

“Wheel of Fortune: The Battle for Oil and Power in Russia”

November 14, 2012

Speaker:

Dr. Thane Gustafson, *Senior Director, Russian & Caspian Energy, Cambridge Energy Research Associates*

Opening Remarks by:

Frank A. Verrastro, *Senior Vice President & James R. Schlesinger Chair for Energy & Geopolitics, Center for Strategic and International Studies*

Discussant:

Edward C. Chow, *Senior Fellow, Energy and National Security Program, Center for Strategic and International Studies*

Moderated by:

Dr. Andrew Kuchins, *Director and Senior Fellow, Russia and Eurasia Program, Center for Strategic and International Studies*

Dr. Gustafson began by providing an overview of the transition from the Soviet oil industry to the present-day Russian oil industry. Following the collapse of the Soviet Union, the Soviet and global oil industries, which had been separate for over fifty years, collided. Since that time, political power and the oil industry in Russia have been locked in a cycle of collapse and revival. *Wheel of Fortune* is, above all else, about the impact of that collision on the development of the oil industry in Russia and the evolution of the political system.

In 1991, the Russian oil industry collapsed, with production falling by more than half. The collapse set off a war for control of licenses, production capacity, and revenues. While many Western observers felt that this struggle for control had led to the independence of the industry, the structure of state control over the oil industry was never truly abolished.

Having bottomed out in the late 1990s, the oil industry took off in 1999 as a result of rising oil prices and the success of the first privatized oil companies in Russia: Yukos and Sibneft. In both, the corporate leadership struck strategic deals with Schlumberger that allowed for the modernization of the companies' technical and management practices. These companies utilized techniques such as fracking and horizontal drilling, which were the precursors to those used in the present-day tight oil revolution.

In 2003 Mikhail Khodorkovsky, the owner of Yukos, was arrested and Yukos' assets were auctioned off at depressed prices to the burgeoning state oil company, Rosneft. The Yukos acquisition tripled the size of Rosneft and have served as the basis for its success ever since. Rosneft was almost privatized three times in 1998. However, Sergey Bogdanchikov, the director of Rosneft during this period, sold the proposition of a national oil champion to both Vladimir Putin and Igor Sechin, setting the stage for Rosneft's emergence. In 2004, Putin appointed Sechin, one of his closest advisors, as Chairman of the Board of Rosneft and since that time Sechin has successfully taken over the company, pushing out Bogdanchikov in 2010.

Over that period, the impact of the first-generation Western oil extraction and production techniques waxed and, ultimately, waned. While Russia quickly adopted fracking, the marginal return in Western Siberia has decreased over time, leaving the oil industry in decline following 2003 and near stagnation in 2008-2009. However, overall production is still increasing due to the contribution of new oil from the Arctic offshore, the Vankor field, and the South Caspian, among others. Nevertheless Russia will face a production deficit post-2015 unless there are major changes in the tax regime and the structure of the industry.

The future will depend on new fields in the Arctic offshore, Eastern Siberia, and South Caspian, in addition to the expansion of production in West Siberia, all of which face much higher costs of production. As such, the rents that have supported the industry and the state will decline or disappear. Meanwhile, the state is becoming increasingly dependent on these oil and gas rents, with a rapidly growing budget of which roughly 40% is covered by oil and gas revenues. It remains to be seen what the impact of this new generation of tight oil techniques will be in Russia or if the structure of the industry will change in the near future. Putin argues that the industry should stay the course of reinvestment through shrinking dividends and profits while contributing to the state budget.

While the industry has been transformed over the last twenty years and has seen dramatic gains in efficiency, the forward momentum has not kept up with the global revolution in the oil industry. It has historically been joint ventures such as those between Yukos/Sibneft and Schlumberger that have led to the breakthroughs that spread laterally throughout the industry. Lately, the drivers of these changes have been TNK-BP and Surgutneftegas.

Discussion:

Mr. Chow began by noting that the recent developments in the Russian oil industry are not encouraging for future development or modernization. The rapid growth of Rosneft into a national oil champion and its acquisition of TNK-BP, which has given it control over 40% of Russian oil production, suggest that the industry is moving in the wrong direction. He then asked Dr. Gustafson to discuss the assertion that Russian policy in the oil industry is at a crossroads and to assess whether the government will need to reimagine its approach.

- There appears to be an adequate level of oil revenue for Putin to support his current system through the end of his third term. However, his ability to do so will be a function of developments outside Russia.
- Beyond Putin's term the situation is more difficult to project, through the prognosis is not favorable for Russia. There are major questions about the future role of oil in the global economy generally. However, arguments can be made in favor of the maintenance of a high oil price over the long term or the rapid decline of the oil price. The real issue with the Russian oil industry is whether or not there will be a 'shock' that will provide the impetus for change and reform to the current system.

Mr. Chow asked Dr. Gustafson to consider how the industry will react to the presence of a dominant company. Will Rosneft leave room for small, medium, or event some large independent producers? What impact will Rosneft's forays into the gas business have on the industry?

- State ownership itself is not the decisive issue. Just as there are uncompetitive, hegemonic national champions that tend not to expose themselves to international markets, there are national champions that are competitive and modern t. The dominant global trend since the 1970s has been nationalization, with close to 85% oil assets currently being held in national portfolios.
- The decisive question for Russia is: how will Sechin choose to run Rosneft? If he chooses to employ the company as a source of rents for the state, it will fall apart. However, if he chooses to

pursue modernization, competitiveness, and reform while seeking out joint ventures with international oil companies, it could flourish.

- Gazprom is the real national champion in the gas field while Rosneft remains an aspirant. Gazprom still maintains control over the entirety of the gas pipeline system. Rosneft would need to wrest control away from Gazprom before it could reach national champion status in the gas industry. Additionally, it is important to note that Rosneft has not historically been a gas company and that only recently acquired a gas business through its purchase of TNK-BP.

Dr. Kuchins asked Dr. Gustafson to assess the realistic prospects for the use of tight oil techniques in Russia and to extrapolate out what impact would be.

- Tight oil depends on three technologies: hydrofracturing, long horizontal drilling, and the utilization of microseismic technology to guide the drill. While Russians have been using all of these techniques from day one, they remain approximately five years behind the global standard.
- The United States also boasts one advantage that truly unlocks U.S. potential: best practices in management. Good management allows for customization of techniques and oversight to unlock potential while keeping costs low.
- The potential for Russian tight oil might be held back by the deficiencies of management and industry structure in their system.

Dr. Kuchins asked Dr. Gustafson to expand on Surgutneftegas' development of tight oil in Russia and whether their tight oil capabilities are homegrown or imported from the West.

- No company in Russia is doing tight oil as we have come to understand it in the United States, though companies are gearing up to attempt to replicate it. These techniques could come into use within the next twelve months.

Dr. Kuchins asked Dr. Gustafson if Putin and Sechin understand that it has been small- and medium-sized companies that have led the revolution in tight oil in the United States.

- They do not seem to understand this. However, it is important to note that we are about to see the development of a set of tight oil ventures that will say much about the future of those techniques in Russia. A joint venture between TNK-BP and Schlumberger, Lukoil's tight oil program, and a West Siberian tight oil venture headed by ExxonMobil and Rosneft will demonstrate Russia's tight oil potential.
- While we have recently heard quite a bit about the Arctic offshore in Russia, the returns there are longer-term, less certain, and more expensive. Russian oil executives are more likely to pursue tight oil in Western Siberian, as the technology is revolutionary, the infrastructure is already in existence, and the returns are both more certain and on a shorter timetable.

The seventh question asked Dr. Gustafson to analyze the potential for state revenues from oil and gas to decline in the short term and the effect that would have on Russia.

- Such a decline is certainly possible given present trends. However, it all depends on the oil price. We should watch for external factors that could influence that price, most notably the situation with Iran and the potential for protracted conflict in the Middle East.