Change in the Vertical Integration in the Russian Oil Industry and Management Strategies of Vertically-Integrated Oil Companies ♦

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1. Political and Economic Trends in Russia

1-1. Political Trends

After taking office as the prime minister in August 1999, Vladimir Putin was appointed as acting president upon the resignation of former President Boris Yeltsin in January 2000. He then won the presidential election held in March 2000, and officially became the Second President of the Russian Federation in May 2000. He was reelected with overwhelming support in the presidential election held in March 2004 and has been serving the second term of presidency since May 7, 2004.

While being regarded by former President Yeltsin as his "successor," President Putin served as prime minister and acting president, and upon officially assuming the presidency in May 2000, he was deemed to have "succeeded" the Russian administration from Yeltsin. Immediately after taking office, President Putin issued a presidential order that "former President Yeltsin and his family and relatives would not be prosecuted for life," expressing his intention to protect their honor and property.

Immediately after taking office, President Putin stood on the balance of power supported by five influential groups, "New Petersburg Group," "Family Group," "Liberal Bureaucrat Group," "Oligarchs," and "Local Governors" (See Table 1-1). On the other hand, because of the strong performance of the Russian economy backed up by the stabilization of domestic political circumstances and high oil price, President Putin also maintained high support ratings among Russian citizens.

The challenge for President Putin in his first term of presidency was how to tint the Russian administration, which he had "succeeded" from Yeltsin and in which these five influential groups contested with one another for initiatives, in his own "color". President Putin took steady steps to achieve this goal. Having shown his confrontational attitude with "Oligarchs" upon the "Yukos scandals" that occurred in July 2003, President Putin removed the Chief of Staff of the Presidential Executive Office Alexander Voloshin in October 2003 and Prime Minister Mikhail Kasyanov in February 2004 on the ground that they stood by Yukos (they belonged to the "Family Group"). Then he successfully integrated "Local Governors" into the governing party, "United Russia." This also implies that the situation in Russia's Council of Federation (Upper House), which consists of representatives of local governments and assemblies as federation members, is becoming favorable to President Putin.

Following the overwhelming victory of the governing party in the election of the members of the State Duma (Lower House) and aiming for his own reelection, President Putin dismissed all cabinet members including Prime Minister Kasyanov in February 2004, and appointed a new prime minister and cabinet members and announced the reorganization of the federal government early March 2004, just before the presidential election. This action can be interpreted as showing Putin's intention to replace the former

♦This report is an executive summary of "A Study on the Vertical Integration in the Russian Oil Industry and Management Strategies of Oil Companies" that we conducted at the end of March 2004 under contract with the Agency of Natural Resources and Energy at the Ministry of Economy, Trade and Industry in fiscal 2003. The ministry has recently allowed us to publish the study. We thank the relevant officials of the ministry for their understanding and cooperation.

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government and policy, which he had succeeded from Yeltsin, with new ones established of his own accord.

On March 14, 2004, Putin was reelected as president by wining an overwhelming majority of votes, i.e. more than 70%. The main point for Putin's second term of presidency that started on May 7, 2004, can be briefly outlined as follows.

Under the current Russian Constitution, no one person shall hold the office of President of the Russian Federation for more than two terms. According to this provision, Putin will have to "resign" from the presidency on May 6, 2008, and afterwards, he would not be able to run for president again. Therefore, attention is focused on the movements of leading politicians who seek the "post-Putine" presidency. The next election of the members of the Council of Federation and the next presidential election are scheduled for December 2007 and March 2008 respectively. The critical point is how far President Putin will be able to maintain his own political power in the latter half of his second term, which will end in May 2008. In the latest presidential election, five candidates challenged but all were "utterly defeated" by Putin who was backed up by the strong political power. None of them seems to have thought that they would have been able to beat Putin in the latest election, but at the present stage, it can be said that anyone "could have the opportunity to win" the next presidential election to be held in March 2008.

Table 1-1 Groups exerting a strong influence on the Putin administration

Group	Members	Characteristics
New Petersburg Group	The majority of members are from the intelligence agency or the military, including those who come from the same hometown as Putin; Federal Security Service (FSB) Director Nikolai Patrushev, Defense Minister Sergei Ivanov, Interior Minister Boris Gryzlov, Head of the Prime Minister's Secretariat Igor Ivanovich Sechin, and the majority of Presidential Plenipotentiaries	They claim themselves to be the president's comrades. They advocate nationalism while opposing market fundamentalism.
Family Group	Family and relatives of former President Yeltsin; former Head of the Presidential Administration Alexander Voloshin, Deputy Chief of Staff of the Presidential Executive Office Vladislav Yuryevich Surkov, Prime Minister Mikhail Kasyanov; Roman Abramovich (Sibneft), Oleg Deripaska (Rusal)	They maintain a strong influence on President Putin. They have close relationships with some Oligarchs and Liberal Bureaucrats.
Liberal Bureaucrat Group	Vice Prime Minister Aleksei Kudrin, Minister of Economic Development and Trade German Gref, Presidential Economic Advisor Andrey Illarionov; Anatoliy Borisovich Chubais (United Energy System) may be included.	Some Oligarchs may be included in this group, but the members are limited to people at the economic departments.
Oligarchs	Mikhail Fridman (Alpha Bank), Sergei Pugachov (Mezhprombank)	They still have a strong influence over the Putin administration, though it has become weaker than that over the Yeltsin administration.
Local Governors	Moscow Mayor Yuri Luzhkov, Khabarovsk Governor Victor Ishaev, President of Tatarstan Mintimer Shaimiev.	Their policy line is somewhat similar to that of the New Petersburg Group. They are relatively more distant from the administration than other groups.

Note: Posts are as of November 2003.

Source: Koji Hitachi, "Pūchin jidai to Roshia no henka; daitōryō daiikki no karikessan" (Putin era and changes in Russia; "provisional sum-up" of the first term of presidency), *Roshia Tō'ō bōeki chōsa geppō* (Monthly report of trade with Russia and Central-Eastern Europe), Japan Association for Trade with Russia and Central-Eastern Europe (ROTOBO) (May 2003), 7

However, President Putin will in the meantime complete, if possible, his second term of presidency at the age of 56, and should have no fear about his health (unlike Yeltsin). For this reason, there is speculation that Putin may, during the second term, amend the Constitutional provision that prohibits reelection to a third presidential term, with the aim of maintaining his administration for a longer period.[1] Furthermore, as the ruling party, United Russia, covers more than two-thirds of the seats in the Council of Federation, it is possible for the party to independently pass the bill for the Constitutional amendment to abolish the provision that prohibits the presidential reelection to a third term.

Although President Putin has repeatedly denied the idea of extending his presidency through the Constitutional amendment, the movement for his third presidential term may be initiated in the Council. There is also speculation that Russian Federation and Republic of Belarus will form a federal state and Putin would take office as the first president of the new state.[2]

In any case, "Putin's third presidential term" will be a focus of debate in the Council, and accordingly, a conclusion will be drawn regarding the issue of the amendment of the Constitutional prohibition of reelection to a third presidential term. Assuming that "election to a third term" is possible, President Putin will, with a view to avoid becoming a "lame duck" during the latter half of his second term, launch a variety of policy initiatives as soon as possible after the start of the second term, with the new government that he himself reorganized and the new prime minister and cabinet members whom he himself appointed.

1-2. Economic Trends

After the dissolution of the Soviet Union in 1991, Russia promoted radical economic reforms to introduce a market economy under the initiative of President Yeltsin and faced a number of problems such as the decline in real economic growth and the occurrence of hyperinflation. In 1997, the GDP increased by 0.9% over the precious years for the first time since the dissolution of the Soviet Union, but the real GDP in 1998 decreased again by 4.9% over the previous year due to the Russian financial crisis in August and the price slump in the international oil market.

The Russian financial crisis, however, brought two benefits for the Russian economy, i.e. restricting imports and promoting exports, through a significant devaluation of the Russian ruble against the U.S. dollar. The steep rise in the international oil price in 1999 and the subsequent stability of the oil price at a high level enabled Russian oil companies to increase oil production and earnings. In consequence, Russia has achieved positive growth of the real GDP for five consecutive years since 1999. Russia's real GDP in 2003 increased by 7.3% over the previous year. In May 2003, President Putin expressed his resolution to ""double the GDP in the next ten years."

Energy industries including the oil industry play an extremely important role in the Russian economy. The biggest factor in the recent strong performance of the Russian oil industry is the high oil price. While the oil industry supports the Russian economy, President Putin aims to decrease such dependence of the Russian economy on the oil industry and diversify and sophisticate the industrial structure. To this end, he seeks to levy a heavier tax on the oil industry and use funds from the increased tax revenues for the development of other industries. However, this idea should also be discussed and settled deliberately from the perspective of maintaining the competitiveness of the oil industry.

2. Energy Supply and Demand in Russia

In the energy supply-demand structure of Russia, domestic production is far larger than domestic demand. Even if Russia continues to achieve positive economic growth, there is only a faint likelihood domestic demand will expand significantly because of a certain level of improvement in the sophistication of

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[1] Masashi Okuyama, "Daitōryōsen ha jijitsujōno shin'nin tōhyō: Naifun ni yureru han Pūchin jin'ei" (Presidential election is in effect an opportunity of vote of confidence: Anti-Pūtin camp shaken by internal troubles), *Sekaishūhō* (Feb. 2, 2004), 12

[2] Masashi Okuyama, "Daitōryōsen ha jijitsujōno shin'nin tōhyō: Naifun ni yureru han Pūchin jin'ei" (Presidential election is in effect an opportunity of vote of confidence: Anti-Pūtin camp shaken by internal troubles), *Sekaishūhō* (Feb. 2, 2004), 12

the economic structure and in the efficiency of energy consumption. Consequently, as domestic energy production increases, the energy export capacity will basically expand.

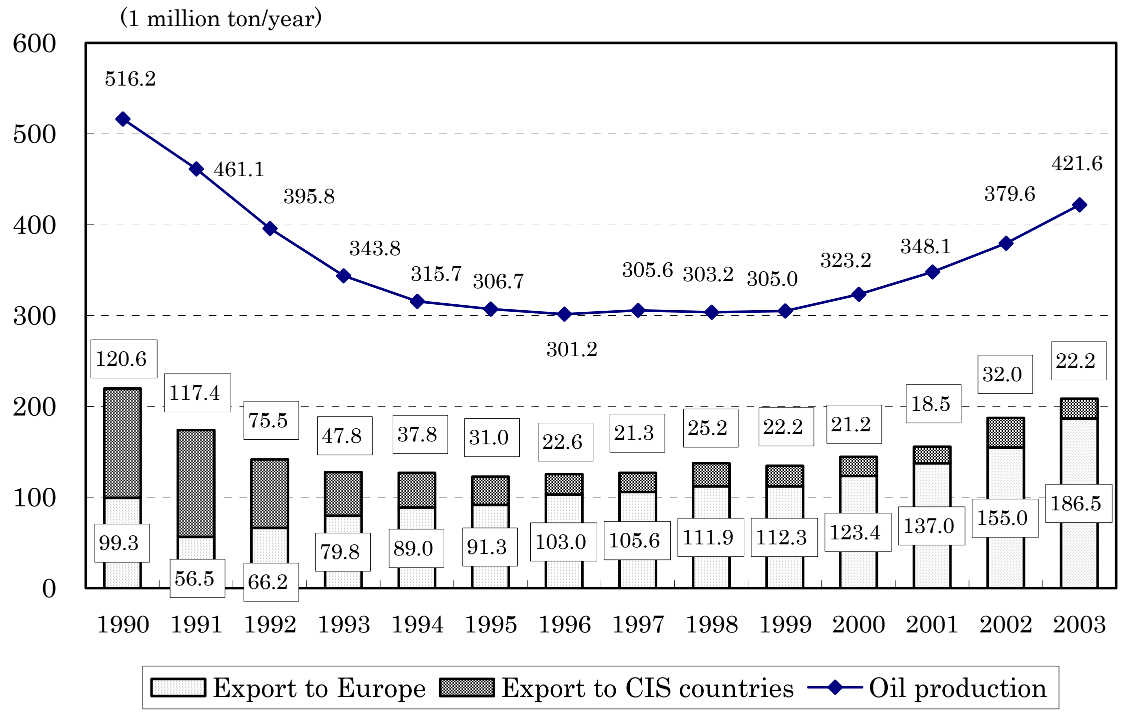
In Russia, natural gas holds a far larger share in the total supply and demand of primary energy than that in other countries, and there is also only a faint likelihood this situation will change significantly unless there is a shift in the economic structure. So far, there have not been effective incentives for energy saving in Russia because of its abundant domestic energy resources, but in the future, with the aim of joining the WTO and applying the Kyoto mechanism on greenhouse gas emission, the central government, local governments, and private enterprises will make efforts to improve energy efficiency in Russia.

Russia increased crude oil production for five consecutive years from 1999 to 2003, making great progress as the largest non-OPEC oil producer, catching up with Saudi Arabia. Almost in proportion to the increase in crude oil production, crude oil export also expanded (See Figure 2-1).

The forecasts of the future trends in crude oil production and export are roughly divided into two: an “optimistic forecast” that crude oil export will increase along with the steady increase in crude oil production, and a “pessimistic forecast” that the increase in crude oil export will be stopped by the suspended increase in crude oil production. Tables 2-1 and 2-2 show the forecasts of crude oil production and crude oil export respectively.

Factors that will affect crude oil production and crude oil export in the future are the crude oil price, the export capacity of pipelines and ports, and the restrictions to be imposed by the Russian government on oil companies in the private sector. Attention should be paid to the changes in these factors.

Figure 2-1 Trends in Russia’s crude oil production and export



Note: Export to Europe in 2002 = total crude oil export – export to CIS countries

Source: PlanEcon Energy Report, Vol. 11, No. 1 (April 2001), 9 (1990-2000); Eastern Bloc Energy, all volumes (2001-2002); Russian Energy Monthly (February 2004) (2003)

Table 2-1 Forecast of Russia's crude oil production

(1 million ton/year)

	Actual figures	Forecast			
	2003	2005	2010	2015	2020
Ministry of Energy of Russia (2000)	421.6	308-327	305-335	305-345	305-360
Ministry of Energy of Russia (2002)	421.6	360-370	370-380	380-400	405-430
Ministry of Energy of Russia (2003)	421.6	420-445	445-490	450-505	450-520
TNK (Interview survey in 2003)	421.6	448	-	455	460
IEA (2002)	421.6	-	430	-	450
Yukos (April 2003)	421.6	420	-	-	-
R. Capital (2001)	421.6	421	512	552	595
Campbell (2002)	421.6	420	335	-	215
Bakhitari (2002)	421.6	400	380	-	-
Ebel (2002)	421.6	410	-	-	-
CGES (2004)	421.6	-	600	665	-
Dr. Franseen (2004)	421.6	445	495	-	-

Source: Actual figures for 2003: Russian Energy Monthly (February 2004); "Russian Energy Survey: 2002," IEA (2002), 53; Eastern Bloc Energy (February 2003), 9, and the same (July 2002), 4; the interview survey.

World Energy Outlook 2002, IEA, 96; Masumi Motomura, "Fukkatsushita sekiyutaikoku Roshia to sono haikei ni arumono: sekiyu, ten'nengasu no seisan bunseki dōkō to chishitsu potensharu" (Revival of Russia as big oil producer and its background: analysis and trend of oil/natural gas production and geologic potential), *Sekiyu/ten'nengasu rebyu* (Oil/natural gas review) (January 2003), 22; Ministry of Energy of the Russian Federation, "Russia's 2003-2020 Energy Strategy" (approved by the government on September 5, 2003); MEES, 22 March 2004, A1-A4.

Table 2-2 Forecast of Russia's crude oil export

(1 million ton/year)

	Actual figures	Forecast			
	2003	2005	2010	2015	2020
Ministry of Energy of Russia (2000)	209	160-175	155-180	155-170	150-165
Ministry of Energy of Russia (2003)	209	290-310	305-340	310-345	305-350
TNK (Interview survey in 2003)	209	294	-	-	285
Dr. Franseen (2004)	209	250	280	-	-

Note: As for data of "Ministry of Energy of Russia (2000)," the actual figures for 2002 on "oil/oil product export" indicate the volume of export of "oil."

Source: Actual figures for 2003: Russian Energy Monthly (February2004); "Russian Energy Survey: 2002," IEA (2002), 53; Eastern Bloc Energy (February 2003), 9, and the same (July 2002), 4; the interview survey.

World Energy Outlook 2002, IEA, 96; Masumi Motomura, "Fukkatsushita sekiyutaikoku Roshia to sono haikei ni arumono: sekiyu, ten'nengasu no seisan bunseki dōkō to chishitsu potensharu" (Revival of Russia as a big oil producer and its background: analysis and trend of oil/natural gas production and geologic potential), *Sekiyu/ten'nengasu rebyu* (Oil/natural gas review) (January 2003), 22; Ministry of Energy of the Russian Federation, "Russia's 2003-2020 Energy Strategy" (approved by the government on September 5, 2003); MEES, 22 March 2004, A1-A4.

3. Russia's Oil Policy

The "Energy Strategy" approved by the Russian government in August 2003 only indicates a rough direction of Russia's future oil policy and it is not legally binding for Russian private oil companies. The "Energy Strategy" refers to various projects covering not only oil but also energy in general, but it is criticized as being incapable of serving as an effective guideline because these projects are not financially supported.[3]

Nevertheless, apart from the "Energy Strategy," the Russian government has been carrying out the policy to tighten "controls" over Russian oil companies. At the same time, the Russian government has been taking measures to weaken the presence of foreign oil companies in the Russian oil industry.

In order to tighten "controls" over Russian oil companies, the Russian government will continue to use "indirect means" such as licensing and taxation, rather than using "direct means" such as stock acquisition and re-nationalization (however, the government will continue to hold all voting shares in Rosneft). The Russian government intends to strengthen its power regarding licensing over Russian oil companies and local governments.[4] The first point is how the Russian government will review the licensing provisions and the actual application thereof.

The second point is the introduction of "windfall-profit tax," which is currently under consideration, and the reaction of Russian oil companies to the introduction of the new tax. Basically, Russian oil companies would never welcome an additional tax burden, even though they have been achieving strong business performance because of the high oil price.

In response to the request of Russian oil companies, the Russian government amended the Production Sharing Act in June 2003 to make it unfavorable to foreign oil companies. More specifically, the Russian government raised the "hurdle to enter" the Russian oil industry for foreign companies. In the future, production-sharing contracts will be approved only with respect to projects with a high level of difficulty in crude oil production (high-cost and high-risk projects targeting new oil fields that are difficult to develop).[5] It is also expected that the Russian government would not allow Russian oil companies to sell their shares to foreign oil companies to the extent that involves the transfer of the management right.[6]

4. Structure of the Russian Oil Industry

Reorganization and privatization of the Russian oil industry was regarded as one of the necessary tasks for the transition from a planned economy to a market economy upon the dissolution of the Soviet Union. The establishment of the Russian vertically-integrated oil companies and their privatization have come true during the term of former President Yeltsin (from the end of December 1991 to the end of December 1999), and the initial "goal" can be evaluated as having been accomplished. As of March 2004, they have ten (substantially eight) vertically-integrated oil companies in Russia. In 2003, the crude oil production of the ten oil companies accounted for 90.4% of the total in Russia (Table 4-1).

In the early 1990s, however, the Russian government originally did not intend to completely privatize vertically-integrated oil companies in the three years after establishment. The Russian government intended to hold a part of the shares in these oil companies and also prevented foreign oil companies from holding more than 15% of the shares in Russian vertically-integrated oil companies, thus showing a cautious stance against foreign companies.

The irony is that the movement toward privatization of vertically-integrated oil companies was promoted by the debt to cover a huge financial deficit of the Russian government. The Russian government had borrowed money from Russian financial institutions by offering as mortgage the shares in the oil

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3 Interview survey (conducted from the end of February to early March 2004)
4 Interview survey (conducted from the end of February to early March 2004)
5 Interview survey (conducted from the end of February to early March 2004)
6 Interview survey (conducted from the end of February to early March 2004)

companies that it owned. Due to the government's failure to repay its debt by the due date, its shares in major Russian vertically-integrated oil companies were transferred to the hands of emerging business groups and financial groups. The structure in which emerging business groups govern oil companies was established upon this occasion and has been maintained to date.

It can basically be said that since 1996, from the last phase of the term of President Yeltsin through to the first term of President Putin, Russian "private" oil companies operated and managed business at their discretion. The vertically-integrated oil companies survived the slump in the international oil price and the financial crisis of 1998, and improved their operation/management performance, with the help of the international oil price that soared, remaining at a high level from 1999. Furthermore, the Russian oil companies, which had become "cash rich," vigorously promoted lobbying activities to encourage the government to carry out policy measures that were favorable to them (such as the amendment of the Production Sharing Act in June 2003), thus displaying their powers. The Russian government owned Rosneft as a 100% state-owned enterprise and held domestic crude oil and oil products pipelines under its control, but did not have any means to directly control the vertically-integrated oil companies that had been privatized.

Table 4-1 Trends in crude oil production by the Russian vertically-integrated oil companies

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Basneft	17.74	16.34	15.36	12.96	12.26	11.94	11.86	12.14	12.05
Komitek	4.53	4.18	3.59	3.46	–	–	–	–	–
Lukoil	55.58	53.79	53.40	53.29	61.32	62.18	62.80	75.69	78.91
Onaco	7.66	7.89	7.93	7.85	7.48	7.51	–	–	–
Rosneft	12.80	13.00	13.47	12.99	12.67	13.47	14.94	16.10	19.57
Sibneft	20.40	18.61	18.17	17.45	16.32	17.20	18.66	26.34	31.39
Sidanco	22.86	20.83	20.26	20.09	6.74	6.65	9.13	16.14	18.61
Slavneft	13.23	12.88	12.32	11.80	11.93	12.27	14.95	16.10	18.10
Surgutneftegaz	33.33	33.26	33.91	34.94	37.58	40.62	44.03	49.20	54.03
Tatneft	25.02	24.78	24.55	24.57	24.08	24.34	24.61	24.56	24.67
TNK	22.72	21.48	21.11	19.82	28.92	30.84	36.69	37.50	42.96
East Oil	11.24	11.24	11.18	10.73	–	–	–	–	–
East Siberia Oil	0.11	0.01	0.03	–	–	–	–	–	–
Yukos	36.09	35.24	35.60	34.07	44.48	49.55	58.11	69.88	80.75
Vertically-integrated oil companies total	283.31	273.53	270.88	264.02	263.78	276.57	295.78	343.65	381.02
(%)	-3.70	-3.45	-0.97	-2.53	-0.09	4.85	6.95	16.18	–
total	306.70	301.20	305.60	303.20	305.00	323.22	348.10	379.63	421.38
(%)	-2.85	-1.79	1.46	-0.79	0.59	5.97	7.70	9.06	11.30
Production share of the vertically-integrated oil companies (%)	92.4	90.8	88.6	87.1	86.5	85.6	85.0	90.5	90.4

(1 million ton/year)

Note:
1. Lukoil acquired Komitek (to hold it as a subsidiary) in 1999.
2. Yukos acquired East Siberia Oil in 1998 and East Oil in 1999 (to hold them as subsidiaries).
3. TNK acquired and merged Onaco and acquired Sidanco to hold it as a subsidiary in 2001.
4. TNK and Sibneft won the bid for privatization of Slavneft on a 50-50 basis in December 2002. They are currently negotiating the distribution of its assets.
5. TNK and BP established TNK-BP on a 50-50 basis in August 2003.

However, upon the arrest of Platon Lebedev, the CEO of Bank Menatep which is the largest shareholder of Yukos, in July 2003 on a charge of embezzlement of public money, the trend of "the vertically-integrated private oil companies enjoying the dominant position in Russia" reached a turning point and shifted to a new trend of "the Russian government tightening controls." This trend shift became decisive when the CEO of Yukos Mikhail Khodorkovsky was arrested and prosecuted in October 2003.

In the future, the Russian government will tighten controls over Russian oil companies by making best use of "indirect means," such as "levying a heavier tax" and "applying strict licensing provisions." Some companies consider that Russian oil companies have lost their former strength to promote lobbying activities, and it has become even more difficult for them to encourage the government, through lobbying activities, to take measures that are favorable to them.[7]

5. Management Strategies of the Major Russian Oil Companies

We analyze management strategies of 10 vertically-integrated Russian oil companies (Lukoil, Yukos, Surgutneftegaz, Rosneft, TNK-BP, Sibneft, Slavneft,Sidanco, Bashneft, Tatneft) and Transneft (main crude oil pipeline operator) in the following.

5-1. Lukoil

Lukoil vigorously promotes projects for production, refining, and sales of oil not only at home but also abroad. In 2003, Lukoil lost its number one position in terms of domestic crude oil production and fell behind Yukos, which had ranked second, but is still maintained the largest crude oil producer including overseas production in Russia.

Lukoil aims to balance upstream sectors and downstream sectors in its oil business and make investments from a long-term perspective, thereby creating jobs and stabilizing its financial position. In the past five years, Lukoil increased its domestic crude oil reserves by acquiring small oil companies as subsidiaries. Lukoil has also drawn attention for its global expansion of downstream sectors by launching oil refining and sales in Middle and Eastern Europe and oil sales in North America.

Lukoil holds a wide range of assets for oil production/refining/sales both at home and abroad, but some of these assets have deteriorated due to aging and currently incur large costs. Therefore, in the future, Lukoil will have to make efforts to increase management efficiency rather than simply aiming at expanding the size of its asset base.

5-2. Yukos

Yukos, which is a private oil company owned by an emerging financial group, expanded the scale of its business and increased crude oil production by acquiring and merging with medium and small-sized oil companies in the 1990s. After the end of the 1990s, Yukos went through drastic management reforms by applying European and U.S. management methods and actively introduced European and U.S. oil exploitation and production technology, thereby successfully increasing crude oil production. Thus, Yukos has managed its business with the primary goal of maximizing interests of the shareholders as well as achieving an increase in crude oil production and earnings in the short term.

Yukos has its production base in West Siberia and it does not operate crude oil production overseas. In 2004, Yukos aims to increase production by 11% from the previous year to 90 million tons[8]; compared with the production growth in 2003 (16.3%), the growth rate is expected to slow down slightly.

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[7] Interview survey (conducted in March 2004)
[8] Platts Oilgra, News (March 1, 2004)

Since the summer of 2003, Yukos has gone through scandals such as the arrest and detention of the CEO of Bank Menatep, Yukos's largest shareholder, and the former CEO of Yukos, and the crackdown of Yukos on a charge of tax evasion. As a result of these scandals, there is growing uncertainty about the future of Yukos. As Yukos was the driving force for the increase in crude oil production in Russia since 1999, attention will be focused on how these scandals and their consequences will influence Yukos's future management and what impact they will have on the entire oil industry in Russia. The Yukos scandals also made European and US investors recognize anew the risks involved in investment in the Russian oil indusry.

5-3. Surgutneftegaz

Since its establishment in 1993, Surgutneftegaz has constantly increased crude oil production mainly in West Siberia, the existing oil-producing district. Surgutneftegaz has ranked second or third in Russia in terms of crude oil production since 1993. Even in the middle of the 1990s when the Russian government considered the tax delinquency of oil companies as a problem, Surgutneftegaz hardly caused a delay in tax payment and therefore it was regarded as an "excellent" oil company by the government. Furthermore, it is pointed out that because of a close relationship with the CEO of Surgutneftegaz Vladimir Bogdanov, President Putin has a favorable impression of the current CEO Bogdanov who, unlike the former Yukos CEO Khodorkovsky, devotes himself to the management of the oil company without "political ambition."[9]

During the 1990s, Surgutneftegaz did not seem to be willing to collaborate or cooperate with other Russian oil companies or European and US oil companies but rather took an "independent path." However, in December 2003, Surgutneftegaz reached an agreement with Rosneft and Gazprom to establish a consortium for the development of oil and gas fields in East Siberia, which may be a significant turning point of Surgutneftegaz. Behind Surgutneftegaz's decision to collaborate with Rosneft and Gazprom for the development of East Siberia where, unlike the current major oil-producing district West Siberia, most fields have yet to be exploited or developed, there was the intention of the Russian government to take the initiative in promoting the development of oil/gas fields in East Siberia.[10]

In the past, Surgutneftegaz's business seemed to be "conservative" as it continued to constantly increase crude oil production through investment in the upstream sectors with steady performance. In the future, however, because of the establishment of the joint consortium, it will draw attention as a major player in the oil development project in East Siberia and the Far East.

5-4. Rosneft

Rosneft is the only Russian vertically-integrated oil company of which all voting shares are owned by the Russian government. During the period of the slump in the international crude oil price in 1998, the Russian government attempted twice to sell (privatize) 75% of all voting shares plus one more voting share in Rosneft, with which strategic management decisions for the company, e.g. merger, could be made, but no private company participated in the bidding. Since then, the government has not invited bids for the privatization of Rosneft.

For the Russian government, with the intention of tightening controls over the Russian oil industry, Rosneft will be a "convenient" oil company that can be operated as the government wishes. For this reason, in the interview survey conducted in Russia, most respondents stated that it was unacceptable that the Russian government planned to privatize Rosneft (sell all or part of its shares in Rosneft) or merge Rosneft

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9 Interview survey (Conducted in March 2004)
10 Interview survey (Conducted in March 2004)

with other Russian vertically-integrated oil companies.

However, Rosneft, though it is a 100% state-owned oil company, does not enjoy more preferential treatments than other Russian vertically-integrated private oil companies in terms of taxation and licenses for development and production. Its crude oil production has been increasing, but viewed more closely, the crude oil production increase has been achieved just by resuming operations of idle wells, and thus increasing number of production wells. Concerns for the future are raised due to its lack of aggressiveness in its new oil exploration and development activities, which should be the basis for a future increase in crude oil production.

There is the possibility that Rosneft, by making use of its close tie with the Russian government, will enhance efforts for crude oil exploration and development in East Siberia and Sakhalin. Attention should be paid to the future movements of Rosneft.

5-5. TNK-BP

TNK-BP has been showing flexible responses to the Russian government's oil development policy. For example, TNK-BP shows understanding on the amendment of the Production Sharing Act by which oil development is forced to be implemented under the general tax system. It also takes a stance of agreeing to pay contributions to the oil stabilization fund and windfall-profit tax, unless the tax or contribution rate is too high. In this respect, TNK-BP seems to be trying to build a good relationship with the Russian government while learning from the Yukos scandal.

By introducing BP's advanced technology and management methods, TNK-BP has been actively investing in projects for developing upstream sectors, increasing the oil recovery rate, modernizing oil refiners, and improving the morale of service station staff; its management style is becoming the most similar to that applied in Europe and the Untied States among the ten vertically-integrated Russian oil companies. Although most of its major production fields are aging, TNK-BP plans to continue to increase crude oil production constantly through business investments and technical innovations. It will become one of the important oil companies that will lead Russian crude oil production. The establishment of TNK-BP is not only drawing attention as a new oil development strategy in Russia after the amendment of the Production Sharing Act, but also attracting interest as to what position TNK-BP will hold in the development of East Siberia and Sakhalin and what impact its actions will have on the international oil market.

5-6. Sibneft

Sibneft, setting its crude oil production goal for 2004 at 37.8 million tons, up 20% over the previous year, aims to accelerate the production increase to a higher speed than other vertically integrated oil companies. On the other hand, Sibneft has not been so active in expanding oil reserves and its oil exploration and development activities have achieved rather moderate results compared with those of other companies. On a positive note, Sibneft has successfully expanded crude oil production through the introduction of advanced drilling technology and oil well management methods applied in Europe and the United States. In the future, it should carry out oil exploration and development activities more actively under a medium-term development strategy. However, Sibneft has not considered launching its downstream operations overseas, and it is expected to continue sales of oil products through current domestic sales channels. Division of Sibneft's assets between Sibneft and TNK-BP is under negotiations; the decision on division will be made by the end of 2004.

In order to expand production and increase earnings in the short term, Sibneft has adopted a business strategy of acquiring and merging oil-producing companies or holding them as subsidiaries, rather than increasing production by consistently carrying out oil exploration and development activities. For this reason, there seems to be no end to the rumor that Mr. Roman Abramovich, a major shareholder of Sibneft, may sell its shares to one of the major overseas oil companies, which are waiting for the opportunity to invest in the Russian oil industry, before Sibneft's earnings decrease and its asset value declines. Nevertheless, due to the alleged tax evasion of about 150 million dollars in March 2004, Sibneft is currently regarded as a more opaque company than before, and therefore a formal negotiation with major overseas oil companies will be postponed.

5-7. Slavneft

In December 2002, former TNK and Sibneft jointly won the bid for privatization of Slavneft on a 50-50 basis. According to the statement made by the Chief Operating Officer of TNK-BP Management Viktor F. Vekselberg in early December of 2003, TNK-BP had negotiations with officers of Sibneft on the division of Slavneft and planned to complete the division by the end of 2004, irrespective of the suspension of the consolidation of Yukos and Sibneft proposed at that time.[11] There is a view that Sibneft is interested in acquiring Megionneftegaz, Slavneft's major asset with annual crude oil production capacity of 13 million tons. There is another view that Surgutneftegaz is likely to buy the Yaroslavl Oil Refining Plant after the completion of asset liquidation. However, what will result from the asset division and liquidation is still opaque and there are also uncertain factors as to the future management of Slavneft.

5-8. Sidanco

Initially, TNK and BP jointly owned Sidanco, holding 57% and 25% of shares respectively. Upon the establishment as a new company between them in September 2003, TNK-BP acquired 77% of shares and became the largest shareholder of Sidanco. As persons related to TNK-BP hold the majority of membership of the board of Sidanco, TNK-BP is expected to have active involvement in the designing of Sidanco's management policies and production plans. For Sidanco, it will be a challenge for the future to improve production efficiency and maintain the production increase with the use of advanced technology applied in Europe and the United States.

5-9. Basneft

Basneft has its crude oil production base in the Republic of Bashkortostan. Its crude oil production was the smallest and its productivity is the lowest among the Russian vertically-integrated oil companies. Major vertically-integrated oil companies such as Lukoil, Yukos, and TNK-BP have expanded their production and refining capacity by acquiring small and medium-size companies subsidiaries. However, as mentioned above, Basneft's production and management structures are not cost-effective, and therefore there is a view that it is hardly beneficial for major vertically-integrated Russian oil companies such as Lukoil or overseas oil companies to acquire Basneft to hold it as a subsidiary.[12] In the future, it will be an important task for Basneft to improve its productivity, or expand crude oil production while reducing the number of production wells, with support from the government of the Republic of Bashkortostan.

5-10. Tatneft

In 2003, Tatneft's crude oil production was 24.67 million tons, the sixth largest following Yukos, Lukoil, Surgutneftegaz, TNK-BP, and Slavneft (larger than that of Rosneft, 19.57 million tons, which is a state-owned oil company). In the oil-refining sector, which had been its weak point, Tatneft established and started operating the Nizhnekamsk Refinery in the Republic of Tatarstan, and started taking actions to

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[11] Interfax Petroleum Report (February 5-11, 2004), 11
[12] Interview survey (February 5-11, 2004)

obtain controlling interest in state-owned oil refineries in the Czech Republic and Turkey.

However, because the fact that Tatneft's largest shareholder is the government of the Republic of Tatarstan as well as its low productivity, despite its high position in the crude oil production ranking (in sixth), and the high sulfur content in its crude oil, which means low management efficiency, there is a view that other vertically-integrated Russian oil companies or overseas oil companies are less likely to acquire Tatneft as a subsidiary.[13] Tatneft will continue crude oil production, refining, and sales in the Republic of Tatarstan with some support from its largest shareholder, the government of the Republic. How Tatneft will manage the Tupras Refinery, the controlling interest of which it acquired in January 2004, will be a testcase as to whether Tatneft will remain a "local oil company" or will go on the path toward "global business expansion."

5-11. Transneft

Transneft exclusively holds and operates major crude oil pipelines in Russia, and all of its voting shares are owned by the Russian government. Since the privatization of vertically-integrated oil companies has almost been completed except for Rosneft, the Russian government cannot give "orders" on operations and management directly to Russian private oil companies other than Rosneft. In this situation, while holding Transneft under its direct control, the Russian government intends to "indirectly" control other Russian private oil companies that use Tatneft's major crude oil pipelines, by setting the crude oil export quota for each oil company and requiring charges for using pipelines. Considering these benefits, the Russian government, with the aim of tightening controls over Russian private oil companies, will continue to hold Transneft as a state-owned company.

Transneft holds and operates the major crude oil pipeline networks, the total length of which is 48,000 km, and it has a plan to build a new crude oil export pipeline to meet the future increase in crude oil production and export by Russian oil companies. However, most of these crude oil pipelines of 48,000 km were "inheritance" constructed in the period of the former Soviet Union. About ten years have passed since the birth of the Russian Federation upon the dissolution of the Soviet Union and the establishment of Transneft. During this period, Transfneft launched and completed construction and finally started operating only two crude oil pipelines; one is part of the Baku (Azarbaijan)-Novorossiysk (along the Black Sea) pipeline, which detours the Chechen district (total length 260km), and the other is the "Baltic Pipeline System" (total length 260km). The total length of these two pipelines only slightly exceeds 500km. For this reason, concerns are raised as to whether Transneft will be able to successfully accomplish the construction of the "East Siberia Oil Pipeline," which could be 4,000km long in total.[14]

As of March 2004, the Russian government has not shown any signs of reforming Tranfneft yet. Rather, the government is expected to continue to hold Transneft as a state-owned company; therefore, Transnfet will be able to get some support from the government when its business conditions deteriorate. However, Transneft has only limited management discretion. Its major source of income is charges for using pipelines paid by oil companies, but the crude oil export quota for each oil company and the amount of such charges must be approved by the Federal Energy Committee. In other words, Transfeft does not have any means to increase or diversify its income.

6. Future Prospects

The ten vertically-integrated Russian oil companies produce 90.4% of the total crude oil production in Russia, and they have been achieving constant growth in operations and financial profits, supported by

[13] Interview survey (February 5-11, 2004)
[14] Interview survey (February 5-11, 2004)

the high crude oil price. On the other hand, crude oil production by independent oil companies and joint venture companies only account for about 10% of the total. Since the amendment of the Production Sharing Act in June 2003, the 'barriers' for overseas oil companies to enter the Russian oil industry has become higher.

After the Yukos scandal, the trend in the Russian oil industry has shifted from "the vertically-integrated oil companies enjoying the dominant position" to "the Russian government tightening controls." However, the Russian government is considering levying a heavier tax on the vertically-integrated oil companies because the government regards such companies as important fund providers. In this regard, the importance of the vertically-integrated oil companies is less likely to decline.

If the crude oil price falls or slumps, it will further encourage restructuring of the Russian oil industry. Upon such occasion, the major role in restructuring will also be played by vertically-integrated oil companies with good operational and financial performance. In conclusion, whether the crude oil price is high or low, the vertically-integrated Russian oil companies are likely to maintain their presence to a certain degree .

The vertically-integrated Russian oil companies will continue to play a "major role" in the Russian oil industry, and as long as the oil price remains at the current high level, they will constantly increase crude oil production and export. In other words, the vertically-integrated oil companies will be the driving force for the future increase in crude oil production and export in Russia.

For the vertically-integrated Russian oil companies, the European market is regarded as an important export market where a certain volume of demand is assured, although demand growth will not be as large as that in the Asian market. Russia will maintain the mutual dependence with European countries through trading of crude oil and oil products.

Exporting crude oil to the Northeast Asian market is a means for the vertically-integrated Russian oil companies to diversify crude oil export markets as well as a means for Northeast Asian countries to diversify oil import sources. In the crude oil export projects targeting the Northeast Asian market, East Siberia/Far East, rather than East Siberia where major oil fields currently in operation are located, will be a potential candidate as the source of oil supply.

For Northeast Asian countries, importing crude oil from East Siberia/Far East is "one of the workable options" but not the "only option available." In this respect, for the success of these projects, it is also important to ensure and strengthen economic efficiency. When these projects are accomplished, Northeast Asian countries will gain another crude oil supply route from East Siberia/Far East in addition to the existing major route from the Middle East. This will bring about competition for oil producing countries in the Middle East.

Russia is the second largest oil producer in the world following Saudi Arabia and also the "largest non-OPEC oil producer." While attending OPEC meetings as an observer, Russia shares the same view as OPEC countries in favor of a stabilized international oil price. However, because of the practical difficulty in implementing the coordinated reduction in crude oil production, the Russian government and vertically-integrated Russian oil companies have not followed the OPEC's intention to stabilize the international oil price through deliberate coordination of the crude oil production quota.

This is because (i) the Russian government has lacked "direct" power or means to make "private" vertically-integrated oil companies reduce crude oil exports, and (ii) the Russian government has not felt such great a concern as OPEC countries about the crude oil price decline. The vertically-integrated Russian oil companies will aim to maximize crude oil production through investment in upstream sectors during the period when the crude oil price remains at a high level, and even if the crude oil price drops sharply and hovers at a low level, they will try to maintain crude oil export at least to the extent that they can acquire hard currencies.

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