The future of Russian energy policy

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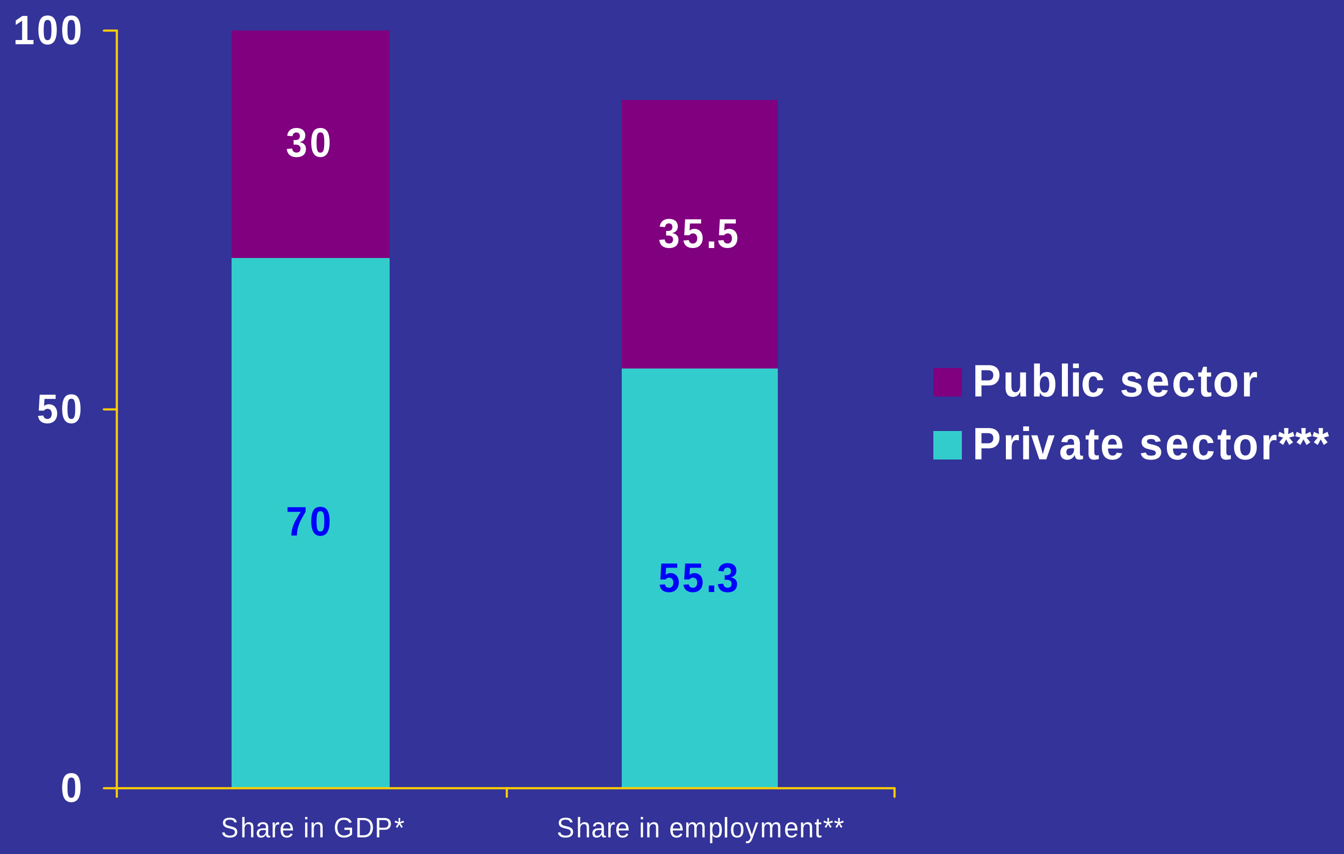
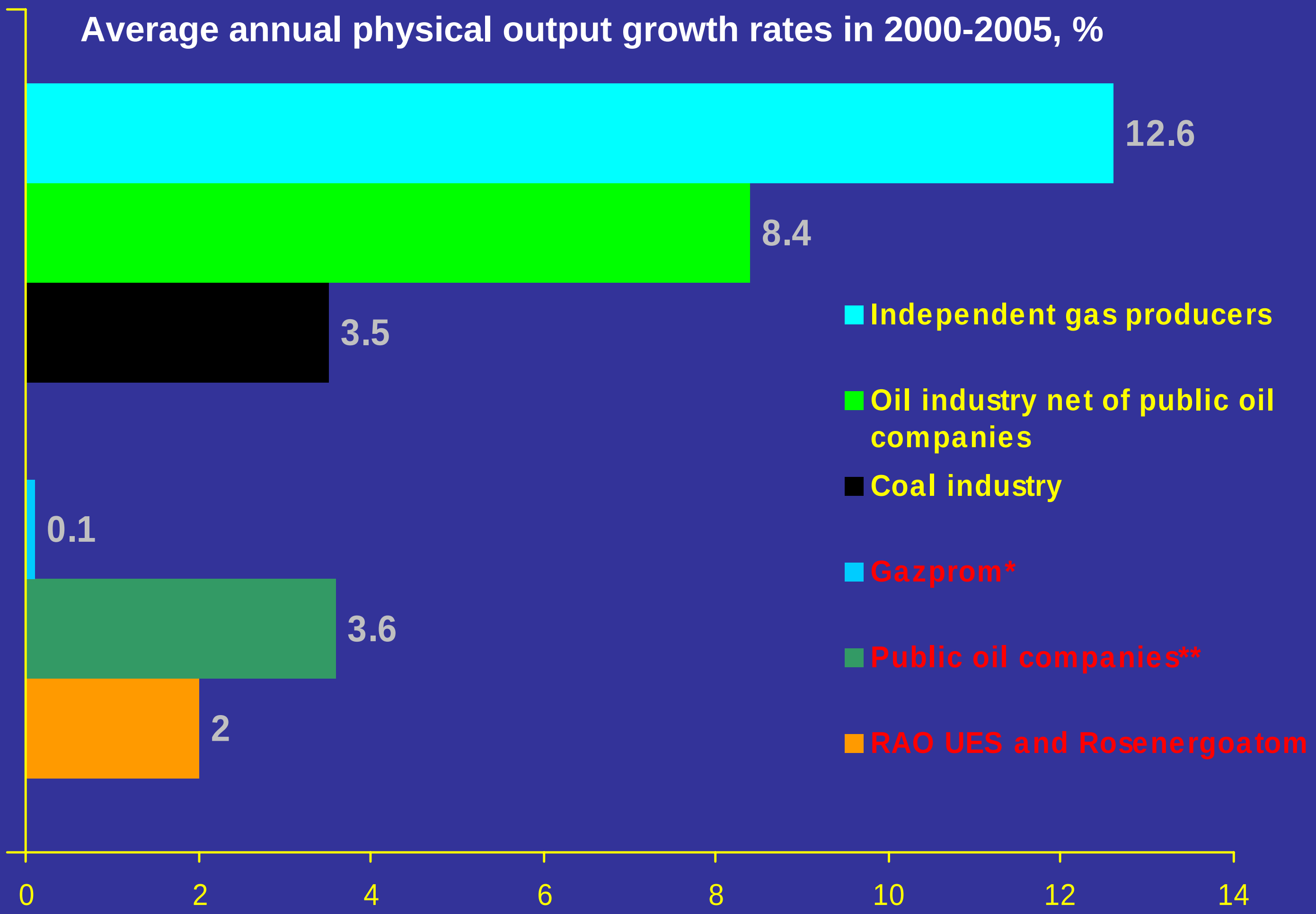
The present: the 'Two Russias' from the economic point of view



Data: 2004. Sources: *EBRD Transition Report 2006; ** Rosstat

*** Including Russian private and foreign owned enterprises; excluding mixed ownership enterprises

The ‘Two Russias’ in the energy sector: private versus public



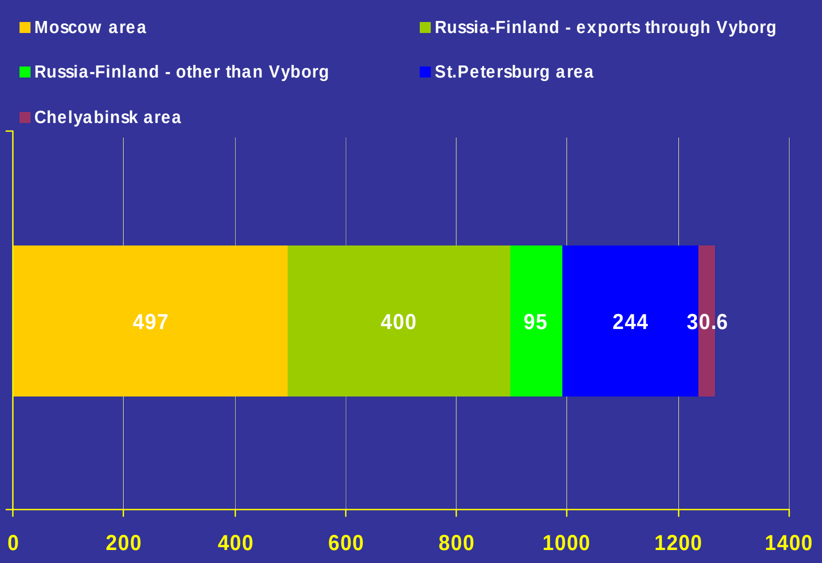
Source: Rosstat, CDU TEK, RAO UES, Rosenergoatom, Gazprom, BP

* Natural gas production only

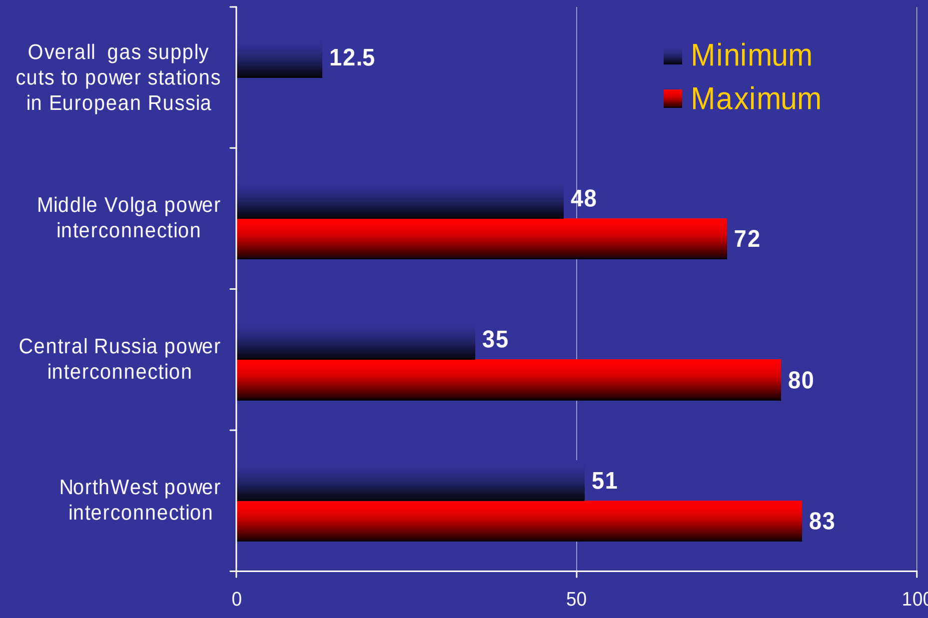
** Rosneft net of Yuganskneftegaz, Tatneft, Bashneft, Gazprom (oil production only)

Power and gas supply shortages in public energy sector: energy weakness of the ‘energy superpower’

Power capacity cuts to consumers by RAO UES during cold temperatures of January-February 2006, MW



Gas supply cuts to Russian power stations during cold temperatures of January-February 2006, % of contractual supply volumes



Source: RAO UES

Shift in Government's policy agenda in 2000-2006

Before 2003

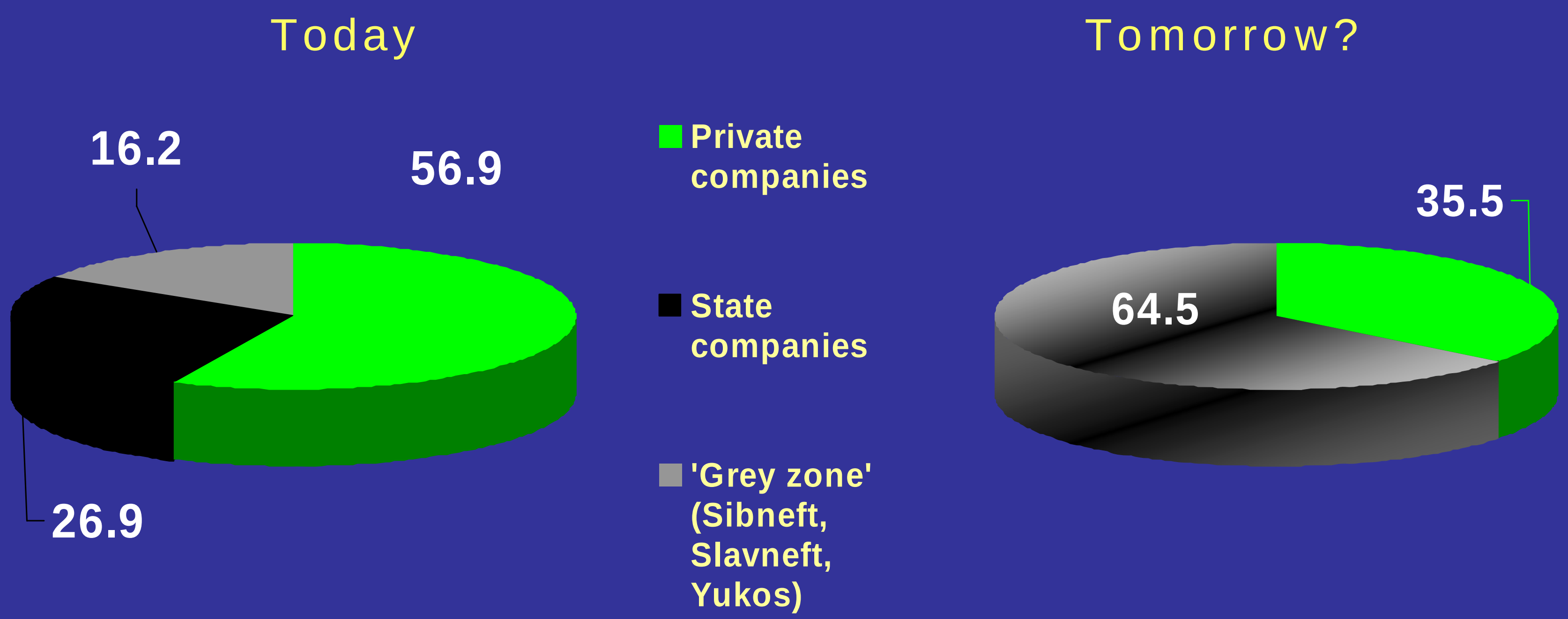
- Assertive privatization of the remains of public sector
- Improvement of business climate for private sector, removal of regulatory barriers
- Reduction in Government spending
- Encouraging FDI
- Market restructuring of public monopolies
- Largely, liquidation of the non-market sector and separation of economic interests and regulatory functions of the Government

After 2003

- End of privatization
- Shift to 'national champions' strategy
- Increasing role of Government in economic affairs
- Increasing Government spending
- Restrictions on FDI
- Failure to separate regulatory functions and economic interests of the Government
- Active arbitrary use of state's regulatory powers in order to advance market positions of state affiliated companies

Recent developments: least efficient public sector expands at the expense of more efficient private sector

Structure of Russian crude oil output by ownership type

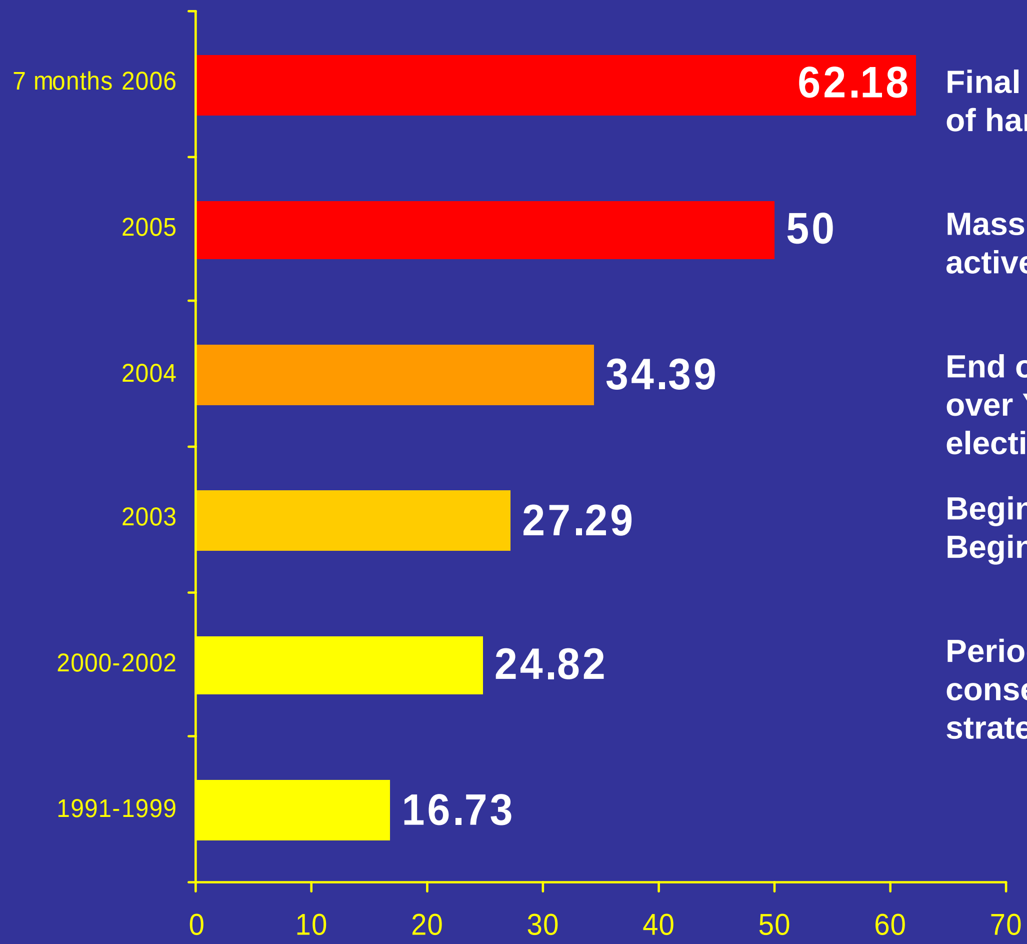


Source: Oil & Capital; * estimate

Who's next and when? Yukos? TNK-BP? Surgutneftegaz?

Why change?

Average Urals price in various periods of modern history, USD/bbl (money of the day)



Final closure of the reform agenda. Institutionalization of hardline foreign policy agenda

Massive dismantling of political freedoms, transfer to active paternalist state policies

End of economic reforms. Establishment of control over Yuganskneftegaz, abolition of governors' elections

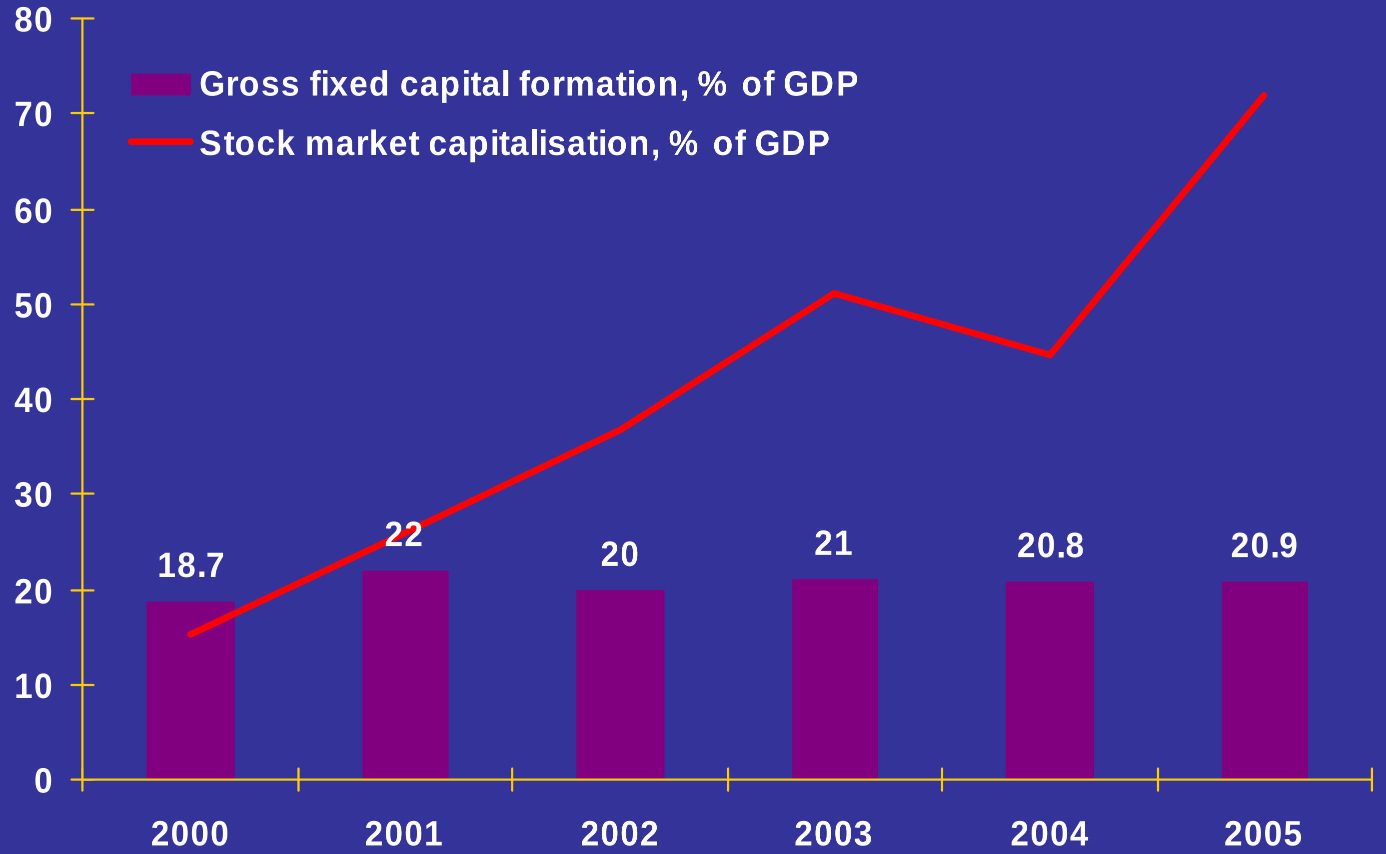
Beginning of dismantling of economic reforms. Beginning of Yukos case, arrest of M.Khodorkovsky

Period of not very active flirt with reforms. Clear lack of consensus among decision makers on the country's strategic direction

Source: The Wall Street Journal

The consequences of policy shift: increased risks, market bubble instead of modernization

Where Russian market players prefer to invest: fixed capital formation vs. acquisition of shares



Source: The World Bank, EBRD

How the success of the Russian privatization is misunderstood in the West

Photo: Rose Lincoln

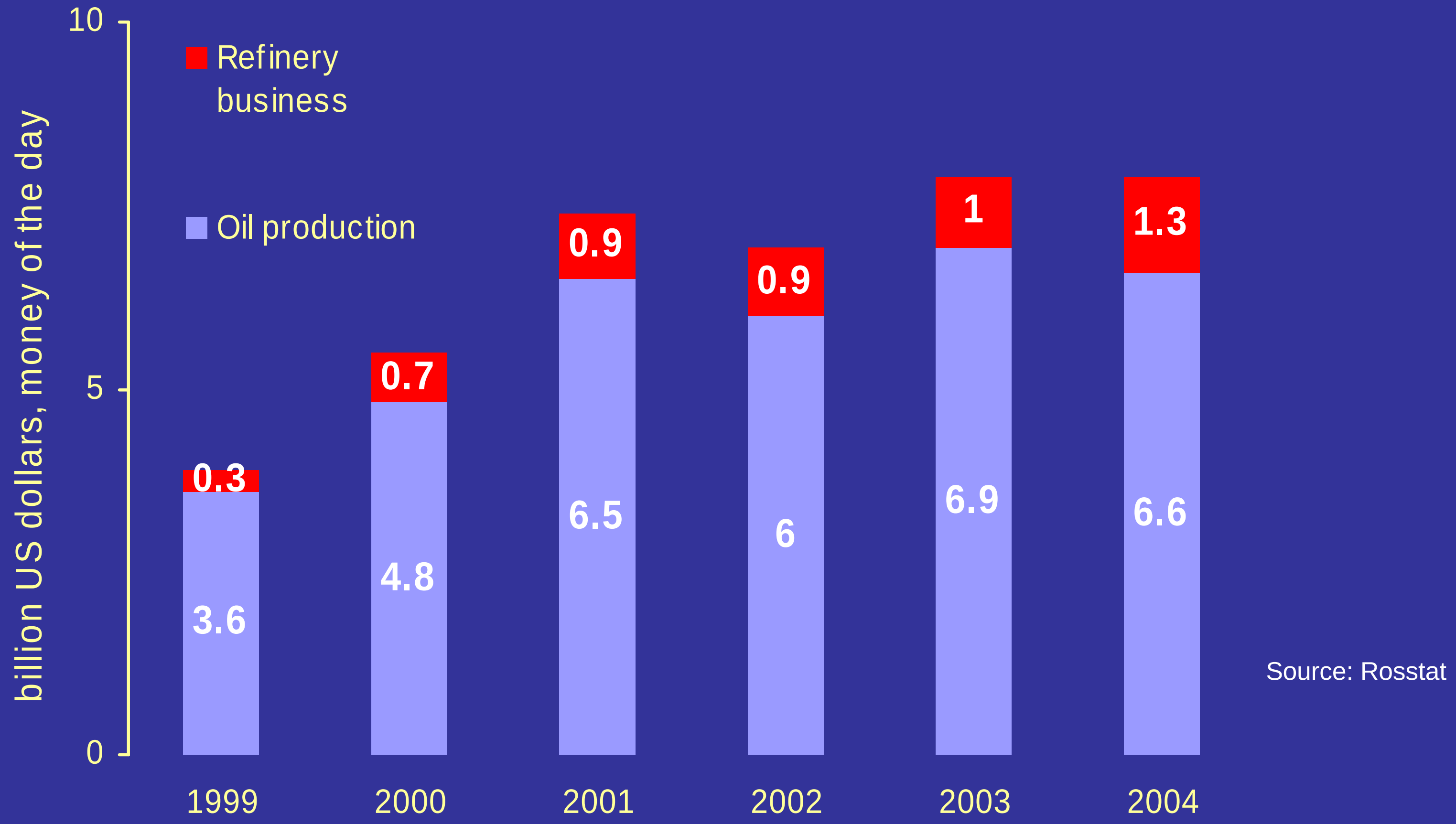
"Russian oligarchs did nothing but send all the money they could outside the country'.

Dr. Marshall Goldman, Davis Center for Russian and Eurasian Studies, Harvard University

From a letter to the Editor of the 'Foreign Policy' magazine, March/April 2006

DID THEY REALLY ?

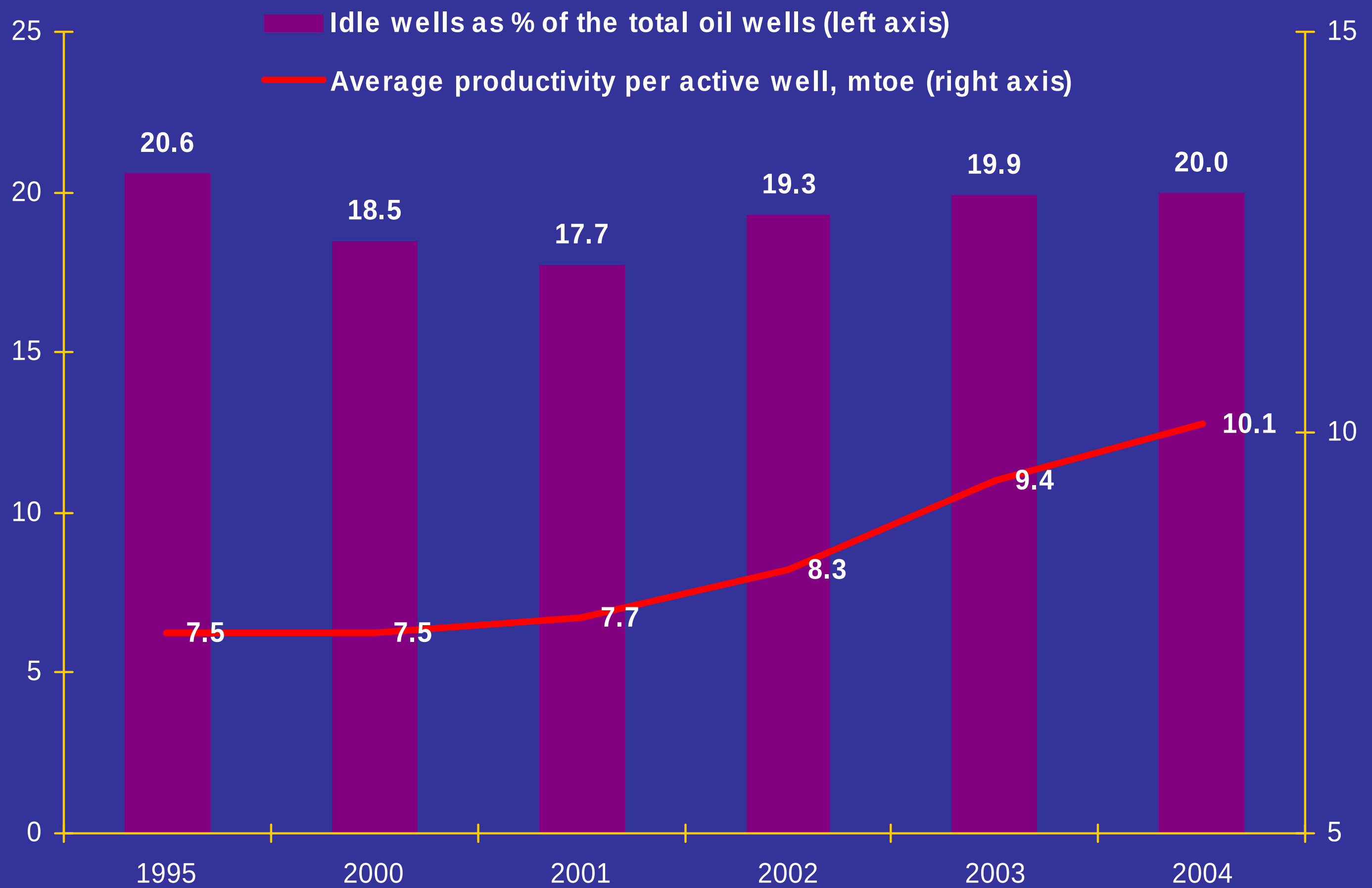
Capital investments by the Russian private oil companies in 1999-2004



CUMULATIVE USD 39.5bn IN 6 YEARS IS NOT A BAD RESULT AT ALL...

Was the impressive oil production growth in 2000-2005 'picking of a low-hanging fruit' or a result of large scale investment?

Some performance indicators of the Russian oil industry, 1995-2004



Source: Rosstat

Russian privatization of large industries was unfair and corrupt.

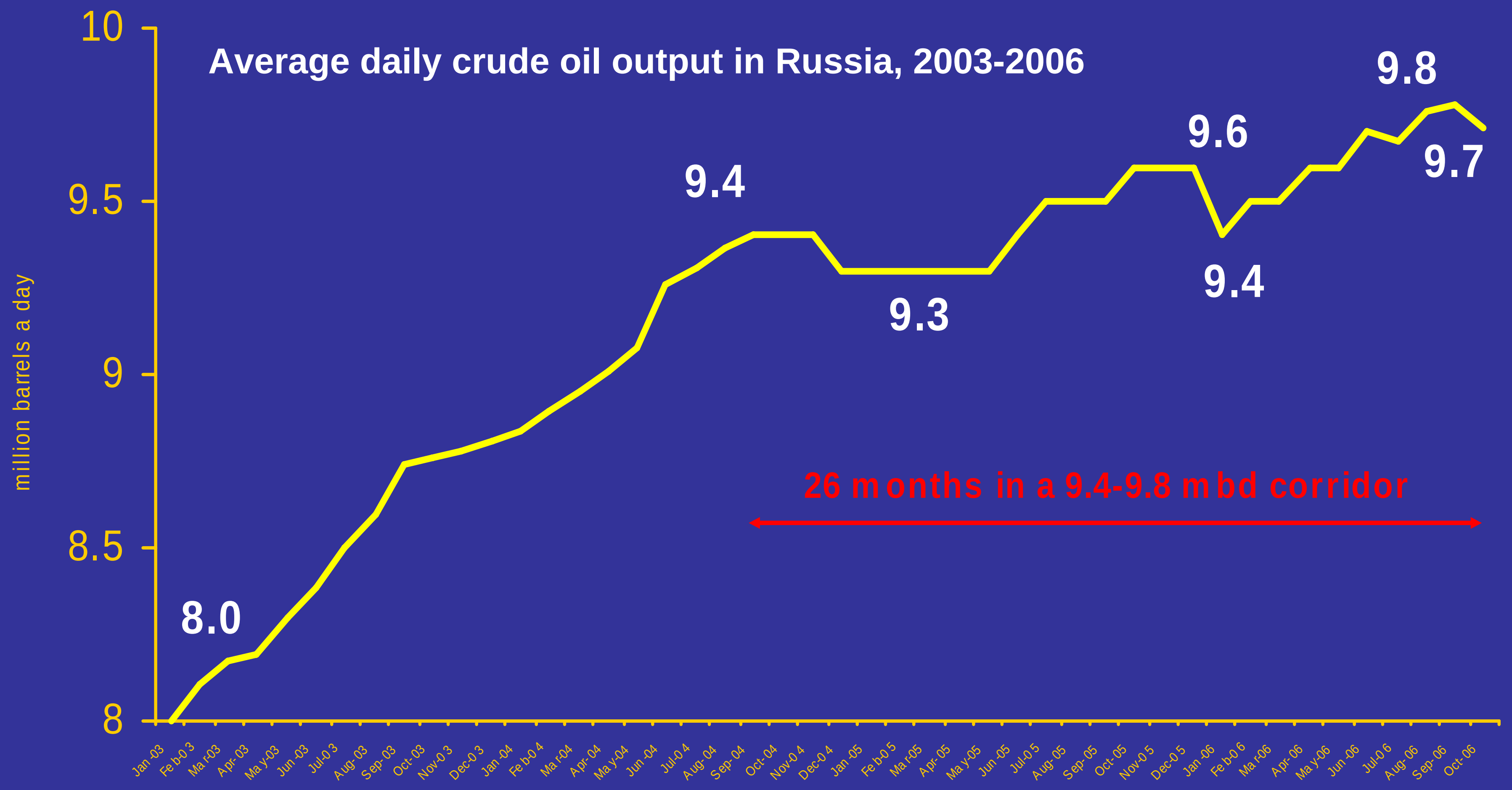
But, it had helped to establish competitive private sector, and promote efficiency and development.

The achieved oil output growth was the result of large scale investment and improved productivity, not of the ‘low hanging fruit’ picking

Oil & gas: picture of stagnation and tough struggle of the efficient private sector for survival

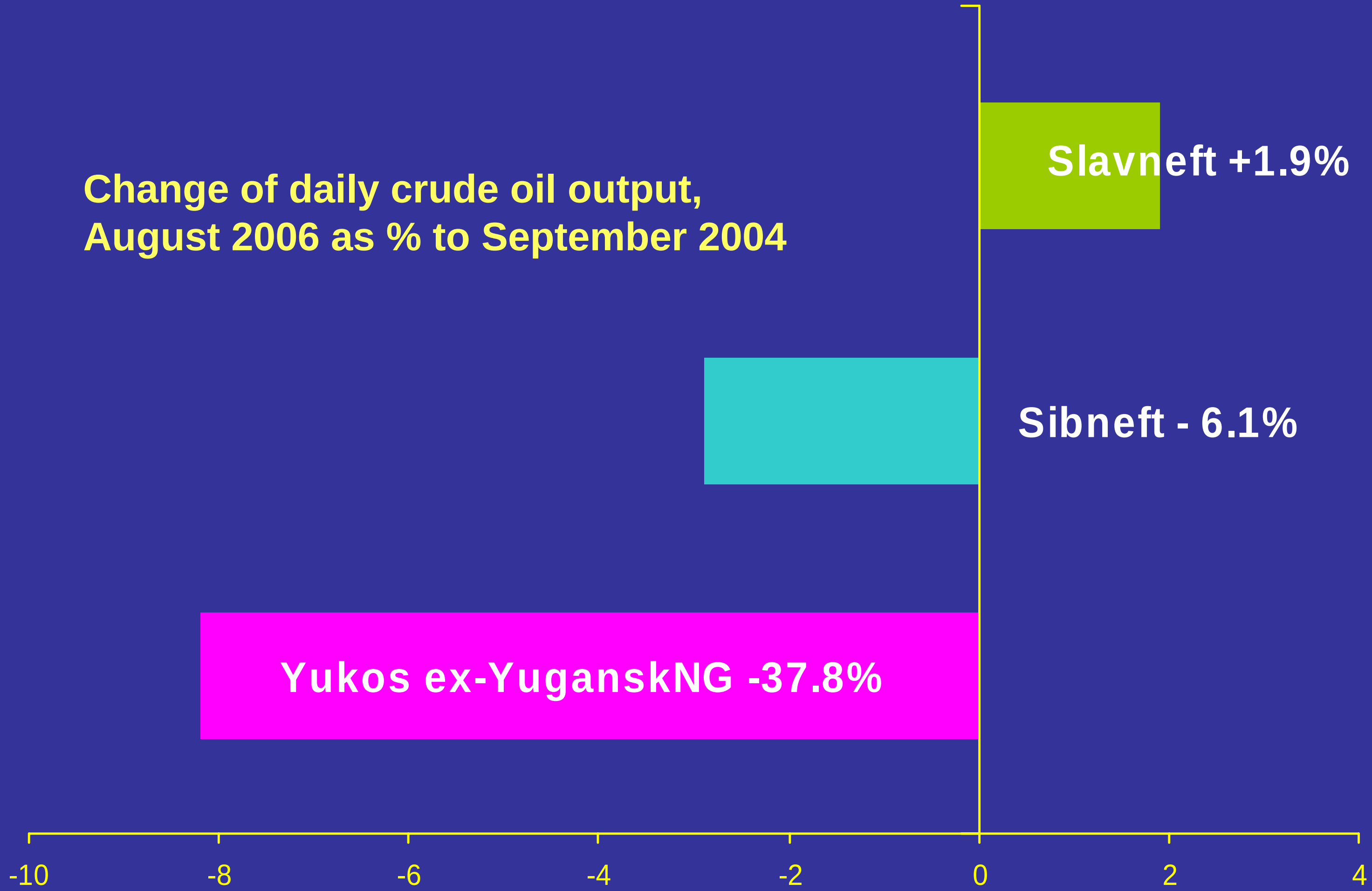
- Asset redistribution in favor of the state-affiliated companies in oil and independent gas producer sectors contains growth
- In oil, production stagnates; in gas, it is about to start to severely decline
- The potential of growth is there, but this is contained by state’s policies and market expansion of the state-affiliated companies

Oil: no room for optimism on future crude output



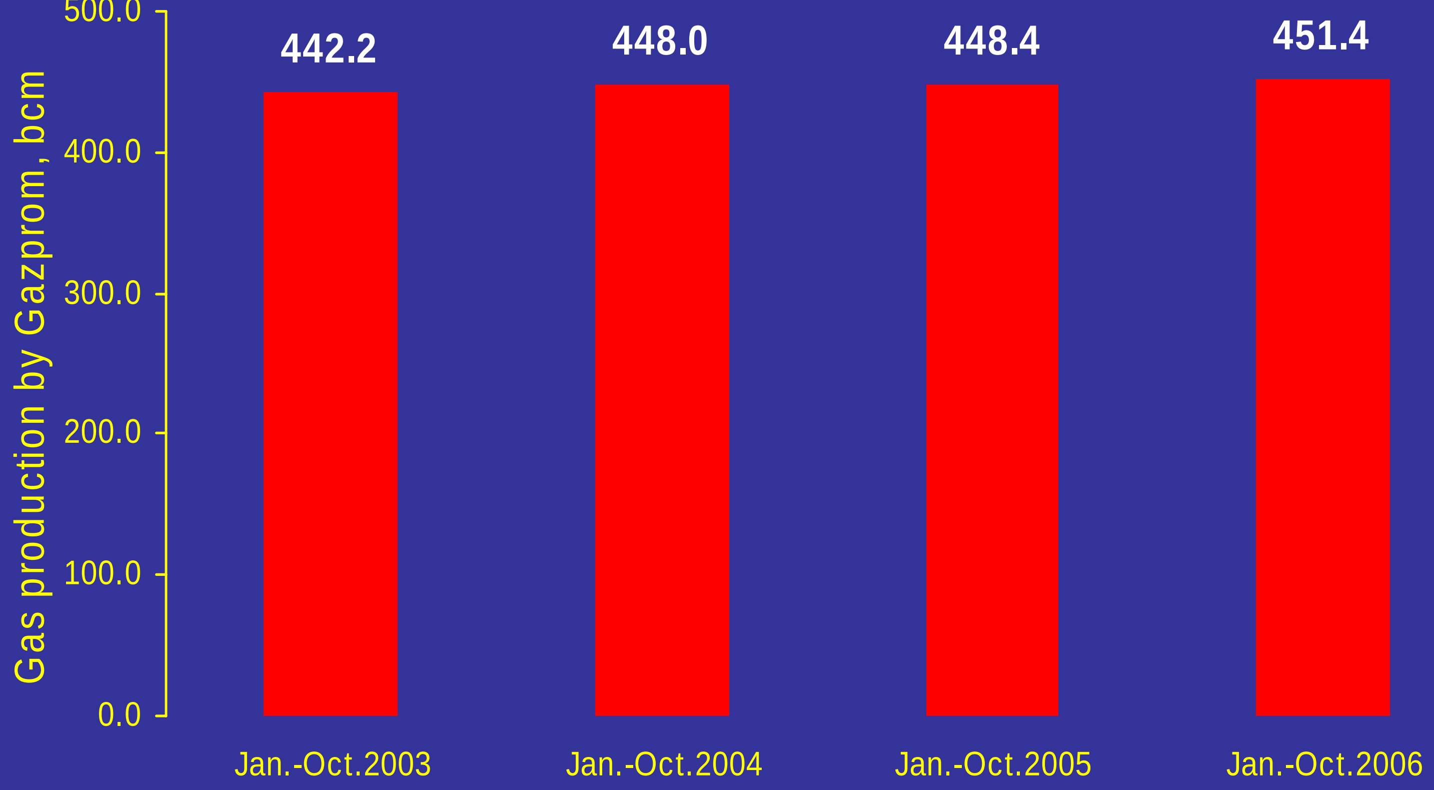
Source: Oil & Capital, CDU TEK

Companies affected by ownership changes were the leaders of output decline in 2004-2006



Source: Oil & Capital, CDU TEK

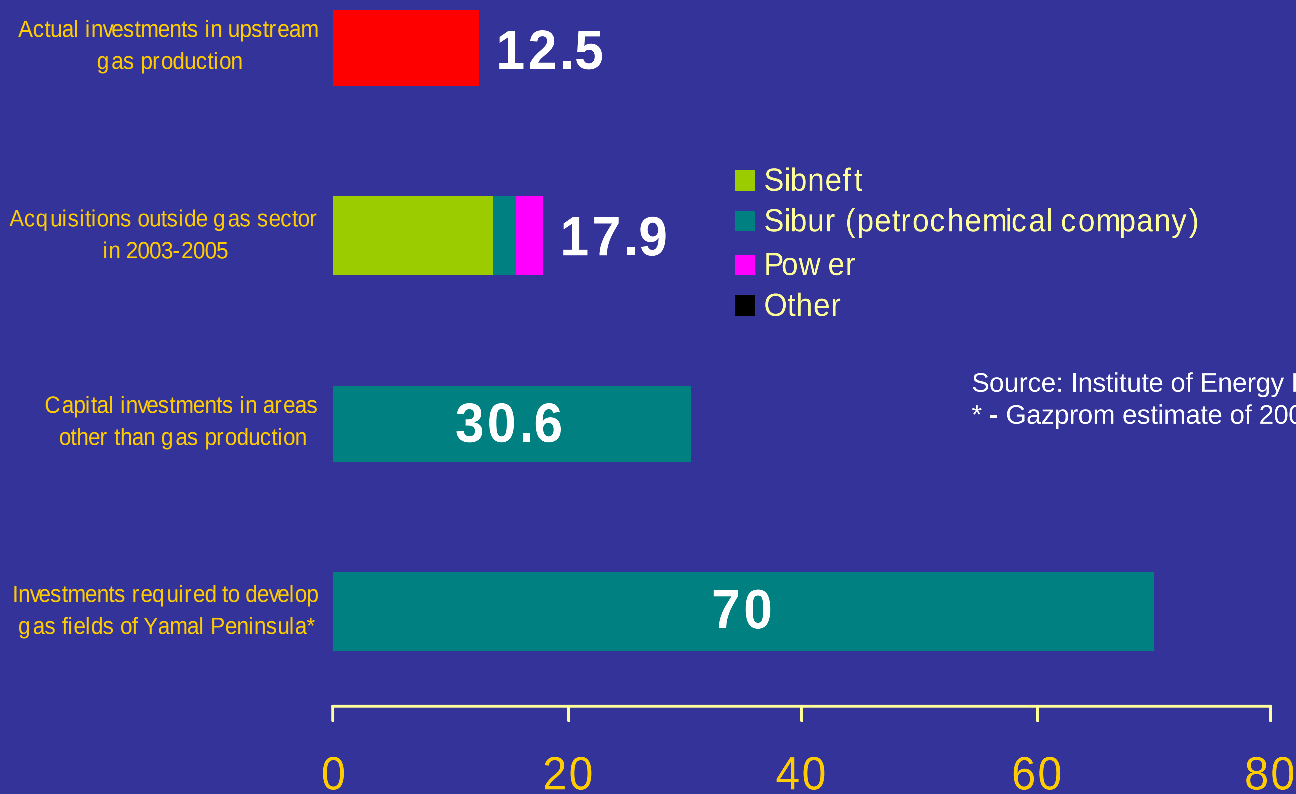
Gas: stagnation in upstream continues



Source: Institute of Energy Policy

Will Gazprom invest more if domestic prices rise?

Cumulative capital investment by Gazprom in 2000-2006, USD bn (money of the day)



Source: Institute of Energy Policy, Gazprom data.
* - Gazprom estimate of 2002

Who's next? Mosenergo? Yukos? TNK-BP? Centrica? RWE? Scottish Power?

In the monopoly environment and under strong state protection, Gazprom will not invest in production development, even if domestic gas prices in Russia will rise substantially.

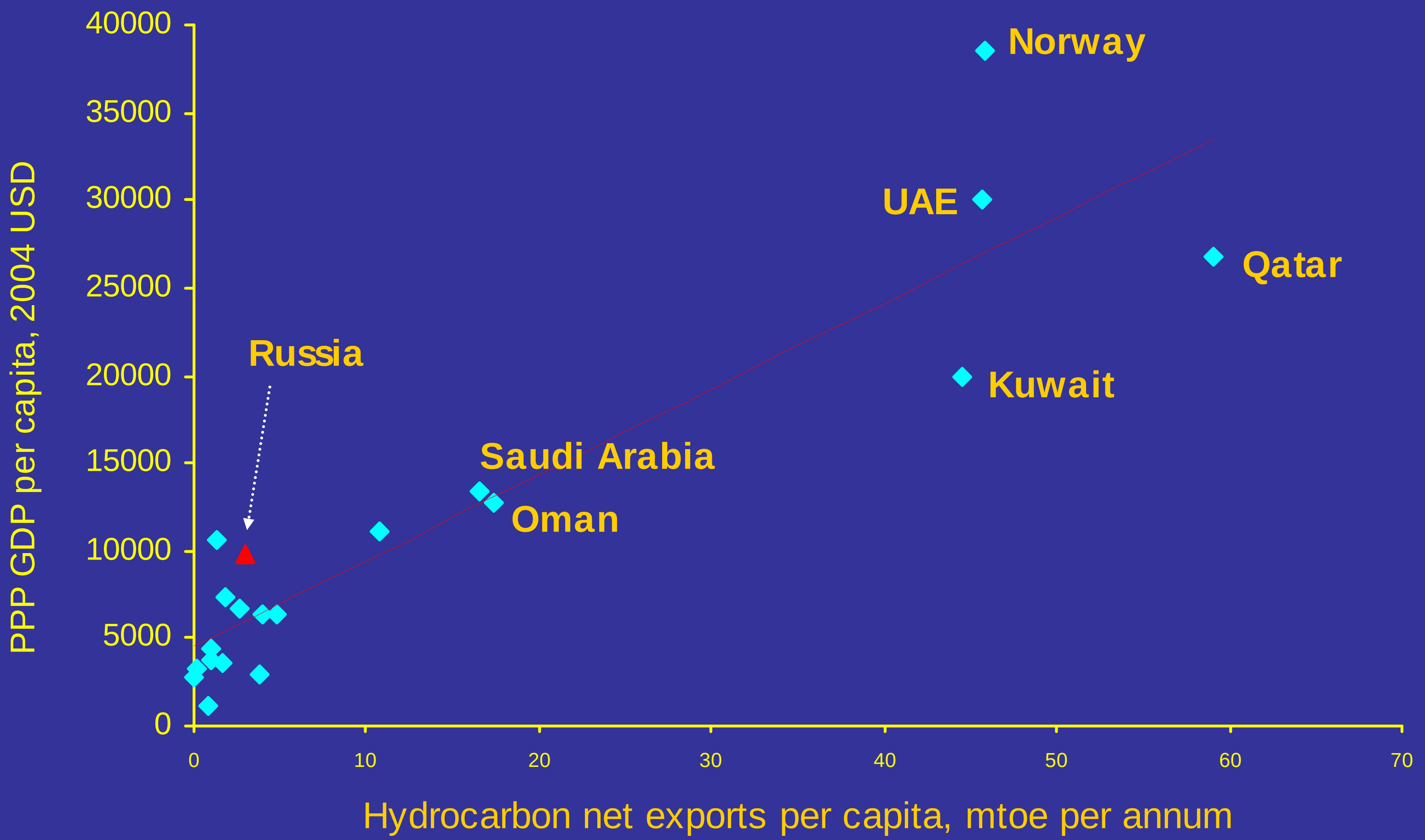
Policy towards FDI: ‘protected territory’ tactics

- Support of market expansion of the state-affiliated companies at the expense of
- Little tolerance for historic agreements (Sakhalin, Caspian Pipeline Consortium)
- Active and arbitrary use of regulatory powers (taxation, environmental protection) in order to create market advantages to state-affiliated companies

Sakhalin-2: does environment matter?

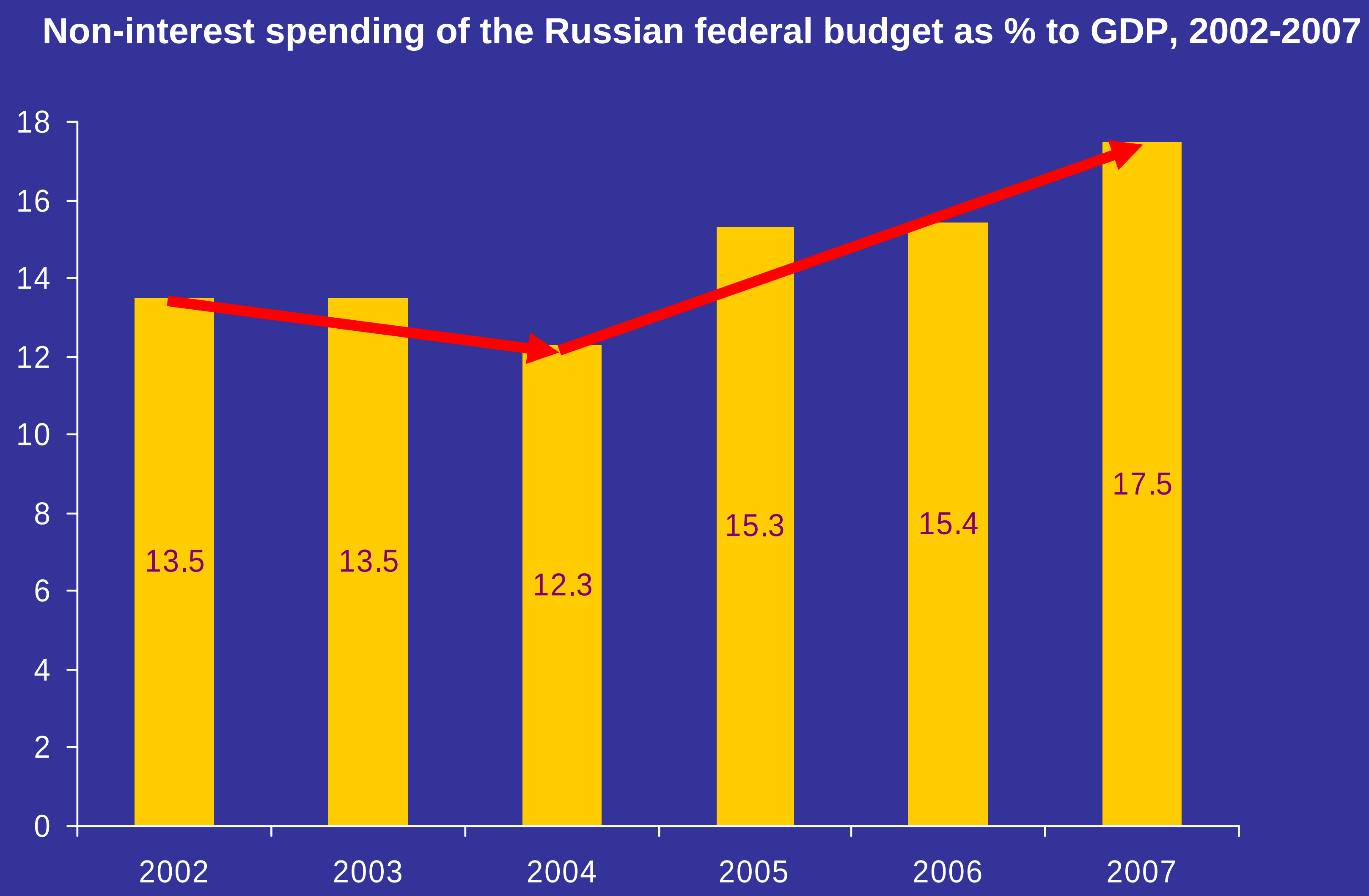
- WHY Government was silent on environmental problems of Sakhalin-2 for years and raised attention only when Gazprom became interested in entering the project at lowest possible cost?
- WHY revoke environmental permit completely, when most of the environmental damage is curable?
- WHY environmental approvals were easily issued for far more environmentally damaging projects such as Eastern Siberian oil pipeline route passing by Baikal lake shore?
- WHY everyone talks about low efficiency of the PSA, but no one is reconsidering it before Gazprom's project entry? WHY environmental claims and not the actual reconsideration of the PSA?
- ISN'T Russian Government simply using it's regulatory powers to help advance market positions of the affiliated companies?

Can Russia build a successful paternalist economy?



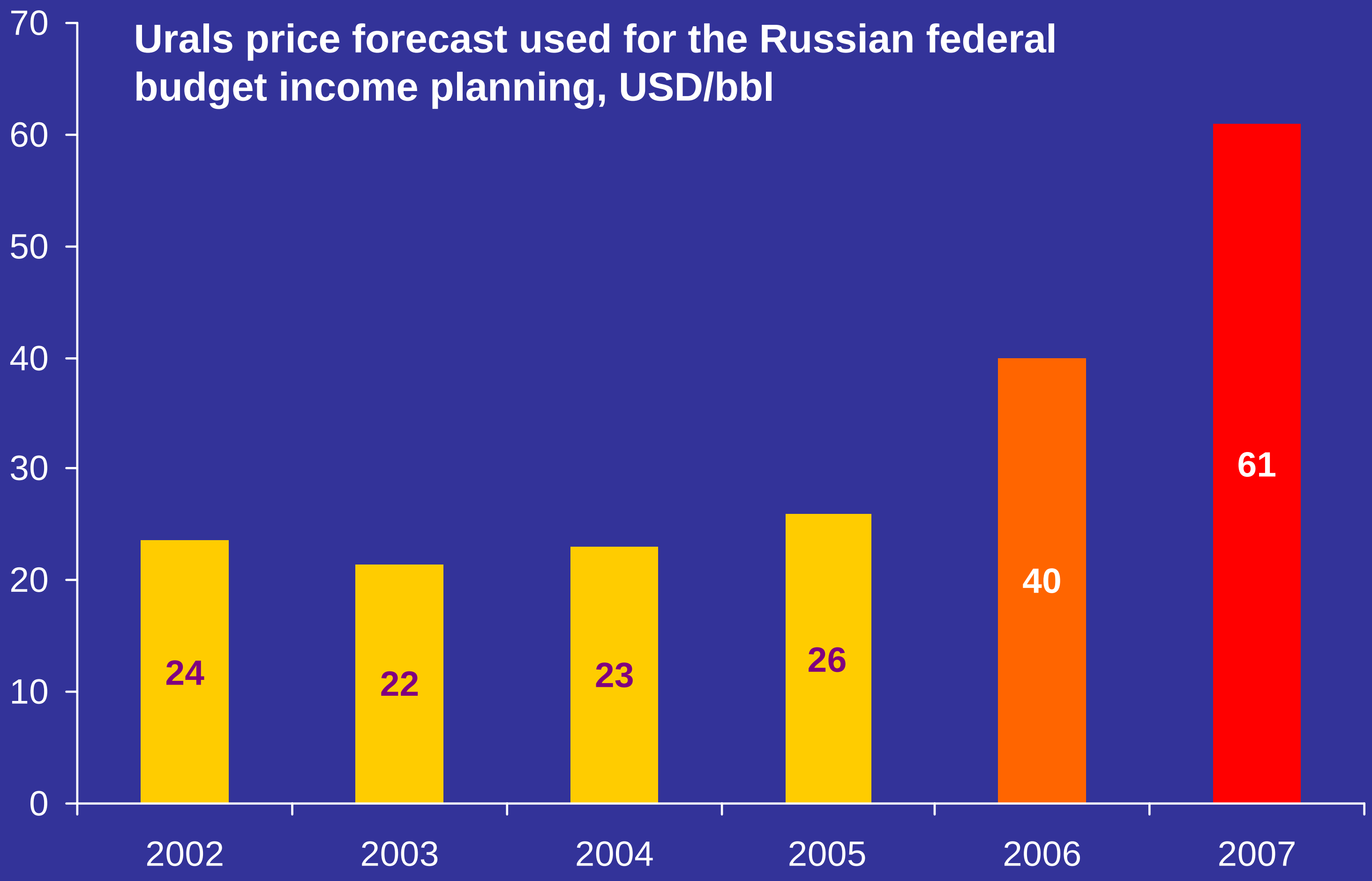
Source: Vladimir Milov, 'Can Russia become an Oil Paradise?', http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=18500

Shift in budget policies: sharp rise in size of the Government



Source: Russian federal budget, Russian Ministry of Finance; 2007 - draft budget adopted by State Duma in the third reading

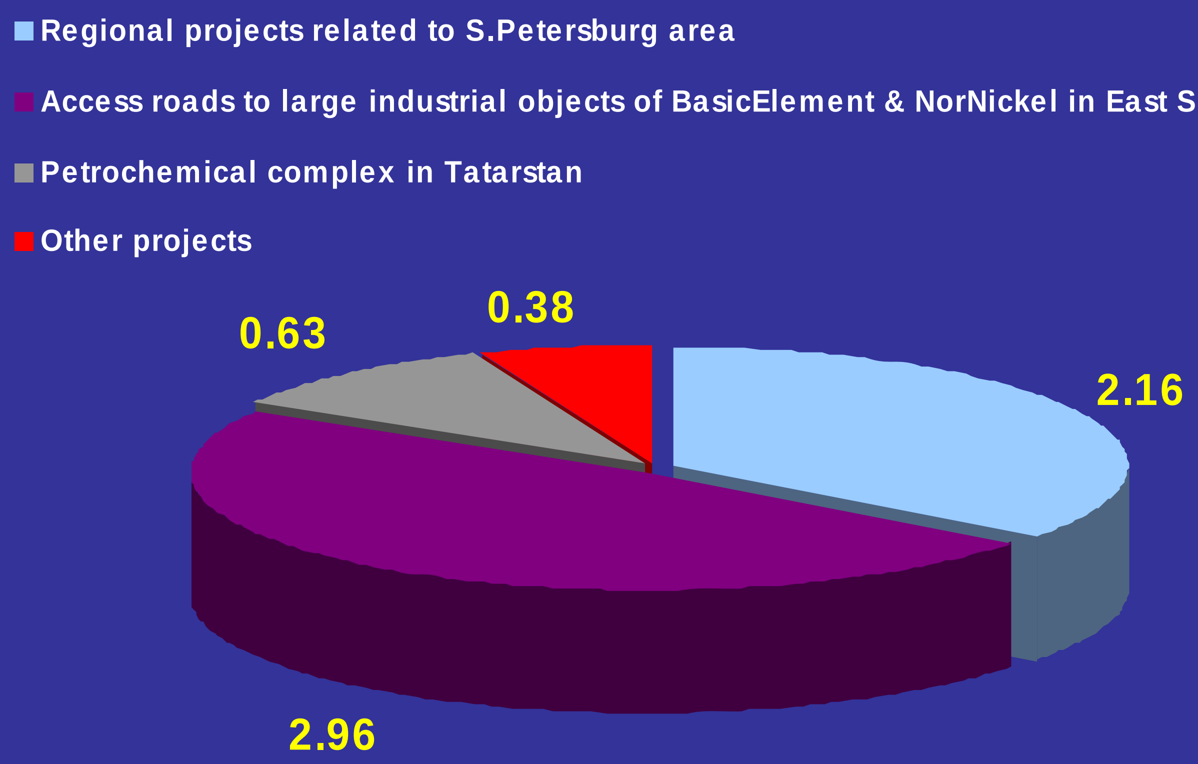
Budget policies become far less cautious, driven by spending appetites



Source: Russian federal budget, Russian Ministry of Finance

Investment fund spending: extremely inefficient, hardly a federal level infrastructure project

Allocation of the Russian Investment Fund expenses as of November 2006, billion USD



Source: Russian media

Conclusions. The future?...

- State policies in the energy sector drive this sector into stagnation and crises
- Despite warnings, state’s policies become more paternalist and less cautious
- Increased state’s role in the economy contains growth
- The safety margin of the Russian economy is much larger than in the 1980s due to market reforms of the 1990s and large role still played by the private sector
- Paternalist policies have no chance to succeed in terms of significantly increasing per capita GDP
- But, Russia surely follows the policy path of mid-1980s

Is there a real perspective for Sino-Russian energy relations?

- Most Chinese energy demand is located in South Eastern areas - land pipelines from Russia no solution
- Chinese net gas imports will not grow significantly (IEA forecasts 60 bcm by 2030), most of it will be satisfied through LNG
- Sakhalin-2 LNG is already contracted with other countries
- There’s a tough situation on price negotiations for supplies through ‘Altai’ pipeline, high costs of the pipeline recently announced
- Russian authorities are reluctant to Chinese access to significant upstream assets
- Oil supplies under 2001 agreement (0.6 mbd from 2010) remain the only solid option

Why no possibility of 'gas OPEC'?

- Gas is not a globally traded commodity
- Spare capacity factor does not exist
- Markets are very fragmented; suppliers are divided between consumer territories
- Iran, Venezuela are hardly net exporters yet
- Turkmenistan interests tend to seriously contradict interests of Gazprom
- Some experts believe a cartel in LNG supplies can appear and exert significant market power over importers (Stern 2006), but not as Russia-Iran-Algeria axis as much as a union of LNG exporters to the Atlantic basin (Qatar-Algeria-Nigeria-Egypt)