The future of Russian energy policy

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The present: the ‘Two Russias’ from the economic point of view

*** Including Russian private and foreign owned enterprises; excluding mixed ownership enterprises
The ‘Two Russias’ in the energy sector: private versus public

Average annual physical output growth rates in 2000-2005, %

- Independent gas producers: 12.6%
- Oil industry net of public oil companies: 8.4%
- Coal industry: 3.5%
- Gazprom*: 0.1%
- Public oil companies**: 3.6%
- RAO UES and Rosenergoatom: 2%

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

<table>
<thead>
<tr>
<th>Area</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moscow area</td>
<td>12.5</td>
<td>48</td>
</tr>
<tr>
<td>Russia-Finland - other than Vyborg</td>
<td>48</td>
<td>72</td>
</tr>
<tr>
<td>Russia-Finland - exports through Vyborg</td>
<td>51</td>
<td>83</td>
</tr>
<tr>
<td>St. Petersburg area</td>
<td>244</td>
<td>30.6</td>
</tr>
<tr>
<td>Chelyabinsk area</td>
<td>497</td>
<td>497</td>
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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

Today

- Private companies: 56.9%
- State companies: 26.9%
- 'Grey zone' (Sibneft, Slavneft, Yukos): 16.2%

Tomorrow?

- Private companies: 35.5%
- State companies: 64.5%

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)

- **7 months 2006**: 62.18 USD/bbl
  - Final closure of the reform agenda. Institutionalization of hardline foreign policy agenda
- **2005**: 50 USD/bbl
  - Massive dismantling of political freedoms, transfer to active paternalist state policies
- **2004**: 34.39 USD/bbl
  - End of economic reforms. Establishment of control over Yuganskneftegaz, abolition of governors’ elections
- **2003**: 27.29 USD/bbl
  - Beginning of dismantling of economic reforms. Beginning of Yukos case, arrest of M.Khodorkovsky
- **2000-2002**: 24.82 USD/bbl
  - Period of not very active flirt with reforms. Clear lack of consensus among decision makers on the country’s strategic direction
- **1991-1999**: 16.73 USD/bbl

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

“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...

Source: Rosstat
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

Average daily crude oil output in Russia, 2003-2006

26 months in a 9.4-9.8 mbd corridor

Source: Oil & Capital, CDU TEK
Companies affected by ownership changes were the leaders of output decline in 2004-2006

Change of daily crude oil output, August 2006 as % to September 2004

- Yukos ex-YuganskNG: -37.8%
- Sibneft: -6.1%
- Slavneft: +1.9%

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)

- Actual investments in upstream gas production: 12.5
- Acquisitions outside gas sector in 2003-2005: 17.9
- Capital investments in areas other than gas production: 30.6
- Investments required to develop gas fields of Yamal Peninsula*: 70


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

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

Non-interest spending of the Russian federal budget as % to GDP, 2002-2007

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

Urals price forecast used for the Russian federal budget income planning, USD/bbl

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

- Regional projects related to S.Petersburg area
- Access roads to large industrial objects of BasicElement & NorNickel in East Siberia
- Petrochemical complex in Tatarstan
- Other projects

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)