | Iran | 4.09 | 6.7 |
| 5 | Mexico | 3.83 | 6.3 |
| 6 | China | 3.62 | 5.9 |
| 7 | Norway | 3.18 | 5.2 |
| 8 | Canada | 3.14 | 5.2 |
| 9 | Venezuela | 2.86 | 4.7 |
| 10 | United Arab Emirates | 2.76 | 4.5 |
| 11 | Kuwait | 2.51 | 4.1 |
| 11 | Nigeria | 2.51 | 4.1 |
| 13 | United Kingdom | 2.08 | 3.4 |
| 14 | Iraq | 2.03 | 3.3 |
| Total production | | 60.94 | |

Sources: www.infoplease.com/ipa/A0922041 and www.eia.doe.gov/emeu/cabs/

Table 4. **Top World Oil Consumers, 2004** (millions of barrels per day)

| Rank | Consumers | Total Oil Consumption | % of Total |
|--------------------------|---------------|-----------------------|------------|
| 1 | United States | 20.5 | 40.6 |
| 2 | China | 6.5 | 12.9 |
| 3 | Japan | 5.4 | 10.7 |
| 4 | Germany | 2.6 | 5.1 |
| 5 | Russia | 2.6 | 5.1 |
| 6 | India | 2.3 | 4.6 |
| 7 | Canada | 2.3 | 4.6 |
| 8 | Brazil | 2.2 | 4.4 |
| 9 | South Korea | 2.1 | 4.7 |
| 10 | France | 2.0 | 4.2 |
| 11 | Mexico | 2.0 | 4.2 |
| Total consumption | | 50.5 | |

Sources: www.infoplease.com/ipa/A0922041 and www.eia.doe.gov/emeu/cabs/

Table 5. **Countries Having the Largest Oil Reserves**

| Rank | Country | Proved Reserves (billions of barrels) |
|------|----------------------|---------------------------------------|
| 1 | Saudi Arabia | 261.9 |
| 2 | Canada | 178.8 |
| 3 | Iran | 125.8 |
| 4 | Iraq | 115.0 |
| 5 | Kuwait | 101.5 |
| 6 | United Arab Emirates | 97.8 |
| 7 | Venezuela | 77.2 |
| 8 | Russia | 60.0 |
| 9 | Libya | 39.0 |
| 10 | Nigeria | 35.3 |

Source: www.infoplease.com/ipa/A0872964.html

Comparative Statistics

Table 3 shows total production in 2004 for the top 14 oil producers. The table includes all countries that produced at least 2 million barrels per day. Russia is the second largest oil producer, behind Saudi Arabia and ahead of the United States.

U.S. oil production was dealt a serious blow when Hurricane Katrina hit the Gulf Coast in the summer of 2005. Some oil refineries were damaged to the point where they were not able to refine petroleum. Gasoline prices in the United States jumped by 25 to 50 percent the week after the hurricane hit and it is likely that gasoline prices in the United States will continue to be high, at least until refining capacity can be restored. Since the USA is the world's third largest oil producer and the world's largest oil consumer, this partial pinching off of its oil supply will have a significant effect on the world oil market.

Table 4 lists the countries that consumed more than 2 million barrels of oil per day in 2004. The United States is the largest consumer of oil, with China a distant second. India is currently in sixth place, although it will likely move up in the rankings if it continues its rapid rate of economic growth. Although the United States consumed 40.6 percent of the oil in Table 4, it would not be accurate to say that the United States consumed 40.6 percent of the world's oil, since the table includes only those countries that consumed at least 2 million barrels of oil a day.

Table 5 shows the countries having the largest oil reserves. Russia is ranked number 8.

Concluding Comments

Russia has one of the largest oil and gas reserves in the world. Disruptions to world energy markets could partially be offset by increased Russian production. However, such an offset could occur only if the Russian industry is able to expand its capacity to meet the increased needs. It appears that the Russian industry is not presently capable of meeting this potentially large increase in demand.

The Russian energy industry has basically two options. It can continue in its present mode, which means it will miss the opportunity to take advantage of potential surges in energy prices. Or it can focus its attention on increasing its capacity, thus positioning itself to meet future demand and take advantage of future profit opportunities.

One way to increase industry capacity is to invest more domestic capital into exploration and production. But that is not the only way. Russian capital alone is insufficient to meet the need. There are already many demands being placed on Russian capital and there simply is not sufficient domestic Russian capital to meet all such needs. Thus, there is a need for foreign capital.

Traditionally there has been hostility toward foreign investment in Russia. Part of this hostility is because of the perception that foreign capitalists who invest in Russia are somehow exploiting mother Russia. This attitude is changing, but it has not disappeared. This attitude exists because of the incorrect belief that trade is a win-lose situation. In fact, trade is a win-win proposition. Both sides benefit by trade. Otherwise, no trades would ever take place. The Russian oil industry could position itself to take advantage of future profit opportunities more rapidly if it invited more foreign investment participation in the energy industry and if it made foreign participation more enticing by reducing counterproductive regulations.

Russia has made some moves in this direction already. The present Russian economic environment is not as hostile to foreign investors as it once was. Corporate tax rates in Russia are not as high as they once were. They are now more competitive with tax rates in other countries and are even

lower than tax rates in many West European countries. These are all good signs. However, more could be done to attract foreign investment.

One area in need of improvement is financial transparency. Foreign investors have many investment options. There are more than 100 countries that offer profitable investment opportunities. Russia has to compete with these countries. If the financial statements of Russian companies are not as transparent as those of the companies in other countries, Russian enterprises are at a competitive disadvantage (McGee & Preobragenskaya 2005). A PricewaterhouseCoopers study of transparency in 35 countries ranked Russia number 34, just ahead of China (Haigh 2001).

Weak corporate governance practices and questionable accounting practices all harm the chances of Russian firms to attract foreign capital. Some suggestions have been made for improving the state of corporate governance in Russia (OECD 2002), but change takes time. The Russian Corporate Governance Roundtable and the Russian Institute of Directors are providing some needed guidance in this area. The RID's Code of Corporate Governance (2002) sets out some basic guidelines in this regard. There is evidence to suggest that corporate governance practices in Russia have been improving in recent years (Puffer & McCarthy 2003; Muravyev 2001) and this improvement is likely to continue.

The Russian oil industry stands to gain from recent world developments. It has oil, which growing economies need. However, it will need to expand its production capacity to take advantage of the economic opportunities that are likely to come its way in the next few years.

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