

The Russian Oil Industry

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Russia is the world's second oil producer. If we take into account that oil prices in the world market are currently at their highest levels, the sector's situation has special international relevance. In contrast to the gas sector, a large part of the Russian oil industry was privatised at the beginning of the 1990s, after the fall of the Soviet Union, parallel to which the Kremlin's politicians during Boris Yeltsin's reign liberalised the internal oil market, as well as the market for its derivatives. Foreign investors were at this time allowed to play an important role within this sector, both in the extraction of oil as well as in its refinement and distribution.

However, with the rise to power of Vladimir Putin a different policy was put in place, with progressive state control over the production of oil used as a political tool, both externally as well as internally. Oil had become not only the source of the extraordinary individual wealth of the so-called oligarchs, but had also encouraged others to foster expectations of direct business interference in the country's internal politics. By controlling oil, Putin sought internal stability, desired by the majority of the Russian people. At the same time, state control of gas and oil supply became an unquestionable vector of external influence, not only within ex-USSR countries and in the geographic area of Russian influence, but also in Asia and Europe. With oil and gas the country has recovered its political prominence on the international stage. The destination of exports of these two products has become the government's foreign policy (China, Ukraine, EU, Japan...), and has even led to the initiation of policies that could lead to the creation of cartels of gas producers, for example. This return to political prominence on the international stage is very much appreciated by the Russian people.

Consequently, the excessive privatisation processes of the Yeltsin era are slowly changing tack, along diverse paths. Oil is thus a very political

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Russian sector of the oil refinement market

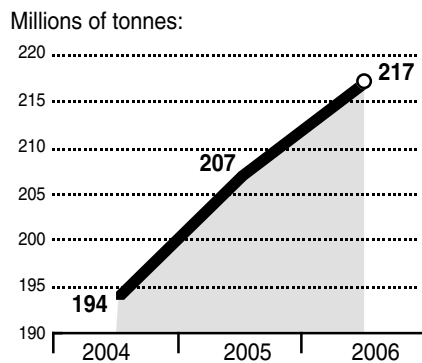
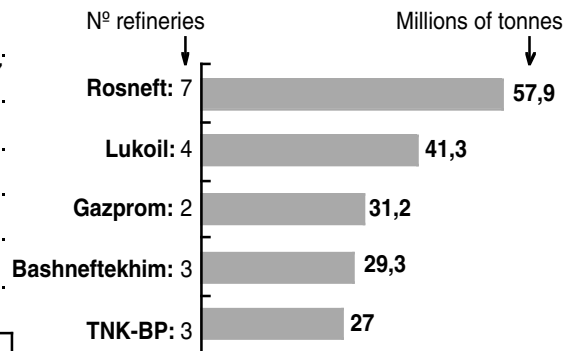
28 large refineries:

Capacity: **255 TMA**
 Load radius: **80%**
 Conversion level: **73,3%**
 Small refineries: **43**

Nearly all the refineries are located far from the Nation's borders and the oil export terminals

Product quality:

Automobile petrol Euro-1
 Diesel Euro-1
 Lubricants of obsolete grading

Processing of oil,

Large refining companies:


Source: OAO VNIPIneft.

issue in Russia, but it is also necessary to bear in mind that progressive control by the state over this sector may hinder its economic efficiency.

Oil production and exports

Although Russia is the world's second producer, behind Saudi Arabia and the United States, it only possesses 7 per cent of the world's verified oil reserves. It is possible that Russian production will continue to grow from now until the end of this decade, although future forecasts are more pessimistic, mainly due to four reasons: firstly, accessibility to the reserves is limited. It is probable that Russia may have large reserves, but they are located in very remote regions with very unfavourable geological and climatological conditions, meaning that evaluation, extraction and inclusion in the verified calculations of oil companies is difficult. Secondly, investment in exploration and production has not been significant during the last few years. Many of the so-called oligarchs that acquired oil companies during the 1990s preferred to use the huge profits received to buy other businesses (real estate, aluminium factories, etc.) instead of investing in production. Thirdly, an important increase in government taxes has not exactly stimulated Russian oil production. Lastly, the state's increasing control over the oil industry during the last few years: combined with restrictions on foreign investment, the state's interven-

tionism and the frequent changes and vagueness of the legal framework have placed the sector's efficiency at real risk.

Oil exports are also facing important challenges. Almost 67 per cent of Russian exports are today destined to the European Union. However, the Russian government wants to diversify its client portfolio, and is directing attention towards Southeast Asia and the United States. As a result of this policy, it is calculated that by 2020 only 50 per cent of Russian oil exports will be destined to Europe, while America and Asia will rise from the current 3 per cent to almost 30 per cent. This geographical orientation will imply an important increase in production, but also involves ambitious transport projects, in particular pipelines. The limitations and deficiencies of current pipeline infrastructures force Russian exporters to transport 50 million tonnes a year via railroad or barges. This type of transport increases costs per barrel between 5 and 7 dollars.

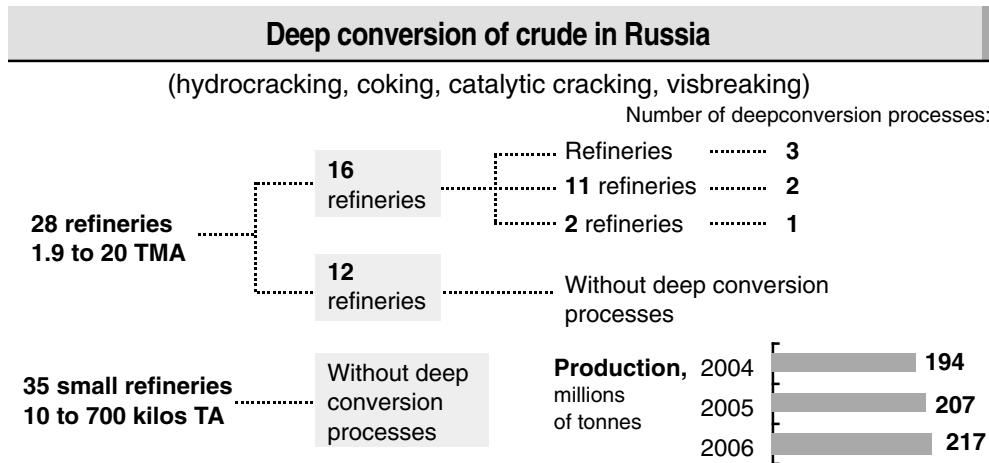
The domestic market

Domestic prices of oil and its products were liberalised in 1992, thus legally the Russian state influences them indirectly, and does not regulate them.

However, this indirect influence is considerable. The state has recovered ownership of important oil companies and, in addition, controls the infrastructure for transporting the crude; this entails that the government can determine prices, and has political control over them. On the other hand, an important component of the price is tax, and these are established by the state. Additionally, the special tax on exports of crude and its derivatives has a decisive direct influence on the decision of a producer to export or sell it on the local market. Finally, the state pressures private oil companies to lower their prices, both with anti-trust investigations, as well as through 'conversations' between the Ministry and the companies. Domestic prices are thus established within a quasi-monopolistic environment.

The privatisation of the oil industry during the 1990s was based on vertically integrated companies concentrated within regions. As a result, these companies are clearly monopolistic in many regions of Russia. In those regions they establish retail prices, although there are also independent traders. Given their power, oil companies interfere with the regional authorities who, at same time, protect their dominant position within the market. Reports from the almost unheard of Russian Anti-trust Commission establish that in two thirds of Russia's regions the market for oil products is monopolistic or oligopolistic.

However, compared with other regions in the world, wholesale oil prices are not excessive: they are generally in line with world export prices (notwithstanding, high octane petrol is comparatively expensive, in view of



Source: OAO VNIPlneft.

scarce production and high demand). Normally these monopolies do not act in an abusive manner, and the increase in the prices of products in Russia is mainly due to the pull from international prices. The difference between wholesale and retail prices in the country is essentially due to the high cost of transport, as a result of the country's gigantic dimensions, and to the small number of refineries, more than as a result of the monopolistic behaviour of companies.

Oil refinement

Although vertically integrated up and downstream, during the 1990s most Russian companies concentrated on the profitable extraction of crude, given that their revenues essentially stemmed from exports. The domestic market was not attractive due to low prices, and because state bodies frequently did not pay. Additionally, relatively high tariffs in the export of products, with the objective of guaranteeing domestic supply, as well as growing taxes, discouraged investing in refinement. Outdated refineries were closed rather than modernised. During the last ten years, the aggregate capacity of Russian refineries has fallen more than 20 per cent. And what remains is in urgent need of modernisation. As a result of this lack of investment, refineries work to 73 per cent of their capacity, and with regards to light products this falls to 55 per cent (the OECD average is 90 and 75 per cent, respectively). Only five Russian refineries operate at 80 per cent. However, the situation is rapidly changing. The increase in demand for refined products, both domestically as well as internationally, together with the increase in the margins for high quality products, is pushing companies towards improving their refinement capacity.

Due to the growth in Russian consumption, domestic demand for refined products is rapidly rising. The increase in the number of cars, for example, has increased the demand for petrol. It is calculated that by 2015 demand will increase by 30 per cent. Since 1998 retail petrol prices have risen faster than the Russian CPI, and thus sales margins have improved. Imports of automobiles require the production of high octane petrol and, therefore, prices of this scarce product have increased spectacularly. In view of the foregoing, since 2000 we have observed a change in the previous trend, and an improvement in the quality of the products, although not at the rate at which this is occurring in other countries. The Russian government is decisively using taxes and tariffs to support the domestic production of refined products. Export tariffs were changed in 2005 so that refined products could become more attractive than crude, a measure which has provoked an increase in the exports of refined products, reaching a level of 100 million metric tonnes in 2006, and generating 44,000 million dollars in revenue. The increase in the domestic market and the fact that exports are favoured has meant that refineries have begun to improve their whole refining infrastructure, investing more in technology.

State control over strategic sectors of the economy

As a result of its being one of the best businesses in the Russian economy, during the last 15 years oil and gas extraction has attracted considerable foreign investment. Thus, a third of all foreign investment in Russia is directed at this sector. Furthermore, another 7 per cent is directed at the refining industry. The largest direct investment (carried out in 1996) was for the projects of Sakhalin I and II by British Petroleum, which in 2000 merged its activities with Tyumen Oil Company (TNK). At the same time ConocoPhillips acquired 20 per cent of Lukoil.

However, the fear of the possibility of foreigners controlling a strategic sector of the economy, as is the oil industry, has become a very active part

GLOBAL SITUATION OF DEEP CONVERSION PROCESSES

Process	Per cent of production			
	Russia	Western Europe		Japan
		USA		
Catalytic cracking	6.7	15.8	35.8	17.1
Hydrocracking	1.9	7.5	9.1	3.5
Coking	2.0	2.5	16.2	2.1
Visbreaking	2.0	12.2	0.2	-

Source: OAO VNIPIneft.

of political debate in Russia. The population is definitely opposed to these investments. And although experts within the ministries and high-ranking bureaucrats are more receptive to foreign investment, public opinion has weighed heavily. The

Deep conversion processes	
Catalytic cracking (11 refineries of 27)	5 refineries have outdated bead catalyst units
	6 refineries have microspheroidal catalyst units
Hydrocracking (5 refineries of 27)	Mild hydrocracking: 1 unit (Ryazan)
	High pressure hydrocracking: 4 units (Perm, Yaroslavl, Ufa, Angarsk)
Delayed coking (5 refineries of 27)	No units have been built during the post-Soviet period
Visbreaking (6 refineries of 27)	Temporary solution to increase the crude conversion level

Source: OAO VNIPIneft

privatisation of the oil industry has been a political weapon between the different factions of Russian politics since 1990, with confrontations between the liberal reformers, at the time in the government, and communists and nationalists, a battle that has taken place both in the Duma as well as in the press. With the change in the political situation, the idea began to assert itself within government that it was necessary to control the foreign presence in such a prosperous sector.

The Russian economic boom guaranteed the internal position of Putin and his political control. One aspect of this is the growing control of

the state over the so-called strategic sectors, preferably through a return to state ownership of the largest companies. Oil without a doubt is one of the most strategic: the formula used is the creation of a holding company via a public company, with shares that enable it to directly control an economic sector. In these holding companies, the state's representatives on the Boards of Directors are public servants from the ministry responsible, many of whom have training within the Russian intelligence services. This change in policy has led to a heated debate, not so much in Russia as overseas, given that in Russia public opinion coincides with the government in considering the oil sector strategic.

Controlling oil as a strategic sector has been done through various methods. Most of the time the state does not make a direct acquisition, but rather uses a state-run company like Gazprom and Rosneft, which are currently overflowing with financial resources. Thus, the state's participation in the sector is placed in the holding company, and the latter continuously acquires, at market prices, shares in the strategic sector, as occurred with Sibneft. Additionally, the presence of foreign investors is restricted with legal measures. This is the usual system. Notwithstanding, other methods have received quite a lot of publicity, especially abroad – methods that are not as clear, and which are based on investigations regarding tax irregularities or environmental breaches, involving the inter-

vention of the District Attorney's office and judges. Company documents are confiscated, accounts are frozen, and in the end the owners and managers are arrested, as in the case of Yukos. This course of action, although to a much lesser extent, was employed in the case of the Sakhalin II Consortium, with the foreign investor eventually selling out to Gazprom. However, these methods are exceptional and the approach of the holding company buying shares on the market is the most common course of action.

The question is: what level of control does the Russian state seek within the strategic sectors? We can divide it into two parts. How many companies can continue operating without state control? And secondly, what is the future role of private investors in state-controlled companies? For now the Russian government has not clearly articulated its response to these questions. In the absence of a clear decision from the central government, plans change depending on the sector and region, according to the variable zeal of the state agencies involved. Possibly this policy will become clearer and consistent.

Conclusions

The state currently controls just under 50 per cent of the oil extraction sector, although if Surgutneftegaz is acquired by the government, as persistent rumours indicate, that figure could increase. However, at the same time, the state company Rosneft has been listed on the Stock Exchange, and Gazprom, the world's largest gas company, which moreover is controlled by the state with a 51 per cent stockholding, also supervises oil-producing companies.

For now all indications are, on the one hand, that the Russian state wants to obtain control of the majority of oil companies – even though it allows private Russian companies to operate in the market without the need for public control (provided they are loyal); and on the other, that foreign investors may be present with a minority stake, provided their attitude is friendly. This is the current not too broadly defined management outline, but the predominance of Russian state-run companies and, in particular, their management as currently exercised, may make it more necessary in the future for more private management processes to be employed, in the search for greater efficiency within the oil sector.