The Russian Oil Policies and Its Oil Industry Trends*

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Section 1 The Political and Economic Trends in Russia

(The Political Trends)

Vladimir Putin, the Russian President, won the presidential election by a landslide in March 2004 with 70% of the vote, and began his second term on May 7, 2004. The issues which President Putin faces in his second term will be 'leaving his mark' on a government that has endured since the orderly transition of power from former President Yeltsin, and the specter of a 'lame-duck' presidency due to the fact that he can not run as a candidate for a third term. President Putin must therefore promote his authority and presence both domestically and internationally.

Since the start of his second term, President Putin has attained two remarkable achievements on the diplomatic front. President Putin has signed an agreement with the EU pledging Russia to join the WTO as a full member, and has ratified the Kyoto Protocol on global warming. If Russia can become a member of the WTO, it would enjoy tremendous economic benefits on trade and introduction of foreign investment. Russia's ratification was a decisive factor for effectuation of Kyoto Protocol under the circumstance of the detection of the United States. In this instance, Russia has demonstrated its presence in the international community through these maneuvers.

Meanwhile, factors of political and societal instability in Russia are growing through the terrorist bombing of Aeroflat airliners and the Beslan School massacre, which left scores of people dead. The Putin administration has also confronted he vehement objections from the pensioners and the opposition parties against his goal of reforming the social security system. It is said that there has also been friction between Dmitry Medvedev, the Russian President's Chief of Staff (Chairman of Gazprom), and Igor Sechin, Deputy Head of the Presidential Administration (Chairman of Rosneft) in the background of the revocation of a merger between Gazprom and Rosneft in May 2005, and some see this as a weakening of the total control President Putin has on the actions of those under him[1]. Despite this, Putin has strengthened his grasp on the private sector by pushing to dissolve Yukos and through his control over the press. It appears, though, that the criticism of his government, on the whole, has been nothing more than superficial.

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[1] Overseas hearing survey.

As of November 2005, there is no politicians who have formally announced their candidacy in the next presidential election in March 2008. In this sense, he is not yet a 'lame duck'. However, to deal with factors for instability would be important for President Putin in the remainder of his second term. The current Russian Constitution prohibits a President from running for a third term. Nevertheless, President Putin may search for ways to run for a third term during the remainder of his second term, or attempt to find someone who could act as 'his' own successor. He would do this to ensure his own safety and political influence even after his presidency is over. Putin may also continue his political activities in some way by forming his own political party after the end of his presidency.

(The Economic Trends)

The Russian economy has developed steadily since 1999. This has occurred because of the steep rise in global energy prices and the recovery of domestic industry caused by the devaluation of the Ruble. The increased revenues from energy exports has encouraged domestic investment and consumption and supporting growth. However, the effects of the Ruble's devaluation have gradually faded in recent years, and the pace of increased oil production that has fueled the Russian economy has also subsided. The reasons why the increased production pace has slowed are a lack of an export infrastructure, and the results of measures taken by the Russian Government to raise export tariffs and taxes on the use of mineral resources and other 'windfall profit withdrawals', which is one of the factors that has deterred incentives for increased production and investment to the domestic Russian oil industry.

The Russian economy is heavily dependent on the energy industry, and its foundation is still weak[2].Therefore, reforms to the domestic economic structure (deregulation, gas, rail, electrical and other reforms of natural monopolies, land, labor, pension and social security system reforms, etc.) are vital to achieve self-sustaining growth of the Russian economy. President Putin is fully aware of the need for these reforms, initiating the establishment of the 'Strategic Policy Center', in which many economists have been mobilized to devise a 'socioeconomic development program' (short, middle and long term) in order to implement the above-mentioned structural reforms. Reforms are proceeding in line with this program.

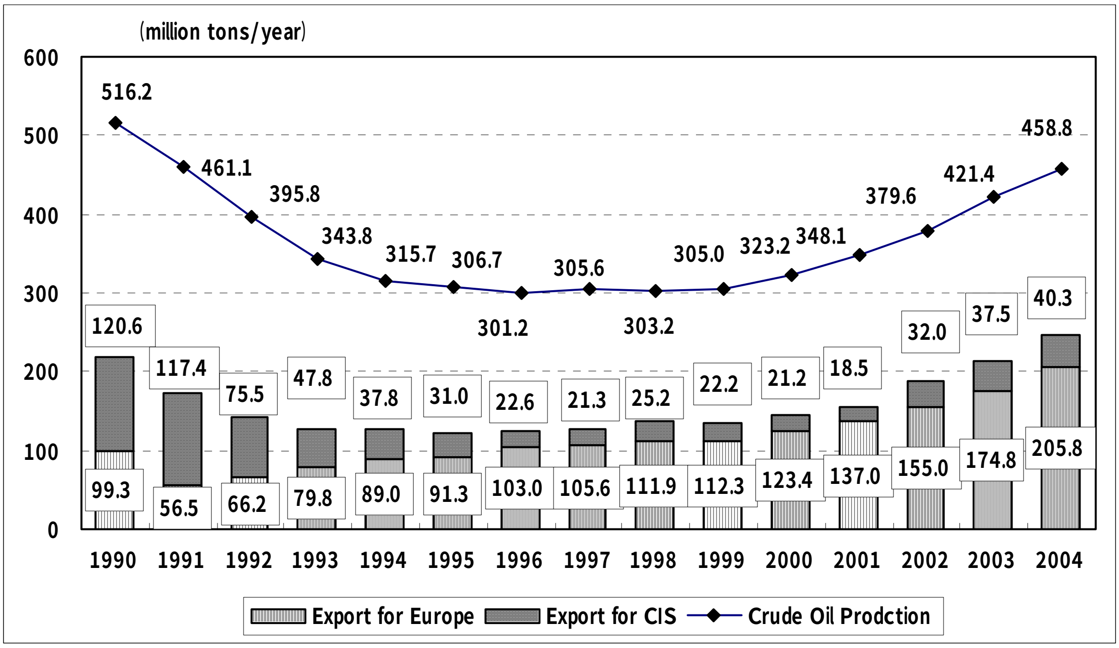
Section 2 Energy Supply and Demand Situation in Russia

In terms of the Russian energy demand structure, domestic production exceeds largely domestic demand, making Russia the world's leading net energy exporter. The share of Russia's natural gas in primary energy supply is remarkably high compared to the rest of world.

[2] As the percentage of crude oil, oil products and natural gas exports covering all Russian exports has risen from 37.4% in 1994 to 54.7% in 2004, while the Russian economy's dependence on oil and gas has grown.

Russia achieved increased production of crude oil in 6 consecutive years from 1999 to 2004 (Figure 1), reaching a remarkable breakthrough as the largest non-OPEC country, and boosting oil exports in almost the same proportion as its increased oil production. The outlook for future oil production and exports in Russia are divided into 'Optimistic' and 'Pessimistic' forecasts (Table 1). Factors which would affect future crude oil production and exports in Russia are oil prices, pipeline, ports and other export-related capacities, as well as concerns over the negative effects of strengthened restrictions and controls on private oil companies by the Russian Federal Government. This leads to many cautious and 'pessimistic' forecasts related to increased production in Russia.

Figure 1: Changes in Russian Crude Oil Production and Exports



Source: PlanEcon Energy Report, Vol.11, No.1, April 2001, p.9. (1990 to 2000), Eastern Bloc Energy, Publishers (2001 to 2002), Russian Energy Monthly, February 2005 (2003 to 2004)
Note: Exports to Europe since 2003 = oil exports & exports to CIS

When we look at reserves, resources and recent exploration activities, there are notable 'pessimistic outlooks'. While the oil and condensate replacement rate in 2000 is 93% of annual production, this dropped to 86% in 2001 and rose again to 100% in 2002. However, the replacement rate seem to be fairly low due to rapid increase in crude oil production and decrease in the number of exploratory wells.

Table 1. The Outlook for Russian Crude Oil Production

(million tons/year)

	Actual	Forecast			
	2004	2005	2010	2015	2020
Russian Ministry of Energy (2000)	—	308-327	305-335	305-345	305-360
Russian Ministry of Energy (2002)	—	360-370	370-380	380-400	405-430
Russian Ministry of Energy (2003)	—	420-445	445-490	450-505	450-520
Tyumen Oil (Hearing survey, 2003)	—	448	-	455	460
IEA (2002)	—	-	430	-	450
Yukos (April, 2003)	—	420	-	-	-
R. Capital (2001)	—	421	512	552	595
Campbell (2002)	—	420	335	-	215
Bakhitari (2002)	—	400	380	-	-
Ebel (2002)	—	410	-	-	-
CGES (2004)	—	-	600	665	-
Dr. Franseen (2004)	—	445	495	-	-
Russian Ministry of Economic Development and Trade (2005)	458.8	475			
Troika Dialog (2005)	458.8	472		-	-
MDM-bank (2005)	458.8	470		-	-

Source: 2003 Performance: Russian Energy Monthly, February2004, "Russian Energy Survey: 2002", IEA, 2002, p.53, Eastern Bloc Energy, February 2003, p.9, July 2002, p.4 and Site Hearing Investigtion, "World Energy Outlook 2002", IEA, p.96, Mayumi Motomura, 'The Rebirth of Russia as a Major Oil Producing Country and Its Background - Oil & Natural Gas Production Analysis Trends and Geological Potential', "Oil/Natural Gas Review", January 2003, p.22, Russian Energy Ministry, "Russia's Energy Stragtegy to 2020 (Approved by the government on September 5, 2003)", MEES, March 22, 2004, pp.A1-A4, Platts Oilgram News, June 17, 2005. p.1.

Russia has achieved the rapid increase in crude oil production from the last half of the 1990's to the beginning of the 21st century because of tremendous efforts to increase oil recovery from older fields using IOR (Improved Oil Recovery), and EOR (Enhanced Oil Recovery), not because of the development of newly discovered large-scale oil fields. Huge investment has been done to development for existing oil fields to increase in crude oil production in a condition of high crude oil price. On the other hand, 2D seismic surveys and exploratory well drilling which would be necessary to discover new oil fields has not been enough. This has resulted in reliance on production from existing oil fields for the moment, and the remaining recoverable crude oil reserves in Russia would shrink gradually in the condition that crude oil production continues to keep a 450 million ton/year level. It will be difficult for Russia to return to the previous reserves level if there are no major discoveries as the only alternative to major oil fields in Western Siberia, in regions where there is strong geological potential such as the area around Sakhalin and Eastern Siberia in the future.

Section 3 Oil Policy in the Putin's 2nd Term

(Domestic Oil Policy)

Russian Federal Government understands and places great emphasis on Russian oil industry as a pillar which supports its economy, and also as a major industry in which it supervises the supply of oil, where there is rising strategic importance. The Russian oil industry exports oil produced mainly in Western Siberia, thus obtaining foreign currency and contributing greatly to government revenues. The Putin administration in the 2nd term is implementing policies to strengthen its control over the all-important oil industry. The methods to strengthen its control are (1) tightening rules for licensing, (2) increasing in taxation and (3) control of crude oil pipelines. Moreover, oil development against the backdrop of higher oil prices can be supported by the strength of the Russian oil industry, and is reinforcing the view that, in terms of the strategically important oil industry, it should be supported by the Russian oil industry to the fullest extent possible, and is strengthening its cautious and reactive posture more than it has done in the past for foreign currency investments to the Russian oil industry.

Firstly, authorities in the Russian Government have adopted policies to tighten rules for licensing. Exploration, development and production licenses have various requirements to the oil companies such as the number of wells to be drilled, the start time for commercial production, production volumes. The authorities have the power to cancel licenses granted in the event oil companies cannot observe these directives. Nevertheless, for licenses involving foreign investment, the Russian Federal Government and the said oil company work towards some kind of "political resolution", and some hold the view that licenses will never be revoked.

With respect to strengthened taxation, mineral resource extraction taxes are fixed to have no relationship to oil production difficulty, while changes such as oil export taxes are set high along with the rising cost of oil, leading to a greater tax burden on Russian oil companies. As a result, Russian oil companies do not feel as if they are receiving the benefits of high crude oil prices, and this is leading to concerns that investments to exploration, development and production sectors will be adversely affected, irrespective of the recent high oil prices.

The Russian Federal Government has strong intention to maintain national controls on the domestic oil trunks and export pipelines at all cost. They do not allow for oil pipelines that are owned and operated by private industry. Additionally, oil exports by oil companies are strictly monitored so that tax revenues are surely gained by the government.

Russia currently has 9 vertically integrated private oil companies (Russian Federal Government has no shares of these 9 private oil companies. Rosneft is the only vertically integrated state-owned oil company.). Yet this would not mean that the private oil companies could operate unrelated to, moreover, against the intention of the Russian Federal Government. Important matters such as mergers of other oil companies and joint projects with foreign oil companies must be presented to Russian Federal Government for consultations prior to their execution and their approval must be gained. Lukoil and Surgutneftegaz maintain good relations with Russian Federal Government. Yukos has breached this ‘unwritten code’ and is on the verge of being dissolved. The Yukos affair can be viewed as an example for which the policies and the attitude of Russian Federal Government to strengthen its direct involvement in the management and organization of oil companies is clear.

(External Oil Policies)

- **Vis-à-vis Europe**

Russia and Europe have an interdependent relationship through oil, natural gas and other trade. For Russia, Europe is a major market for crude oil exports, and securing its market share in Europe would continue to be a major issue in the future. Therefore, Russia has undertaken projects to boost crude oil pipeline export capacities and new construction projects for Europe (CPC[Caspian Pipeline Consortium] Pipeline and Baltic Pipeline System). Russia also announced a partnership to facilitate greater cooperation with EU in the energy field in October 2000.

- **Vis-à-vis Northeast Asia**

For Russia, Japan, China and other nations in Northeast Asia are characterized as a potential crude oil export market in the future. On the other hand, for Asian countries, there is an advantage of diversifying their oil supply source through importing Russian crude oil in the future. For Northeast Asia, Russia is one of the promising choices for diversifying their oil supply sources. The focus up to now has been the choice of routes for the ‘Eastern Siberia Crude Oil Pipeline Construction Plan’ (including branch lines route from Skovorodino to Daqing in a trunk line route of ‘Pacific Route from Taishet to Perevoznaya). Russian Federal Government has scheduled construction of Phase 1 from Taishet to Skovorodino, yet there has been no final decision on the route after that as of November 2005. One of the reasons for this is crude oil reserves at a scale where the oil pipelines for both routes can be effectively utilized have not been confirmed at the present time[3]. Besides, Russia has also signed accords primarily for the oil and gas sectors with China, South Korea and India since 2004, and has been working to strengthen its relationships with them.

- **Vis-à-vis Central Asia**

Russia has been trying to retain the maximum amount of influence over Central Asian countries, which have been striving for economic autonomy from Russia. For that aim, Central Asian countries have tried to gain hard currencies by exporting crude oil and natural gas, which are produced onshore and offshore areas in the Caspian regions. Kazakhstan and Azerbaijan have attempted to

[3] Overseas hearing survey.

export crude oil they produce in the Caspian Sea region through the construction of crude oil pipelines that would detour around Russia. Russia, on the other hand, has appealed to these countries to use crude oil pipelines that pass through its own territory. As a result, Kazakhstan has decided to use crude oil pipelines to Samara and CPC pipeline, which pass through Russian territory to export Kazakh-produced crude oil.

Azerbaijan has used both the 'Northern Route' crude oil export pipeline, which passes through Russian territory and a 'Western Route' crude oil export pipeline, which detours around Russian territory at the beginning. Yet Azerbaijan has completed BTC(Baku-Tbilisi-Ceyhan) Pipeline, which detours Russian territory as its main crude oil export pipeline. If the BTC pipeline, which has an export capacity of 50 million tons/year, is fully operational in the future, this may lead to competition between Azerbaijan and Kazakhstan against Russia mainly over oil exports to Europe.

Russia has good relations with Azerbaijan and Kazakhstan. These three countries made an agreement in May 2003 on the borders of the northern area of the Caspian Sea (though Turkmenistan and Iran have objected). Russia has signed long-term accords with Kazakhstan on the quota for Kazakh-produced crude oil to pipeline through Russia.

- **Vis-à-vis Middle East**

For Russia, to strengthen cooperation in the oil sector with Iran signifies a kind of 'check' on the United States (US oil companies cannot invest in the Iranian oil industry because of economic sanctions imposed by the US Government). The point of focus is what role Russia will play in reconstructing the oil industry in Iraq. Coordination between Russian and US would be important in this regard. Whether Russia, one of the world's largest crude oil producing countries, would cooperate with, or oppose to decisions in the oil sector made by Saudi Arabia, the kingpin of OPEC, would make difference in crude oil supply volume and supply/demand fundamentals in the international crude oil market.

The Putin Administration in the 2nd term is working to strengthen its energy relationship with Iran (cooperating in the oil, gas and the nuclear power sectors). Their intention in their governmental relationship with Iraq is to fully support regaining its interest in the Western Al-Qurnah oil fields which Lukoil had signed agreements with during the former regime of Saddam Hussein.

- **Vis-à-vis the United States**

The once thin energy relationship between Russia and the US has made a dramatic transformation, with the rising international crude oil price from 1999 to 2000, the 'Energy Crisis' in the US and the terrorist attacks on September 11, 2001.

The terrorist attacks have, in contrast, cooled America's relationship with Saudi Arabia, and the

US has looked toward Russia, which has increased crude oil production rapidly since 2000, as one of the crude oil alternative sources. Putin has supported the US-led War on Terror, leading to the anticipation of a new political partnership between Russia and America. The US and Russia agreed to Strategic Arms Reduction Treaty at the summit in November 2001, and announced a “Russia-US Energy Partnership” at a summit between their leaders in May 2002. At the 2nd Russia-US Energy Summit in September 2003, the focus of the discussions was a LNG export plan from Russia to the US, yet LNG exports from Russia to America have not materialized as of June 2005.

Russia may be pressed to coordinate its views over its handling of Iran and Iraq with the US in the future. Russia, which is working to strengthen its relationship with Iran, and with whom the international community suspect is developing nuclear weapons, is a factor that ‘upsets’ the US. In contrast, Russia, which is focusing on ‘recovering’ its lost interests in Iraqi oil, needs to have good relations with the US.

- **Vis-à-vis OPEC**

Russia is the largest non-OPEC oil producing country. Russia participates as an observer in OPEC. Russia has cooperated with OPEC in ways to reduce crude oil exports when OPEC reached an accord and implemented this effort with non-crude OPEC countries from April 1998 to March 2000. As oil prices have recently risen to historic levels, OPEC’s task is not to lower production ceilings but to raise them. Thus, Russia need not consider how to cope with coordinated lowering crude oil production levels with OPEC. Russia would have to make a clear decision on the relationship with OPEC again only when crude oil price would decline and needs for crude oil production levels would arise.

Section 4 The Structural Changes in the Russian Oil Industry and the Overview of the Russian Oil Companies

The restructuring and privatization of the Russian oil industry is ranked as a critical task to shift from a planned economy to a market economy accompanying the breakup of the former Soviet Union.

The restructuring of the Russian oil industry can be classified into the following 4 major stages.

Stage 1 (1992 - 1st Half of 1990’s): Sell-off of state-owned assets (privatization) and establishment of vertically integrated oil companies

Stage 2 (1st Half of 1990’s - 2000): Continued privatization process. Purchase and divesting of small and mid-sized oil companies by large oil companies, increased power of large oil companies controlled by financial capital and the oligarchy

Stage 3 (2000 - Mid 2003): Progress of restructuring and integration between large oil companies

Stage 4 (Mid 2003- Present): Potential for further restructuring caused by the 'Yukos affair'

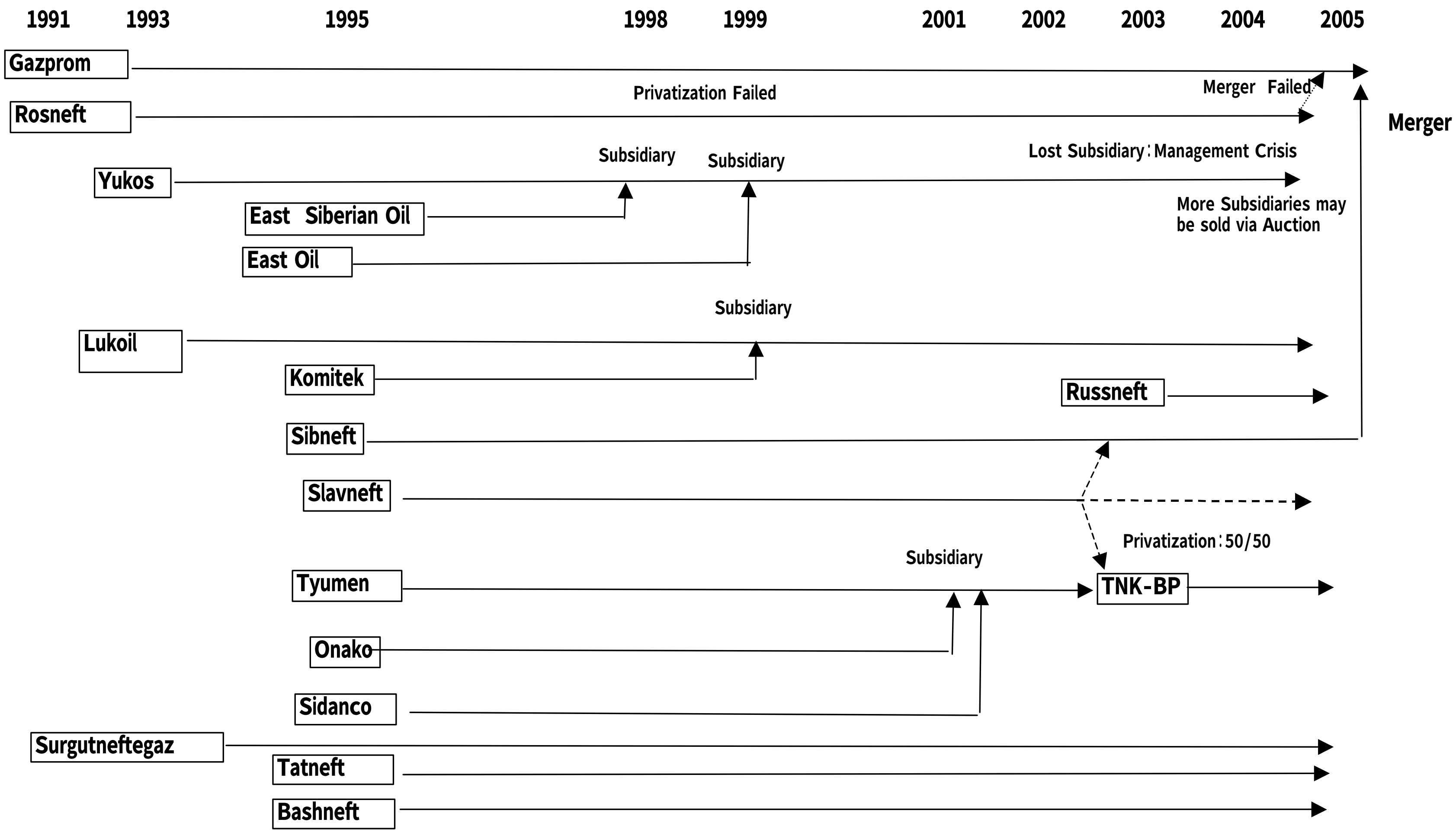
The establishment and privatization of vertically integrated oil companies was completed under the former Yeltsin Administration (From the end of December 1991 to the end of December 1999), and its initial 'purpose' can be regarded as successful. However, no full privatization was to be implemented in three years period time from the establishment of vertically integrated oil companies in the first half of 1990s (some of the said oil company stocks continued to be held by the government). Moreover, Russian Federal Government was 'cautious' for foreign capital and had restricted investment from foreign companies to Russian vertically integrated oil companies up to 15%. Privatizing Russian vertically integrated oil companies was accelerated ironically due to the loan, which Russian Federal Government held for compensation for huge financial deficit. Russian Federal Government has borrowed a loan from the Russian financial institutions on the security of vertically integrated oil companies stocks it held. Then. Most of these oil companies stocks were transferred to the Russian financial institutions because the government failed to pay off its debts within the deadlines. The new oligarchs controlled the Russian oil companies at that time. Then, large vertically integrated oil companies proceeded to merge small and mid-sized oil companies, and the number of vertically integrated oil companies has been reduced from 14 in 1995 to 10 as of June 2005.

Yukos-related affairs is a critical point in forecasting the trends in Russian oil companies in the future, and clearly indicates the intention of Putin to strengthen his control over the Russian oil companies. Mikhail Khodorkovsky, the President of Yukos, was arrested in July 2003. Yukos was declared to be a tax delinquent and requested to pay fines from Russian Federal Government in December 2003, major production subsidiaries were sold off (transferred to Rosneft) in December 2004. These developments indicate Russian Federal Government's intention to dissolve Yukos ultimately. Russian Federal Government would auction for oil production subsidiaries other than Yuganskneftegaz, refining and oil products sales subsidiaries for the purpose of collecting delinquent taxes and fines from Yukos, which the government has demanded.

Gazprom and Rosneft are at the forefront of companies bidding in these auctions. Yukos has protested to the Yuganskneftegaz sale and has appealed to the courts both inside Russia and internationally. Thus the major Western oil companies are fearful of the legal risks of appeals by Yukos, and there may be very little likelihood of them participating in the sale of Yukos-held assets (production subsidiaries, refineries, oil product sales affiliates) in the future. In addition, other Russian vertically integrated oil companies would not probably participate in these auctions if there is no ‘prior agreements’ with Russian Federal Government. Therefore, Rosneft and Gazprom will play a major role in the future restructuring of the Russian oil industry according to the actual breakup of Yukos

As of June 2005, there are 10 vertically integrated oil companies that are active in Russia: Lukoil, Yukos, Surgutneftegaz, Rosneft, TNK-BP, Sibneft, Slavneft, Rusneft, Bashneft and Tatneft. These 10 vertically integrated oil companies have produced a total of 423.17 million tons in 2004, which is equal to 92.2% of the entire crude oil production of Russia.

Figure 2: Trends in Russian Oil Industry's Restructuring (1991 - 2005)



Source: Prepared by the IEEJ

Section 5 Management Strategies of the Major Russian Oil Companies

5-1. Lukoil

Lukoil is the Russia's largest oil company, and has continued to maintain its top ranking in oil production performance, together with its overseas oil production at 87.21 million tons (84.10 million tons domestically, 3.11 million tons internationally) in 2004. Lukoil has focused on oil resources, and reliable production activities to maintain sustainable crude oil production. Lukoil has maintained good relations up to now with Russian Federal Government, and this has been useful for Lukoil when it attempts to implement major projects both domestically and internationally[4]. In terms of their relationship to foreign capital, joint projects with ConocoPhillips would attract attention in the future.

Similar to their business expansion inside Russia, Lukoil's overseas businesses are very diverse from upstream to downstream, and it has launched mechanisms for their completion overseas from upstream to downstream consistently through its own projects[5]. Lukoil currently maintains good relations with Russian Federal Government, and if it promotes strong cooperation with overseas oil companies with ConocoPhillips at the head of the list, Lukoil, which will invest in the secure upstream sectors, will continue to maintain its position as the largest oil company in Russia in the future.

5-2. Yukos

Yukos is a private oil company managed by a financial oligarchy, which has expanded its business scale and boosted crude oil production through the purchase and mergers with small and mid-sized oil companies in the 1990's. From the end of the 1990's, Yukos has employed a Western-style management method, and implemented fundamental management reforms. Yukos was active in introducing Western exploration and production technologies, which could boost its production, and managed the company with focus on maximizing earnings for stockholders, short-term crude oil increases and boosting revenues.

Yukos's major production sites are located in Western Siberia, and it does not conduct production activities overseas. Yukos exceeded Lukoil in crude oil production and became Russia's largest domestic oil producer), with its crude oil production of 85.68 million tons (18.7% share) in 2004. Yukos's 4.93 million ton increase in crude oil production in 2004 put it at a roughly 13.2% share of

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[4] With respect to ConocoPhillips acquiring Lukoil stock, Lukoil held prior discussions with the Russian Government and gained their consent (Overseas hearing survey).

[5] For example, there are the following 2 project plans
(1) Joint development of oil fields with PDVSA in Venezuela, and refining oil in a new refinery in Venezuela, then Lukoil would supply oil products to service stations it holds in the US, (2) Lukoil will provide crude oil produced in Russia to the Petrotel refinery in Romania, then supply oil products to service station in Hungary which it purchased.

increased crude oil production throughout Russia. However, Yukos's assets, including Yuganskneftegaz, a major production subsidiary, were seized by Russian Federal Government in 2004. Yuganskneftegaz was auctioned off in competitive bidding in December 2004, for which ownership ultimately was transferred to Rosneft. Therefore, Yukos was forced into a severe situation where the massive back taxes and fines have to be paid, and is destined to be 'dissolved'.

Since 1999, Yukos was the driving force of increased crude oil production in Russia. Foreign oil companies were again aware of mounting risks in investment climate for the Russian oil industry when they saw the development of 'Yukos Affairs' and re-auditing toward other companies, in addition to that, demand for back taxes and fines to be paid,

5-3. Surgutneftgaz

Since its establishment in 1993, Surgutneftgaz has expanded its crude oil production with its base in Western Siberia. Its crude oil production has ranked between 2nd and 4th in Russia since 1993 (59.62 million tons of crude oil production in 2004). Surgutneftgaz also had little tax arrears even when the Russian Government was focused on this problem with Russian oil companies in the middle of the 1990's, and, for the Russian Government, Surgutneftgaz was an 'excellent' oil company.

Up to now, Surgutneftgaz has not shown an active stance to cooperate with other Russian or Western oil companies, and has taken its 'own way'. However, its agreement to establish a consortium to develop oil and gas fields in Eastern Siberia with Rosneft and Gazprom in December 2003 may be a major turning point for Surgutneftegaz. Against this background is the aim of the Russian Government, with respect to future development of Eastern Siberia, which covers almost all of the unexplored and undeveloped mining areas unlike Western Siberia where there are major existing oil producing regions, to develop oil and gas fields in Eastern Siberia under their control[7].

President Bogdanov of Surgutneftgaz, an engineer on profession, is more interested in acquiring exploration and development licenses that purchasing (acquiring stock in) other Russian oil companies[8]. Surgutneftgaz will certainly realize increased crude oil production in the future with reliable, superior exploration and production technologies.

5-4. Rosneft

Rosneft is the only vertically integrated oil companies in Russia, all of voting stocks of which are held by the Russian Federal Government. For Russian Federal Government, which would like to

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[7] Overseas hearing survey.
[8] Overseas hearing survey.

strengthen its control of Russian oil companies, Rosneft is a 'convenient' company that may reflect and carry out the aims of the Russian Government in the future. Russian Federal Government, which envisions the 'dissolution of Yukos', has auctioned off Yuganskneftegaz, an affiliate of Yukos, and Rosneft, the state-owned oil company was successful in its bid for it. Nevertheless, the merger plan of Rosneft and Gazprom, which was accepted by Russian Federal Government in September 2004 has been resisted by Rosneft, and Russian Federal Government announced the withdrawal of this plan in May 2005. Against the background of the withdrawal from this merger plan, there is said to be a kind of 'conflict' between Dmitry Medvedev, the Russian President's Chief of Staff, who holds interests in the natural gas sector, and Igor Sechin, the Deputy Head of the Presidential Administration, who holds interests in the oil sector[9].

If this merger plan were to be realized, Gazprom, which boasts the world's largest natural gas reserves and production, would become Russia's largest oil producing company, together with Rosneft which acquired Yuganskneftegaz, a blue-chip oil producing company, and have a tremendous impact on the restructuring of Russia's oil industry. Rosneft, without merging with Gazprom, has brought Yuganskneftegaz under its umbrella as an independent company, thus has already shifted quickly from being the 8th largest oil producer to becoming its 2nd (73.38 million tons in 2004).

Production subsidiaries, refineries and oil products sales affiliates, other than Yuganskneftegaz, which Yukos retains, may be sold off one after another at Yukos's dissolution. When they are sold off, Rosneft (and Gazprom), which has been given the nod by the Russian Government, will become the major focus as the successful bidding company. Thus Rosneft, in the future restructuring of the Russian oil industry accompany the actual dissolution of Yukos may become the major player.

5.5. TNK-BP

TNK-BP has responded flexibly to the oil development policies of Russian Federal Government. For example, TNK-BP has accepted the situation where the company had been forced to develop oil fields under the existing ordinary tax regime by amendments of Production Sharing Agreements, and also seems to accept imposition of Oil Stabilization Funds and windfall profit taxes as long as the tax rate are not very high. In a sense, TNK-BP would try to put some distance between the company and Russian Federal Government based on the experience of the 'Yukos Affair'.

TNK-BP has introduced BP's cutting edge technology and management method, improved its upstream development and oil recovery rate, modernized its refineries, been active in investing in cultivating Service Station employee morals, and is approaching the most Western style of any of

[9] Overseas hearing survey.

the 10 Russian vertically integrated oil companies. While many of TNK-BP's oil fields are aging, they have planned for steady crude oil production increases at their major production sites in the future through equipment investments and technology innovations, and will become one of the vital companies which will shoulder Russian crude oil production (70.27 million tons of crude oil production in 2004).

The establishment of TNK-BP has put attention of new measures for oil development in Russia after the amendments of PSA Law, and there is interest gathering on what position they will occupy in the future in the development of Eastern Siberia and the Sakhalin, and what affect they will have on the global oil market. Since 2004, there have been obvious risks in investment climate risks in Russia such as demand for back taxes and fines to be paid by TNK-BP from the Russian authorities, the forfeiture crisis of development rights of the Kovyktinskoe fields of RusiaPetroleum, thus the focus will be how TNK-BP, with its new business model, will overcome this difficult situation.

5-6. Sibneft

Sibneft has a plan to boost crude oil production, yet it has no real active strategy to increase its reserves. Sibneft has introduced drilling technology and oil field management methods from the West, which allowed them to boost crude oil production. Thus their future task may be active exploration and development activities based on a mid-term development strategy (33.98 million tons of crude oil production in 2004).

Sibneft has adopted a corporate strategy of boosting crude oil production in the short-term and raising earnings through the purchase and merging of production subsidiaries, rather than through steady exploration and development, and there are endless rumors that Abramowicz, who is one of the major shareholders in Sibneft, will sell off his stocks to large overseas oil capital interests that are searching for investment opportunities in Russia, before Sibneft's earnings fall and asset prices drop. Sibneft is praised for its business model, which is similar to Yukos, in that it has frequently achieved strong increases in crude oil production and exports, yet the differences in response to the Russian Government are apparent. Abramowicz extended negotiations with Russian Federal Government and succeeded in discounting to less than 1/3 the back taxes due and other measures. This contrasted with Khodarkovsky, the former President of Yukos, who was fully opposed to Russian Federal Government. This incident left a strong impression both domestically and internationally that, ironically, there is a need to build good relations with the government in order for private Russian companies to survive. In September 2005, Gazprom has acquired 72.7% of Sibneft stocks.

5-7. Slavneft

Negotiations on the splitting of Slavneft assets continue to be held between TNK-BP and Sibneft, and no information on the specifics of this has been heard as of May 2005. Incidentally, Sibneft has also showed its interest in acquiring Megioneftegas (an annual crude oil production of 13.00 million tons), a major asset of Slavneft. There is strong likelihood that Surgutneftgaz will purchase the Yaroslav Oil Refinery in the event that their assets are liquidated. Nevertheless, the specific development of the split-up and liquidation of the assets is still unclear, and there may be many factors of uncertainty in terms of the future management form of Slavneft. Slavneft's crude oil production in 2004 was 22.01 million tons.

5-8. Russneft

Russneft is an emerging oil company, yet it is still a smaller scale company, compared to other vertically integrated Russian oil companies, in terms of crude oil production, export and refining (8.78 million tons of crude oil production in 2004). Some of Slavneft's assets were transferred to Russneft. Russneft has expanded its corporate scale by M&A of small and medium-sized oil companies. M&A would be the major strategy of Russneft for the future.

5-9. Bashneft

The center of Bashneft's crude oil production is located in the Republic of Bashkortostan, yet its crude oil production is at the lowest level among the Russian vertically integrated oil companies (12.03 million tons of crude oil production in 2004), and it has low productivity. Russian large-scale vertically integrated oil companies such as Lukoil have up to now purchased small and midium-sized vertically integrated oil companies to boost their crude oil production and refining capacities. One of the important tasks for Bashneft in the future is to improve its productivity(to maintain and increase crude oil production level with reducing the number of production wells) with the support from Bashkorstan Republic Government.

5-10. Tatneft

Tatneft's crude oil production in 2004 was at 25.10 million tons, slightly higher than in the previous year. Additionally, even in their 'weak' refining division, Tatneft has constructed the new Nizhnekamskneftekhim Oil Refinery and has launched its operations. Tatneft has also started to move to acquire controlling stock in the national refineries of the Czech Republic and Turkey. Tatneft will receive constant support from the government of the Republic of Tatarstan, and continue to produce, refine and sell crude oil within the Republic. Management of Turkey's Tupras Refinery which Tatneft acquired the controlling stake is a touchstone for the company. It would determine whether Tatneft would remain the present status of 'Regional Oil Company', or would be able to develop its international operation.

5-11. Transneft

Russian Federal Government has been trying to strengthen its control of Russian oil industry, and has controlled domestic crude oil trunks and export pipelines through state-owned company Transneft. Russian Federal Government has not approved the construction or operation of a crude oil pipeline under the direction of a private company, and would to continue to control and operate the oil pipelines[10].

Russian Federal Government can pressure specific oil companies by not approving of the allocation of pipelines. In this instance, if the allowance for this is transferred to other oil companies, there would be no loss of crude oil exports on the whole for Russia and no losses on the tax side for the Russian Government. Russian Federal Government effectuates its control through Transneft, and monitors the oil exports of oil companies in order to gain tax revenues. Since the basic policy of Russian Federal Government is state control of crude oil trunk and export pipeline, Transneft would continue to be a state-owned company. Transneft's major revenue sources are crude oil pipeline tariffs gained from oil companies, and the tariff levels require approval of the Russian authorities. Transneft is said to be a company with little 'own discretion' in management, yet it may serve a role in executing crude oil pipeline construction plans for Russian Federal Government in the future.

5-12. Gazprom

Gazprom was established in 1989. Gazprom gained great power and was called 'State within the State' as the gas monopoly entity during the tenures of its first President Chernomyrdin and its second President Vyakhirev. In May 2001, Miller, one of the most loyal confident to President Putin, took office as the third President of Gazprom. Thus, President Putin has put Gazprom under his control.

Gazprom is the world's largest natural gas producing company. Gazprom has been producing natural gas mainly from three existing fields in Western Siberia : Urengoi, Yamburg and Medvezhe. Gazprom has also started to develop and produce natural gas from new Zapolyarnoye field to compensate decrease natural gas production level from the existing three main gas fields mentioned-above.

For Gazprom, natural gas exports to Europe have become the cornerstone of its operations. Thus the critical management task for Gazprom is to boost natural gas export pipeline capacities for Europe, and Gazprom has been constructing the new 'Yamar Gas Pipeline' and 'North European Gas Pipeline'. Gazprom has, at the same time, tried to diversify its natural gas export outlet. Gazprom was designated by Russian Federal Government to coordinate natural gas development

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[10] Overseas hearing survey.

and export project promotion in Eastern Siberia. Gazprom has signed cooperative agreements with CNPC of China and Gail of India in the natural gas sector, as it targets natural gas exports to Asia in the future. Gazprom also has a project in the works to develop Stockman Gas Fields offshore in the Barents Sea and export LNG to the US.

Gazprom's plan to merge with Rosneft was withdrawn in May 2005. The plan itself got approval from Russian Federal Government in advance in September 2004.If this merger plan were to have been realized on schedule, Gazprom would have become a powerful company with a status of the world's largest natural gas producer and Russia's largest oil producer. Although the merger plan with Rosneft was withdrawn, Gazprom has aquired 72.7% of Sibneft stocks in September 2005. Moreover, when the sell off of the remaining affiliates of Yukos commences again, Gazprom will become, along with Rosneft, the leading candidate for biddings and tenders. Gazprom may play a central role in the further restructuring of the Russian oil industry because of the Yukos 'Management Crisis (sell off of affiliates)'.

Section 6 Russian Oil Production, Exports and Effects on Global Oil Market

The Russian Government realizes and recognizes that its oil industry is the cornerstone of its economy and a vital industry which overseas the supply of oil, and has a growing position in Russia as a strategic resource, and may be attempting to strengthen is control of the oil industry, which is achieving increased production and revenues because of the continued rise in oil prices since 1999, through (1) tightening licensing, (2) strengthening taxation and (3) national control of the crude oil pipelines. In addition to that, Russian Federal Government has been trying to impose restrictions on foreign investment into the Russian oil upstream sector. Russian Federal Government's oil policies mentioned-above would prevent effective use of huge resource potentials and the Russian oil companies' incentive for investment. Therefore, it would lead to slump in crude oil production in Russia as a whole.

We could see both 'pessimistic' and 'optimistic' view on the future outlook for crude oil production in Russia. If we look at the 'pessimistic view', we see that reduction in crude oil production in Russia, as the world's largest non-OPEC oil-producer, means reduction in crude oil production in Non-OPEC as a whole. It is essential that there is increased crude oil production by oil producing states, in order to respond to global oil demand, which is expected to grow steadily in the future. In this instance, oil demand on OPEC would grow, and OPEC's market share would increase. Thus it would bring a decline in OPEC's spare production capacity. Supply and demand in the global oil market will would be tightened. International crude oil price would easily go up.

In contrast, from the ‘optimistic view’, increase in crude oil production in Russia means directly increase in crude oil production in Non-OPEC as a whole. It would be expected to lead stable supply and demand situation and stable crude oil prices in the international oil market.

Table 2 below is an outline of Russia’s ‘great increases in oil production’ as opposed to ‘stagnation in oil production’, and what this will mean for Europe, Northeast Asia, Central Asia, the Middle East, the United States and OPEC.

Table 2. Global Significance of Increases/Stagnation in Russia's Crude Oil Production

	Increases in Russia's Crude Oil Production	**Stagnation in Russia's Crude Oil Production**
On Europe	• If the development of export pipelines continues at a strong pace, Russia will continue to keep the position as one of the major suppliers to Europe.	• Crude Oil exports to Europe as a source of acquiring foreign currency will be important, even if there is stagnating oil production. Yet, Russia's share of the European market would shrink.
On Northeast Asia	• Although this is premised on great increases in crude oil reserves in Eastern Siberia and the Far East, as well as developing an export pipeline for Northeast Asia, Northeast Asia would be new crude oil export clients besides Europe.	• The most important issue for Russia will be obtaining existing oil exports for Europe. Russia may have to postpone its oil export plans for Northeast Asia, which would require massive investments.
On Central Asia	• There will be more severe competition over Europe, the major crude oil export market. There will be less room for allocating oil through transit pipelines in Russian territory for Central Asian countries.	• Russia's share of the European market may be lost to Central Asian countries.
On the Middle East	• There will be more severe competition over Europe, the major crude oil export market.	• Russia's share of the European market may be lost to Middle Eastern countries.
On the United States	• It would be good for exporting crude oil to US as a spare exporting capacity. Moreover, even if this plan does not materialize, Russia will boost oil exports to Europe, which may lead to the US increasing oil imports from other oil producing countries.	• There is little likelihood of crude oil exports to the US.
On OPEC	• When international crude oil prices go down because of increase in crude oil production in Russia, Russia must decide whether to reach an accord with OPEC in order to reduce production level or not.	• Stagnation in Russia's oil production would invite increases in oil demand on OPEC. This would bring down OPEC's spare capacity even more, and would increase international crude oil price. No need for adjusting crude oil production level in cooperation with OPEC.

Source: Prepared by the IEEJ.

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