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Russian Oil and Gas Sector: Political and Economic Prospects

Abstract

Energy sector has a pivotal role for the economy and the political system of the Russian Federation. Oil and gas industry provides a quarter of the GDP, two thirds of the exports and half of the budget income. As a result, Russian economy and Government expenditures rely on high oil price. A sudden drop would bring to a deep economic crisis, with unpredictable consequences.

Oil and gas companies played also a political role in during the last decade. Putin strategy included a strong reaffirmation of the Government's control over the main energy companies.

In order to cope with the current and future challenges, Russian leadership needs to promote a multi-level diversification, which could lead to a more stable and resilient economic and political system.

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Russian endowment of natural resources is unique. Its oil reserves amount to 12 billion tonnes, representing 5% of the world total. During the 20th century, this huge potential was vital for the Soviet military power. After WWII, it also became a key-element of the Soviet (and Russian) wealth.

Oil is the most valuable resource, but it is not the only one. Coal reserves amount to 157 billion tonnes (18% of the world total), making Russia second only to the United States. At the current production level, those reserves could last for almost 500 years, giving to Russian fossil energy a very long-term prospect.

The third main resource is natural gas. Russian reserves amount to 48.000 billion cubic metres, the largest in the world (21% of the total)[1]. Nowadays, natural gas is the fuel of the Russian economy, making up more than half of the Russian energy mix.

Economic exploitation

The exploitation of this massive energy endowment (oil, coal and gas) has deeply influenced Russian economic development. Indeed, industrial production is based on energy-intensive sectors and processes, which benefit of cheap supplies. Moreover, industrial sectors directly related to the energy production thrived, as in the case of oil refining. As a result, the whole energy sector makes up more than a quarter of the Russian GDP.

However, the single most important aspect of the Russian energy sector is the flow of oil and gas exports, mainly towards Western Europe. In 2011, Russian net exports amounted to 375 million tonnes of oil, earning 182 billion dollars, and 196 billion

[1] Unless otherwise stated, the source of data is BP, *Statistical Review of World Energy 2012*.

cubic metres of natural gas, earning 64 billion dollars. Including oil products, the value of this outward flow amounted to 342 billion dollars, two thirds of the Russian exports and 18% of the Russian GDP[2].

Revenues and stability

The huge size of the energy exports entails that the stability of the international trade of oil and gas is the main pillar of the Russian economy. In addition, the recent accession to the WTO and the expected growth of Russian imports are bound to improve the need of oil and gas exports in order to keep the current account in surplus.

The growing importance of oil and gas exports for the economic stability is a long-term feature of the Russian economy, since the last decades of the Soviet Union. In 1971, oil and gas exports earnings totalled 600 million dollars, 22% of Soviet hard-currency incomes. This share increased constantly, reaching in 1985 the level of 74%, while its value grew to 15 billion dollars[3]. During the following years, the decline in the oil price contributed to accelerate the collapse of the Soviet Union.

After 1991, Russian economy retained its dependence on oil and gas exports. Indeed, Russian default in 1998 was strongly related to the extraordinary low prices of oil (in 1998, the average price was lower than 13 dollars per barrel). Although the forecasts for oil price are relatively stable for the next few years, contemporary Russia is still very vulnerable to a fluctuation of the oil price on the international markets. In particular, a steady drop would seriously hit the cash flows of the largest Russian companies, such as Gazprom, Rosneft and Lukoil, with a rapid contagion to the whole economy[4].

Political consequences

The consequences of this dependence on the oil and gas exports are not limited to the economic domain. Russian political system has been deeply affected by the size of the energy sector. During the 1990s, the privatisation of the oil industry contributed to the rise of the oligarchs, who wielded considerable power under Yeltsin’s presidency. Also Gazprom, which was only partially privatised, played an important role as an autonomous source of power within the weak political system.

The struggle for gaining back to the Government the control of the largest energy companies became one of the main issues since the beginning of Putin’s presidency. Initially, in 2001, Putin focused on reducing the autonomy of Gazprom’s management, appointing loyal officers to the key roles, as in the cases of Alexey Miller and Dmitry Medvedev. Putin’s strategy of consolidation of the political system involved a progressive de-privatisation of the oil sector, notably with the acquisition by Rosneft of the assets of Yukos, after the conviction of its main shareholder, Mikhail Khodorkovsky, for tax evasion and other criminal offences.

This strategy continued during the following years, granting Gazprom a legal monopoly on gas exports (2006) and strengthening the position of Rosneft. The most recent step was the acquisition by Rosneft of TNK-BP, third-largest oil producer in Russia, in October 2012. As a result of Putin’s strategy, Rosneft and Gazprom are the main player in the oil and gas sector. Both companies are State-controlled and their strategies are now consistent with the policies of the Government.

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[2] Bank of Russia (www.cbr.ru) and International Monetary Fund (www.imf.org) online databases.
[3] T. SMEENK, *Russian Gas for Europe Creating Access and Choice. Underpinning Russia’s gas export strategy with Gazprom’s infrastructure investments*, Clinendael International Energy Programme, The Hague, 2010.
[4] The price of the exported natural gas is linked to the price of oil, even if this pricing mechanism is under pressure on the European markets.

Private companies are still on the market, notably Lukoil and Novatek, and they exert a considerable influence on the Russian economy. However, their political role is limited and generally they do not represent autonomous powerhouses which could challenge the stability of the political system.

Oil-based State budget

The importance of oil and gas sector for the political system is also related to the role of revenues in the State budget. Almost half of the Russian federal budget income comes from oil and gas revenues, including mineral extraction tax, VAT and excise taxes, and export duties[5]. Even a small decrease in oil price could create serious imbalances in the Russian budget.

In 2012, the break-even oil price reached the record level of 116 dollars per barrel and for the next three years is bound to remain above 105 dollars[6]. Such a high threshold entails an extraordinary level of vulnerability, which could even worsen after 2015, when a current account deficit is expected even with stable oil prices[7]. In the case of a significant drop, Russian government finance would rapidly face serious imbalances. As a consequence, Putin would be forced to reduce spending, disregarding the pledges made at the time of his last presidential election. Moreover, in order to cope with the situation, the rouble is likely to depreciate significantly, causing negative effect on the middle and poorer classes.

The oil price is not the only threat to the stability of the Russian revenues. EU markets are the main destination for Russian oil and gas exports, making up almost 60% of their value. The ongoing economic crisis and the progressive shift in the consumption patterns across the EU are questioning the future level of imports from Russia.

Russian gas for Europe

This uncertainty is particularly relevant in the case of natural gas. In 2011, Gazprom exported to the EU 113 billion cubic metres, 24% of the European consumption[8]. The pipeline system linking Russia to its main customers in Europe provides little room for flexibility: Russian gas can only be exported to the countries along the pipelines and when the profitability of those markets decreases, there is no alternative destination available for Gazprom.

Long-term contracts with take-or-pay clause have so far preserved both volumes and value of the Russian gas exports. However, in the last three years several factors challenged Russian position. European consumption is shrinking and it is expected to recover only slowly over the next years. At the same time, the increasing offer of liquefied natural gas is enhancing competition and reducing prices on the European markets. Those two factors forced Gazprom to a renegotiation of the long-term contracts with its main costumers (RWE, E.On, Eni, PGNiG), causing a loss of several billions dollars to the Russian company.

A third factor is even more dangerous for the profitability of Russian activities in the EU. The yearslong battle opposing the European Commission to Gazprom reached a new stage in September 2012, when the DG Competition announced the opening of a formal proceeding against the Russian company for hindering competition and possible abuses of its dominant position in

[5] IEA, *World Energy Outlook 2011*.
[6] Reuters, *Russian budget banks on firm oil prices*, 9 July 2012.
[7] *Economy: Little scope to spend way out of trouble*, in «Financial Times», 18 October 2012.
[8] EUROGAS, *More customers, consuming less gas, in 2011*, 29 March 2012.

Eastern Europe[9]. The outcome of this legal case is uncertain, but the potential impact on Gazprom's operations is great. In the worst case, Gazprom would be fined and forced to revise its commercial practices, losing a large share of its profits on the European markets. Moreover, in this case the relationship between Russia and the EU countries could be negatively affected.

Multi-level diversification

Russian leadership is going to face several tough challenges and its strategy will need a multi-level diversification. On the domestic level, Russian economy needs a development of its non-energy sectors, in order to curb its vulnerability to the oil price volatility. It is a risky process, since it would require deep economic and social reforms, which could challenge Russian political stability. Moreover, an effective diversification of Russian economy would need huge investments, especially FDIs. However, massive foreign investments could trigger negative reactions, which could destabilize the political system.

The process of diversification should also involve the federal budget income, with a steep reduction of its reliance on the energy revenues. This process would necessarily require a cut in the expenditures, such as welfare-state or direct and fiscal support to the State-owned companies. However, this process could prove to be particularly painful for the stability of the political system, strongly limiting the chances of a quick and throughout implementation, at least in the short-term.

A diversification process should directly concern the energy sector. First of all, the future output of the Russian oil and gas fields depends on massive investments. In particular, over the next twenty years oil and gas sector will need more than 2 trillion dollars in upstream and midstream projects, in order to exploit new regions and substitute depleted fields[10]. Russian companies will need foreign capitals and technologies in order to cope with such a huge requirement.

The energy companies should also diversify the source of their income, dramatically improving the profitability of the domestic market. In particular, domestic gas market absorbs almost 70% of the Russian production, but the average price is 30% of the price paid to Gazprom by its European customers[11]. Higher domestic prices would increase profits and boost efficiency, potentially leaving more gas for the foreign markets.

Eventually, diversification should also concern foreign markets for the oil and gas sector. In the case of oil, this would mean more investments in Russian export terminals in different regions, in order to reduce transport costs. Indeed, this strategy is already underway in the West (Primorsk), in the East (Kozmino) and in the Arctic region (Varandey).

In the case of natural gas, a strategy of geographic diversification is more complex, since the construction of new pipelines requires a high level of cooperation with the international partners. Indeed, the existing pipelines run only in the former Soviet Union and in Europe.

A first step towards export diversification has been made with the liquefaction plant in the Eastern island of Sakhalin, commissioned in 2009. From the terminal, about 15 million cubic metres of Russian gas are currently exported to Japan and South Korea. Sakhalin project is expected to expand, in order to supply more gas to the Asian markets, including India and China.

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[9] *Commission Opens Proceedings against Gazprom*, 4 September 2012, Commission Press Release, IP/12/937. For a detailed analysis of the case, see A. RILEY, *Commission v. Gazprom: The antitrust clash of the decade?*, CEPS Policy Brief no. 285, 31 October 2012.
[10] IEA, *op. cit*.
[11] GAZPROM, *Gazprom in figures 2007-2011 Factbook*.

Natural gas exports diversification should also include more pipelines. However, at the moment the only advanced projects are in Europe: after the completion of the second line of Nord Stream, Gazprom and its partners are planning a new pipeline under the Black Sea, South Stream. Instead, Russian interest should be more orientated towards China, which has a strongly dynamic market.

A pipeline has already been proposed, in the Altai Mountains, at the narrow border between Siberia and Xinjiang. The pipeline would allow to export 30 billion cubic metres per year. Notwithstanding Chinese fast-growing demand, the project is stranded because there is a lack of agreement between the parties. Chinese are proposing very low tariffs, while Gazprom aims at selling at the same price charged to its European customers. The Russian company would also face the risks deriving from the lack of a proper rule of law background in the case of a litigation with a Chinese company.

A difficult task

Multi-level diversification is a complex task for the Russian leadership: reshaping the role of the State in the economy, attracting more foreign capitals, redefining its international partnerships. It can also prove to be very painful on the domestic side. Higher gas prices, more competition, less public spending represent a heavy burden, which could erode even the widespread support enjoyed by Putin at the last elections.

Confronting with the unpredictable trend of the oil price, the Kremlin will need to carefully balance the urgency of the reforms and the preservation of the internal order and political stability. It will be a tough challenge, but it will shape the place of Russia on the world stage for the next decades.

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