Draft
November 21, 2005

RUSSIA'S ENERGY POLICY: FOCUSING ON NEW MARKETS

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In 2006, Russia will assume the rotating presidency of the G8. The G8 Agenda's focus will be on energy security and energy efficiency. In Russia's foreign policy, the central direction taken after September 11, 2001, was close and cooperative relationship with both the US and Europe, including anti-terrorism efforts, the WMD (weapons of mass destruction) non-proliferation, and the expanded energy supply. Europe and, increasingly, the U.S. are concentrating their attention on Russia's role as a supplier of energy.

The long-term projections adopted by the Russian government include the following goals:

- By 2015, Russia would produce about 530 million tons of oil a year (10.6 Mbd), exporting about 310 Mt (6.2 Mbd)
- By 2015-2020, the oil production in the new producing areas in Eastern Siberia, Yakutia and Sakhalin would reach about 75 Mt a year
- By 2015, the Asia-Pacific region would account for 15-18% of the Russia's oil exports, being supported in a large part by an oil pipeline constructed from Eastern Siberia to the Pacific Ocean coast
- By 2015, the natural gas production is expected to reach 740 Bcm, allowing exports of 290 Bcm. In Eastern Russia the gas production would increase by the factor of 15 over the current level, reaching about 130 Bcm by 2020.[1]

In the context of these projections, Moscow has begun pursuing a long-term energy posturing in East Asia and the Pacific, targeting the markets China, Japan and the ROK, as well as India and the United States.

Oil production and oil exports are increasingly important dimensions in Russia's domestic development plans and its external relationships, particularly with regard to the new markets, outside Europe. The importance of oil exports for Russian economy is difficult to overestimate:

- ❑ In January-October 2005, Russia's oil exports stood at 209 Mt
- ❑ In the first 6 months of this year it was valued at $32.5 billion
- ❑ Oil exports contributed 33% in Russia's export revenues
- ❑ Oil share is above 50% in the exports of fuels.

Since 2000, the oil production in Russia increased by 40%, while in 2005 it could grow further by about 3%, meaning an additional 13-15 million tons (Mt), which is roughly

[1] Victor B. Khristenko, "The 21st Century Energy Sector: Efficiency and Security," Opening Speech at the Main Session of the 5th All-Russia Oil and Gas Week, Moscow, October 31, 2005.

equivalent to the amount of oil exports to China by rail planned for 2006. In September 2005, Russian oil companies were producing 9.53 million barrels a day (Mbd).

Russia's oil exports are growing faster than production. In September 2005, non-CIS exports via Transneft's pipeline system climbed to a new high of 3.99 Mbd, an increase of 15.5% compared with same period of last year. In 2005, total exports, including those by pipeline, rail and other means (the latter accounts for about 4.5% of the total), could expand by 10-11%. In physical terms, exports would constitute about 275 Mt, with domestic demand remaining close to 200 Mt.[2]

New projects are coming on line. Following Sakhalin 2, the Sakhalin 1 project will further boost crude output and exports. On October 2, 2005, ExxonMobil, the project operator, launched commercial oil production at the offshore Chaivo field. By 2007, output from Sakhalin 1 could reach 0.25 Mbd.

The delivery infrastructure development and its expansion towards 2015 are among the strategic targets, including the Pacific pipeline project. New pipeline routes reflect new priorities, which are roughly the following:

- Avoid and/or reduce dependence on transit routes
- Diversify markets (Asia-Pacific region)
- Upgrade "Urals" blend
- New production centers in Eastern Russia …
- … that require geological exploration …
- … and a new pipeline to the Pacific coast (named as a "project of national significance").

The construction of the Baltic Trunk-line System (BTS), with its current annual capacity of 50 Mt is a major achievement. Russia plans to reduce the dependence on Europe as the dominant destination for oil exports. Diverting some 30 Mt of oil from Western Siberia to markets in the Asia-Pacific region means higher revenues.

Oil output reaching 530 Mt by 2015-2020, including about 50 Mt or more produced from new sources in Eastern Siberia and the Far Eastern region (without Sakhalin projects). Oil exports could reach 310 Mt by 2020, with up to 30% of these volumes directed to markets in Northeast Asia and beyond. However, the total amount of investment required for the oil sector in the next 15-20 years could be close to $60-70 billion, including the funds needed for geological exploration and development in new areas.

The two-phase project called the Eastern Siberia Pacific Ocean pipeline (abbreviated in Russian as VSTO) should serve as the infrastructural backbone of the Russian oil strategy, aimed at:

(1) reduced export dependence on Europe to avoid unwanted commercial losses[3]

[2] In January-June 2005, Russia's oil exports stood at 125 Mt. It was valued at $32.5 billion and contributed 33% in export revenues and 53.4% in exports of fuels (in June, average export price for "Urals" was $324 per one ton).

[3] Transneft also plans to build the 0.48 Mbd Northern Pipeline, which will run from Kharyaga in the Timan Pechora oil province to Indiga on the Pechora Sea, probably at the same time as the Pacific pipeline construction goes on. Previously, Transneft had planned to launch the former only once the initial stage of the

(2) a drastically improved environment for exploration and development in new areas

(3) the industrial and social advancement of Russia's eastern regions.

The first phase of the project envisages the construction of the 2,400 km, 0.6 Mbd capacity Taishet-Skovorodino section and an oil terminal on Perevoznaya Bay towards the end of 2008. Transneft plans to raise $6.6 billion to finance the first phase of the project, including a $5 billion issue of Eurobonds.[4] The second phase of the VSTO project may be financed through a project-financing scheme, bringing the full cost of the pipeline to $11.5 billion.

The second phase will include the 1.0 Mbd pipeline stretch from Skovorodino to Perevoznaya and the expansion of the capacity of the Taishet – Skovorodino section to 1.6 Mbd. In addition, the government plans to maintain and increase its oil-by-rail exports to China and may consider a pipeline connection from Skovorodino to Daqing. This approach mirrors the one proposed by the 2020 Energy Strategy: a pipeline to the Pacific coast (50 Mt) plus a branch pipeline to Daqing (30 Mt).

President Putin has declared the VSTO pipeline to be a project of national significance, recently requesting from the government to speed up all the inter-agency approval procedures.

Recent developments in the oil sector indicate that the oil companies react to these plans positively. First, Rosneft made a decision on construction a feeding pipeline, connecting its Vankor fields in Krasnoyarskiy Krai with the Transneft's system. It will be 350 km long with annual capacity of 18 Mt, the volume Vankor will produce in 4-5 years after the beginning of production.

Second, the Talakan field in Yakutia could produce 8-10 Mt of oil by 2010-20012. Surgutneftegaz, the project operator, also announced its plans to build a feeding pipeline that on the way to the south could also connect Verkhnechonskoe field to the VSTO pipeline.

Third, for the TNK-BP, the eastward-oriented projects also likely to be the priority direction, including the development of Verkhnechonskoe field with 201.6 Mt in reserves. The indication is the recent decision by the company to allocate $270 million for the test phase of oil production and plans to coordinate production with the VSTO pipeline project.

However, proven reserves of oil in the eastern regions is the problem. Only about 1,500 Mt is currently available in Eastern Siberia and the Far Eastern Region, requiring the following steps:

1. Moving available C2 volumes of oil to the categories of ABC1

2. Promoting the exploration work program supported by Government, which would allow adding 1,500 Mt to reserves and 1,500 Mt to resources

3. Improving the legislation: Amended Law on Subsoil Use

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latter had been completed. The northern pipe is to carry crude from the Timan Pechora region, an area being developed by LUKoil.

[4] Transneft maintains that it can raise as much as $7-8 billion for a period of 15-18 years at an attractive refinancing rate. During the last 48 months, the company has invested about $3 billion by borrowing money.

4. Comprehensive licensing to developers.

However, the government wants to secure its dominant role in the industry by exercising the exceptional development rights for "strategic projects", retaining control over the delivery infrastructure (pipelines), and by promoting the new roles for Gazprom and Rosneft.

The challenges are multiple. In 2004, only 21 new oil fields entered the production with the total output of only 150,000 tons, requiring the drilling of 145,000 meters of new wells. The volumes of exploratory drilling for oil have dropped from 5 million meters in 1990 to only 1 million meters in 2003.[5] The list of problems to deal with includes the following:

- Reserve replacement severely lags behind production
- Uncertainties related to legal and fiscal regulations
- A deceleration in production
- Obsolescent refineries and low processing depth
- No tax benefits for hard to recover reserves
- No tax benefits for green-field projects in frontier areas.

The government wants to improve the tax regime for the oil sector by introducing a differentiated production tax and provide greater stability to the user-state relationships via amended Law on Subsoil Use. It is expected that the single-stage bidding for exploration and production rights will be introduced. It is less certain that the open auctions for licenses will be enacted because Russian oil companies are fearful of foreign competition. In short, the government wants:

(1) Encourage investment in exploration
(2) Rationalize the resources utilization
(3) Introduce effective control over the license use
(4) Increase budget revenue
(5) Provide more support to the regions.

In short, the government is to decide over the next two to three months on the allocation of tax breaks for companies investing in green field projects in Eastern Siberia and Russia's offshore. Companies could be granted tax holidays of up to seven years during the development stage of new projects to cover the costs of financing the project. Other measures being considered to accelerate the exploration and development of oil and gas resources, including production tax differentiation.

Very briefly, about the prospects for natural gas projects in Eastern Russia… The recent forecasts appear optimistic, but the exploration and development program is huge, expensive and prone with the number of uncertainties, including, above all, the market demand for natural gas, higher prices compared with gas produced in Western Siberia, and high-cost transportation infrastructure.

Currently, the "three options" scenario proposed by Gazprom and the recently proposed "Integrated Gas Program" for Eastern Russia are on the government's plate. The details of the "Integrated Gas Program" include the following three groups of considerations:

[5] Russian Statistical Yearbook 2004 (Moscow: Roscomstat, 2004), p. 378.

Market development and access:

1. Domestic users and local gasification
2. Long-term supply contracts
3. Inter-governmental agreements.

Investment returns:

1 Tax breaks for companies investing in projects
2 Synchronized development of oil and gas
3 Transportation tariffs.

Resources related:

1. Revised licensing agreements
2. Helium separation and utilization
3. Associated gas utilization.

For the natural gas industry development in Eastern Russia international cooperation is indispensable. In this context, the guidelines recently announced by METI could somehow influence not only the prospects for Sakhalin reserves of natural gas, but also those of Eastern Siberia and Yakutia. What could be even more important, however, is the Gazprom's policy in entering the LNG business and prospects for natural gas processing industry development in eastern regions.

Russia maintains a number of the "energy dialogues" not only with economies of Northeast Asia, but also with EU, India and the United States. The "action plans" that cover energy issues were adopted with Japan and the Republic of Korea. Gazprom established contacts with KOGAS and CNPC. These frameworks are all different, responding to specific needs and priorities. The dialogue with EU is well established, while the one with India is relatively new.

The practical connections established with the U.S. are growing in significance. According to the U.S. Department of Energy, oil imports from Russia could reach 20 million tons this year. The share of the U.S. market that Russian oil companies occupy increased from 2.3% in 2004 (12^{th} position, 0.205 Mbd), to 3.6% (8^{th} position, 0.476 Mbd) in 2005, including 0.35 Mbd of crude oil supplied. From October 2005, oil from Sakhalin 1, produced by ExxonMobil supplements these transactions. The longer-term target could be 1.0 Mbd of supplies (4-5 in ranking), provided that LUKoil exports oil via yet to be built Khariyaga-Indiga pipeline. In addition, U.S. market could grow further in importance, if the URALS is used for the U.S. Strategic Oil Reserves.

As far as the 2006 G8 Summit agenda is concerned, its main direction should be enhanced energy security on a global scale coupled with the long-term stability of the energy markets, considering the following building blocks at its foundations:

- Transparency and availability of data on energy demand, reserves and resources
- Long-term supply contracts and the producer-consumer dialogues
- Adequate development of energy infrastructure
- Improved energy efficiency, including hydroelectric power and other renewables
- Intensive R&D aimed at promoting new sources of energy.

Maintaining the status of an “energy superpower” is a continuous challenge. For Russia, its leaders and the government this means an ongoing struggle with vested interests, investment climate hurdles and various external problems, including, above all, markets. Not surprisingly, the bottom line in this struggle is money. The estimated cost of the long-term Energy Strategy 2020 plan adopted by the government in 2003 is between $650 and $800 billion. On the other hand, in 2005 alone, the projected net profits of the eight leading oil companies in Russia could amount to $27 billion. Then again, to sustain the current production levels of natural gas, there is a need to invest around $13-14 billion in the next two decades in new wells to secure an adequate production base.

THANK YOU!

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