

Issues Involved in the Russian Crude Oil Transportation System and the Role of the State-Owned Pipeline Company, Transneft

Komori Goichi
Senior Researcher, Energy Strategy Unit
The Institute of Energy Economics, Japan

Summary

Transneft is one of the state-owned companies and the sole crude oil pipeline operator in Russia. Transneft has several plans for upgrading existing pipeline and building new pipelines in order to prepare for the increase in crude oil production and export. The Russian Federal Government has not intended to privatize Transneft. Since pipeline quota and tariffs need permission from the Russian Federal Government, Transneft has little room for management discretion and diversification. The Russian Federal Government regards Transneft as one of the measures to control Russian vertically integrated oil companies through crude oil pipeline quotas and tariffs.

Introduction

Russia's crude oil production has increased for six consecutive years since 1999. Russia exports more than half of its production to Europe. The Russian economy has been largely supported by its oil industry. In order to continue to increase production and exports of crude oil, upgrading and improvement of pipelines for exporting crude oil to Europe is one of the essential tasks for Russia. Construction of a new East Siberian crude oil pipeline is also significant for Russia from the standpoint of diversification of the crude oil export. Thus, we will discuss here the issues involved with Russia's crude oil transportation system and the role of Transneft, the sole crude oil operator in Russia.

1. Transneft

Transneft, a company operating and managing Russia's crude oil pipelines both from domestic market and export (total length of 48,000 km), comprises 11 regional pipeline subsidiaries and 11 subsidiaries providing repair and maintenance services.¹ Transneft, along with other vertically integrated oil companies like Yukos, etc., was established (official establishment in August 1993) during the reform process of the Russian oil industry from 1993. All of Transneft's voting stocks are held by the Russian Federal Government.

The Russian Federal Government has almost privatized the production, refining and sales sectors of the Russian oil industry; however, it intends to control the vertically integrated companies by holding all the voting stocks of Transneft, which operates and manages crude oil pipelines, and by

¹Transneft ;

<http://www.transneft.ru/About/Subsidiaries/Default.asp?LANG=EN> (Date of access 2004.11.25)

keeping the management rights of the pipeline transportation sector. As the shareholder of Transneft, Russian Federation Government receives not only corporate tax but also dividends from Transneft. This is the reason why the Russian government has not yet moved toward the privatization of Transneft. It is presumed that privatization of Transneft is not likely in the foreseeable future.

Transneft's total revenue has been constantly rising. It has increased from 34.8 billion rubles (\$1.41 billion) in 1999 to 97.9 billion rubles (\$3.12 billion) in 2002, up 30.7% from the previous year.² Furthermore, both operating profits and pre-tax revenue have been steadily increasing. Transneft virtually monopolizes the Russian crude oil pipelines; however, its total income (in 2002) remains at a level of 20 to 30 % of the Russian major oil companies such as LUKoil or Yukos. Furthermore, Transneft's total assets are approximately 40% of Lukoil's and 60% of Yukos'.

A major income source for Transneft is the pipeline fees paid to Transneft by vertically integrated companies such as LUKoil and Yukos, etc. Transneft transports crude oil produced in Russia to domestic refineries or exports it to Europe or to the CIS. Since Transneft exclusively manages the Russian crude oil pipelines, it is regarded as “a natural monopoly company” by the Russian Federal Government. Also, pipeline tariffs by Transneft should be approved by the Russian government and are based on a combination of “per ton” price and “per kilometer of transportation length” price. Fee levels are different between domestic transportation and export to Europe.

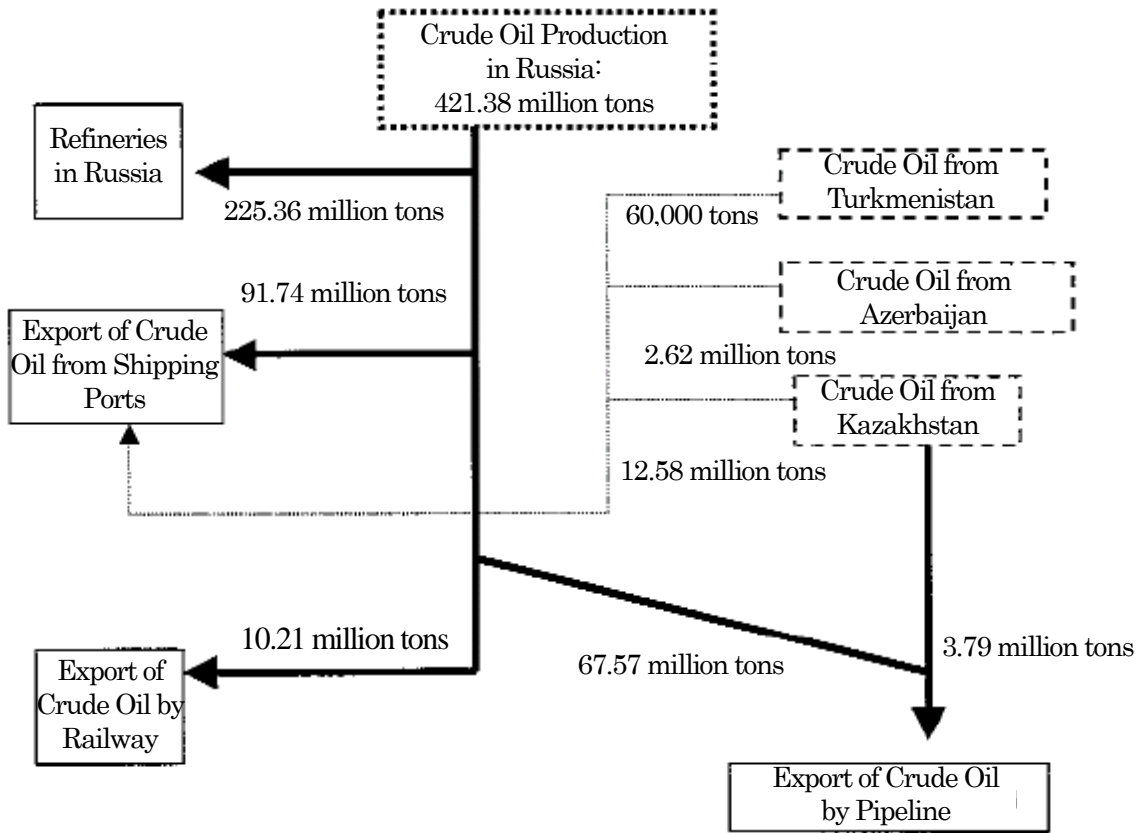
Once approved by the Russian Federal Government, the pipeline fees are fixed until the government permits the revision of fees. In other words, under this system, the pipeline fees can not be changed without the approval of the Russian government, even if the international crude oil price (export price to Europe charged for the vertically integrated oil companies) fluctuates (Pipeline fees are not tied to the daily changes in crude oil price.). Therefore, the cost burden on the general users of Transneft, the vertically integrated oil companies, becomes lighter when the international oil price rises or stays at a high level; whereas, the burden gets heavier when the oil price falls or stays at a low level.

2. Russia's Crude Oil Transportation System

Figure 1 shows how crude oil produced in 2003 in Russia and its neighboring countries, such as Kazakhstan, was transported to the domestic refineries and exported to other countries. This figure indicates that in 2003, 225.36 million tons, which is equivalent to 53.5% of the total production in crude oil in Russia (421.38 million tons), was transported to domestic refineries through Transneft pipelines, and 169.52 million tons, which is equivalent to 40.2% of the total, was exported outside the CIS through the Transneft's transportation system.

² Goichi Komori & Sanae Kawarada "Study Regarding the Change in the Vertically Integrated Companies of Russia and Management Strategies of Each Oil Company", Chapter 5 Management Strategy of Russian Major Oil Companies, The Institute of Energy and Economics, Japan; <http://eneken.ieej.or.jp/data/pdf/889.pdf> (Date of access 2004.11.25) , July 2004,p.106.

Figure 1: Crude Oil Flow by Transneft's Transportation System in 2003 (Export to Outer CIS Region)



Russia's Total Export of Crude Oil: 169.52 million tons, Export via Russia: 19.05 million tons

(Source),

The Amount of Crude Oil Production in Russia is compiled from the Interfax Petroleum Report, January 16-22, 2004, p32.

The Amount of Crude Oil Export from Russia and via Russia is compiled from the Interfax Petroleum Report, January30 – February 5, 2004, pp10-11.



As mentioned previously, since Transneft exclusively operates and manages Russian crude oil pipelines, crude oil produced in the oil fields in Russia is initially transported through the Transneft's pipelines, and a part of it is delivered to domestic refineries and the rest is exporting abroad. Europe is the major importer of Russian crude oil, and Transneft has three means of exporting crude oil: shipping ports, pipelines and railways. Shipping ports handled 91.74 million tons (54.1% of the total crude oil export), pipelines 67.57 million tons (39.9%) and railways 10.21

million tons (6.0%) in 2003.

In addition to that, Transneft exported 3.79 million tons of Kazakhstani crude oil by pipelines, and shipped 12.58 million tons of Kazakhstani crude oil, 2.62 million tons of Azerbaijani oil and 60,000 tons of Turkmenistani oil from the ports in 2003.

Against the background of an increase in crude oil production since 1999, the volume of Russian crude oil export to Europe is also on the rise. In order to maintain the steady increase in crude oil production, Russia must resolve constraint of the transportation capacity of pipelines. Upgrading the capacity of existing crude oil pipelines and the building of new pipelines are certainly important tasks for the future.

The Transneft's pipeline network of Russian crude oil supply lines has been developed from Angarsk, Western Siberia, toward the West (to Europe). Crude oil produced in major production regions today, such as West Siberia, Ural, and Volga, is transported to refineries within the country and exported to European countries. This has contributed significantly to the Russian economy.

Crude oil export pipelines to Europe are currently near in full capacity, due to an increase in the production and export of Russian crude oil over the past three or four years. Upgrading capacity of existing pipelines and the construction of new pipelines are essential in order to promote a sustained increase in the Russian crude oil production, as well as in crude oil export volumes to Europe.

A construction project of a new pipeline for crude oil in North East Asia is also an important issue in the long run from the perspective of the diversification of Russian crude oil export markets.

The following four cases are new Transneft pipeline construction projects³.

(1) Baltic Pipeline System

This project is to extend the existing pipeline, which runs from Timan-Pechora (Komi Republic) to Kirishi (Leningrad Province), to Primorsk, a coastal town of the Baltic Sea. Construction began in March 2000 and the pipeline started its operation in December 2001, with an increase in the transportation capacity from 12 million tons/year to 42 million tons/year in early March 2004. There is a plan to increase the transportation capacity to 50 million tons/year during 2005, with the eventual target being 62 million tons/year.

(2) Burgas — Alexandroupolis

A pipeline construction plan is currently being examined to transport crude oil from Russia and the Caspian Sea region, in order to bypass the Bosphorus and Dardanelles Straits, which are

³ Goichi Komori & Sanae Kawarada "Study on the Change in the Vertically Integrated Companies of Russia and Management Strategies of Each Oil Company", Chapter 5 Management Strategy of Russian Major Oil Companies, The Institute of Energy and Economics, Japan; <http://eneken.ieej.or.jp/data/pdf/889.pdf> (Date of access 2004.11.25), July 2004, p.110.

extremely congested with oil tankers.

(3) Druzhba – Adria

A plan is presently underway to export crude oil from Russia to Southern Europe and the Mediterranean by connecting the existing Druzhba pipeline for export of Russian oil to Europe via the Adrian crude oil pipeline.

(4) Angarsk – Nakhodka

At the time of Prime Minister Koizumi's visit to Russia in January 2003, Mr. Koizumi offered cooperation for this project, and thus, it has been attracting a lot of attention as a main rival candidate against the Angarsk – Daqing Line, which Yukos had promoted. The total length of pipeline is said to be approximately 4,000 km with expected investment of around \$5 billion to \$6 billion (twice the Daqing pipeline in both length and amount). The Russian Federation Government had not determine which of the pipelines, the Nakhodka Line or Daqing Line, should be given construction priority. President Putin is reported to support the Nakhodka Line because of diversification of the crude oil export market, although the construction costs and periods would be much higher than Daqing Line. (In the meantime, Prime Minister Kasyanov, who is said to support the Daiqing Line, was removed from office in February 2004). In March 2004, Transneft presented a new route plan for constructing pipeline from Taishet to Perevoznaya (to the south of Nakhodka), one that would run through the north of the original route.

In April 2005, the Russian Industry and Energy Ministry issued the order to construct a new crude oil pipeline from Taishet to Skovorodino as the first phase of this project. However, as of June 2005, the Russian Federal Government had not yet made the final decision as to this crude oil pipeline route.

Lukoil announced a project for the construction of a crude oil pipeline from Western Siberia to Murmansk in June 2002. This project is aiming for crude oil export to the United States. In November 2002, Lukoil signed Memorandum of Understanding on constructing this crude oil pipeline by 2007 with other Russian oil companies: Yukos, Tyumen Oil, Sibneft. However, the Russian Federal Government hold a negative attitude toward a crude oil pipeline project by private Russian oil companies.

3. The Role of Transneft in the Future

Transneft owns and operates crude oil pipeline network of 48,000 km in length throughout Russia. In preparation for the future increase in crude oil production by Russian oil companies, Transneft has several construction plans for new pipelines of crude oil, as mentioned previously.

As of July 2005, the Russian Federation Government has not revealed any intention to privatize state-owned Transneft. Furthermore, it is believed that the government will maintain Transneft's status as a state-owned entity, and therefore, the company can expect some degree of financial support from the government when its business suffers a downturn. (Nonetheless, Transneft does not generally receive any preferential tax treatment, even though it is state-owned.)

On the other hand, Transneft has very limited discretion in management. Transneft's main source of income comes from the pipeline fees paid by oil companies, and both the export quota to individual oil companies and the pipeline fees are subject to approval by the federal government. Therefore, it is fair to say that the company is completely depended on the government policy for its financial performance.

Furthermore, with new projects in sight, for example, the construction of new crude oil pipelines by Russian private oil companies like LUKoil, President Putin has expressed the Russian Federation Government's intention to keep control of Transneft. Therefore, Transneft will continue to play the role of a tool used by the Russian Federal Government to control the vertically integrated oil companies from the aspect of crude oil transportation.

Contact: report@tky.ieej.or.jp