Analysis

The Russian Oil Industry between Foreign Investment and Domestic Interests

By Julia Kusznir and Heiko Pleines, Bremen

Abstract

As the world's second biggest oil producer, Russia has profited hugely from high world market prices for oil. In contrast to the gas industry, the Russian oil industry was privatized in the 1990s and the domestic market for oil and oil products was liberalized. Foreign investors were allowed to play an important role in the development of the industry. However, at present the Russian leadership is aiming to increase state control over oil production and to focus on the development of the domestic market. This strategy may hamper efficiency.

Oil Production and Exports

Though Russia holds only 7 percent of worldwide proven oil reserves, the country has in recent years been the world's second largest oil producer, ranking between Saudi Arabia and the USA. Russia's oil production is likely to rise until the end of this decade. However, for the following decade many forecasts are pessimistic. They see four main risks to production growth. First, known, accessible reserves are limited. Undiscovered oil reserves may be large, but their exploitation will be difficult due to their remote location and unfavorable geological conditions. Second, investment in exploration and production has declined in recent years. Third, onerous windfall profit taxes block rising world market prices from stimulating Russian oil production. Fourth, state ownership in the oil industry has been growing in recent years. Combined with restrictions on foreign investment, expanded state intervention poses a serious risk to efficiency.

Oil exports also face major challenges. Nearly two thirds of Russia's oil exports go to the EU. However, the Russian government seeks a diversity of customers as a clear long-term aim. According to its energy strategy, exports to Europe will grow, but at a much slower pace than exports to Southeast Asia and North America. As a result, according to the targets, Europe's share in Russian oil exports will decrease to about 50 percent by 2020, while the proportion sent to America and Asia will rise from 3 percent to about 30 percent. This different geographical focus implies not only a considerable rise in production, but also the realization of ambitious pipeline projects. Because of constraints on the existing export pipeline infrastructure, Russian exporters are forced to export over 50 million tons of oil per year via more costly railroads and internal waterways. Using these forms of transportation increases costs by $5 to $7 per barrel.

The Domestic Market

Domestic prices for oil and oil products were liberalized in 1992 and, according to Russian legislation, they are not subject to regulation by the state. Therefore, the state has only indirect influence on prices. However, this indirect influence is considerable. First, the state owns some production companies and the operators of the oil and oil products pipelines. As a result, it can directly determine the price policy of some market players. Second, a large part of the prices of oil and oil products consists of taxes, which are also directly set by the state. Third, export tariffs for oil and oil products set by the state have a direct influence on the attractiveness of supplies to foreign vs. domestic markets. Fourth, the state can pressure the oil companies to lower their prices either formally through anti-monopoly investigations or informally through round table talks with leading managers to impose a temporary moratorium on prices increases.

Domestic prices for oil and oil products are set in a highly monopolistic environment. The privatization of the oil industry in the first half of the 1990s was based on regionally-concentrated, vertically-integrated oil companies. As a result, there are wholesale monopolists in many regions, which in turn determine retail prices, although independent retail traders have emerged in most regions. As the oil companies often collude with regional authorities, their dominant market position is often protected by regional administrations. According to an estimate by the Russian Anti-Monopoly Commission, the market for oil products is either monopolistic or oligopolistic in about two thirds of Russian regions.

Nevertheless an analysis by the Cambridge Energy Research Associates came to the following conclusions: "(1) domestic wholesale prices for refined products are not excessive, but generally in line with export parity levels (although gasoline is priced at a premium due to the tightness of the balance for high-octane material); and (2) there is no evidence of monopoly rents in retail prices even in highly monopolized regions where a single company might control 75–85 percent of sales. We believe that the major factor causing the substantial increase in product prices within Russia is the upward pull exerted by international price trends. It also appears that the wide gap noticed between retail and wholesale prices in Russia can be largely attributed to the relatively high transport costs of moving products over Russia's vast geographical space from a relatively small number of refineries rather than monopoly rents per se."

Oil Refining

In the 1990s, Russia's major vertically-integrated oil companies focused on the upstream business, deriving most of their profits from crude exports. The domestic market for oil and oil products was unattractive due to low prices and the inability of many customers to pay for the oil they consumed. In addition, high export tariffs for oil products (meant to secure supplies for the domestic market) and tax levels rising in line with refining depths, discouraged investment in refining.

Outdated refining capacity was shut down rather than modernized. In the last ten years the aggregate capacity of Russian refineries dropped by nearly a fifth. The remaining refining capacity is still in need of modernization. As a result of under-investment, the average depth of refining in Russia does not exceed 73 percent, and output of light oil products is estimated at 55 percent (rates in the OECD are about 90 percent and 75 percent respectively). Only five Russian refineries have a refining depth of more than 80 percent.

However, the outlook for Russian refining is brightening fast. Demand for refined products is rising domestically and internationally, while at the same time margins for high-quality products from Russian refineries are rising faster than those for low-quality products.

Domestic demand is rising rapidly due to increased consumer spending. The dynamic growth in car sales has led to growing demand for gasoline. Although gasoline use per car is expected to fall, the Russian Ministry of Industry and Energy forecasts overall demand for gasoline to rise by a third by 2015. Since 1998 retail gasoline prices have risen much faster than average consumer prices, thus improving sales margins. The industry's limited capacity to produce high-octane gasoline for cars has led to a pricing premium in the domestic market for gasoline.

At the same time, refining margins have been rising worldwide, driven by a global move towards cleaner fuels. As utilization rates have risen, the long-distance trade in refined products has become an important aspect of the business, increasing the international demand for Russian exports of oil products. As a result, the average capacity utilization at Russian refineries has risen from about 65 percent in 2000 to about 80 percent in 2005, not too far below the average worldwide rate of 86 percent.

The Russian government has adjusted taxes and export tariffs to favor domestic oil refining. Since export tariffs were changed in 2005 to make exports of refined products more attractive than crude exports, exports of oil products have soared, rising above 100 million metric tons (mmt) in 2006 and generating revenues of $44 billion. In addition, tax levels are no longer rising in line with refining depths. Accordingly profit margins for high quality products have become higher, thus encouraging investment in new production technology.

State Control over Strategically Important Sectors of the Economy

As the oil industry is one of Russia's most important and most profitable businesses, it has attracted considerable foreign investment. As a result Russia's oil and gas production accounts for about a third of total foreign investment in the country. In addition, oil refining contributes another 7 percent. The biggest foreign direct investors in the oil industry so far are the participants in the major Sakhalin production sharing agreement (PSA) projects (Sakhalin I and II), concluded in 1996, and British Petroleum, which merged its Russian activities with the Tyumen Oil Company (TNK) in 2003. Additionally, ConocoPhillips has entered the Russian oil industry through portfolio investments and now holds 20 percent of Lukoil. For an overview of foreign investment in the Russian oil industry, see Table 1 on page 15.

However, fears of a sellout to foreigners in strategic parts of the economy have always been a part of Russian political debates and often strike a chord with Russian voters. The population strongly opposes any foreign involvement in strategic sectors of the economy and in the energy sector, in particular. Experts from the state sector, such as high-ranking bureaucrats from the relevant ministries and members of respective parliamentary commissions, are more open to foreign investment in general. But a majority of them speak out against foreign investment in the oil and gas industry (see Graph 1 on page 14).

However, in the 1990s Russia did not pursue a consistent policy towards strategic sectors. On the one hand, this policy was part of a political struggle between liberal-minded reformers in the government and the communist/nationalist factions in parliament. On the other hand, the treatment of strategically important companies was often improvised according to specific urgent needs, including financial ones.

The present economic boom has now made Russia under President Putin much more self-confident. State policies currently seek to increase state control in strategic sectors of the economy mainly through ownership of big enterprises in these sectors, which are then united into a state holding company. Through this state holding company the state can then control the respective economic branch and influence its development directly. State representatives to company boards are state employees either from the responsible ministry or, in the case of chairpeople, sometimes with a secret service background.

What is not yet clear, and subject to controversial debate in Russia as well as internationally, is the way through which the state wants to acquire additional stakes in enterprises it considers to be of strategic importance and the extent to which the state wants to concentrate ownership in the respective sectors of the economy.

As far as the ways to increase state control are concerned, the Russian state has used both civilized and uncivilized methods. While the former clearly prevail across the economy as a whole, the latter have received much greater publicity, particularly because of their application in the energy industry. In most cases the state does not directly acquire ownership, but rather acts through state-owned companies like Gazprom or Rosneft.

The civilized method of increasing control over strategic sectors of the economy is to unite all state shares into one holding company and to let this holding buy additional stakes at market prices, as happened in the case of Sibneft. In addition, ownership by outside (and especially foreign) shareholders is restricted by legal means.

The uncivilized method of increasing state control over strategically important enterprises is based on manipulated allegations of legal wrongdoings (especially concerning tax, safety and environmental regulations), which lead to pressure in the form of bad publicity, office searches and the confiscation of company documents, frozen bank accounts, hefty fines and the arrest of senior managers. This strategy is above all associated with the Yukos case. In addition, the Sakhalin II consortium was put under pressure in order to sell a stake to Gazprom.

In summary, it seems that the state wants to increase its share in the oil industry considerably and rapidly, and therefore uses uncivilized measures, whereas in other branches of the economy deemed strategically important, the state has used more civilized methods, such as creating a “national champion,” which will then be able to compete successfully with foreign investors in the longer run.

The second important question is how much control the state wants to get over these strategic sectors. This question has two aspects. First, how many enterprises can continue to operate without state ownership and second, what will the role of private investors be in state-controlled companies? At present the state does not seem to have a clear answer to these questions. As a result, plans for different branches change rather rapidly, while conflicting concepts are being developed by different state agencies. State acquisitions of strategic enterprises often look improvised. A consistent framework may only emerge after the election period of 2007/08.

Conclusion

It should be noted, that in oil production the state’s share still stands below 50 percent, as Graph 2 on page 14 indicates (though it may increase further if Surgutneftegaz is sold as persistent rumors have it). At the same time, shares of the state-owned Rosneft company have been issued through an IPO. Gazprom, the major gas company which now has acquired assets in oil production, is only 51 percent state-owned. This situation seems to indicate that, on the one hand, the state wants majority ownership in the major oil companies, but, on the other hand, loyal (majority Russian-owned) companies can continue to operate without the state as a shareholder and foreign investors can be active as (friendly) minority owners. However, the government’s present ideas about corporate governance suggest that the performance of Russian state-owned companies may serve to supply arguments in favor of private ownership.

About the authors:
Dr. Julia Kusznir and Dr. Heiko Pleines are researchers at the Research Centre for East European Studies at the University of Bremen, Germany.