



THE JAMES A. BAKER III
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THE ENERGY DIMENSION IN RUSSIAN GLOBAL STRATEGY

REORGANIZATION OF RUSSIAN PETROLEUM INDUSTRY
AND ITS EFFECT ON BUSINESS STRATEGY

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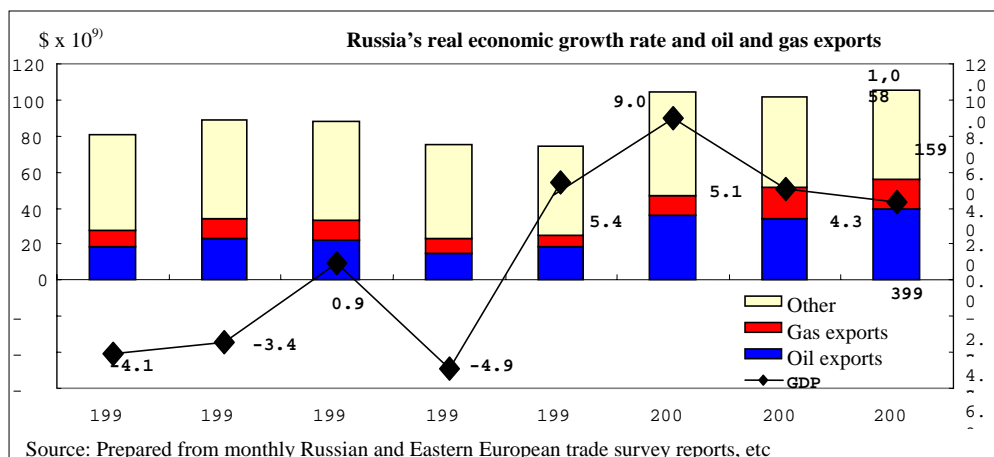
Involvement of Petroleum Industry and Government

Position and Importance of the Petroleum Industry for the Russian Government

Having recovered from the 1998 financial crisis, the Russian economy continues to perform satisfactorily. Russia's economic growth rate dipped to 4.3% in 2002, down from 5% in 2001, before ramping up to 7.3% in 2003. The oil sector is playing an important role as the prime mover of this more favorable Russian economy. In 2002, for instance, Russia's oil exports accounted for \$39.9 billion or 38% of \$105.8 billion in total exports. Moreover, the oil sector also remains an important input to Russian gross domestic product (GDP), with oil-related tax revenue occupying an extremely important place in the Russian government's total tax revenue.

Oil has become recognized as one of the important resources for strengthening Russia's presence in international relations. This is because Russian oil and natural gas resources draw great interest from the main players on the international energy stage, including the United States, Europe, Asia and the Organization of Petroleum Exporting Countries (OPEC). Moscow is asserting stronger control of the industry as a result of its growing importance to the state.

Figure 1 : Changes in Russia's GDP Growth Rate, Total Exports, Oil and Gas Exports



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Important Oil Policy and Oil Industry Policy Issues for the Russian Government

Based on the issues discussed above, the government is facing several policy choices. The first is how to develop the Russian oil sector. In other words, development refers to how to increase and maintain crude oil production and to promote infrastructure development as well as enable foreign investment in order to increase exports.

The second issue for the government is how to ensure and increase tax revenue from oil. This is not only a short-term issue, but it is also critical as a source of revenue to diversify and strengthen the Russian economy over the long-term. Therefore, the actual collection of tax and the examination of new taxes and public charges are important considerations for the government.

The third issue is how to “supervise” the Russian oil sector. This is a matter of government coordination with the vertically integrated Russian companies that are at the core of increased crude oil production. Under consideration is how to maintain control through the administration of export infrastructure. Although some Russian observers believe that the “Yukos incident” – which included the government claims that Yukos owes \$3.4 billion in taxes and the high profile arrest of former Yukos CEO Mikhail Khodorkovsky – reflects the political feuding and antipathy between Russian President Vladimir Putin and Khodorkovsky, there are others who suggest that the incident might symbolize the Russian government’s increasing trend for participation in and reinforced supervision of the oil industry.

The recent increase in Russia’s oil production is remarkable, showing a 38% increase from 1999, to reach 8.43 million barrels per day (b/d) in 2003. At the heart of this production increase is the aggressive oil field development accomplished by private vertically integrated Russian companies, such as Yukos, Lukoil, TNK and others.

These vertically integrated private oil companies have greatly increased their own earnings and profits due to substantially higher oil production and exports as well as high crude oil prices. With their strength as business entities, they have emerged with a more powerful voice and

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influence in Russian politics and the economy. Under these circumstances, Russian private oil companies like Yukos began to promote large-scale oil export (infrastructure) plans outside the former national administration, including plans for a crude oil export pipeline from Eastern Siberia to Daqing, China and plans for exports to the U.S. from Murmansk. These moves characterized private oil companies' efforts towards strengthening the voice and influence of the oil industry.

The Yukos incident, however, appears to have halted this trend. The private oil companies are mindful of lessons learned from the Yukos incident and are concerned about the Russian government's more aggressive involvement in the oil industry. It is not surprising that these companies are now trading more cautiously with the Russian government.

Reorganization Trends and the Future of the Oil Industry

Privatization and Development of Vertically Integrated Oil Companies since the 1990s

The birth of vertically integrated oil companies dates back to 1991, with the dismantling of the Soviet Union and the subsequent formation of the Russian Federation. These developments led to the reorganization of oil-related state commissions and ministries of the former Soviet Union (FSU), with some entities reorganized and privatized. By 1993, the companies that had emerged were the first result of the sale of state-owned assets. These holding companies held stock controlling crude oil production subsidiaries, refining subsidiaries (refineries) and marketing subsidiaries. This process led to a fourteen-company system in 1995.

The purchase of medium-to-small companies (or production subsidiaries) by the major oil companies progressed in the latter half of the 1990s, including Lukoil's purchase of Komitek in 1999, Yukos' acquisition of East Siberia Oil in 1998 and East Oil in 1999. By 2003, a ten-company system emerged, comprised of Lukoil, Yukos, Surgutneftegas, Rosneft, Tyumen Oil, Sibneft, Slavneft, Sidanco, Bashneft and Tatneft. Total crude oil production for the ten companies in 2003 was 7.64 million b/d, or 90.4% of Russia's total crude oil output.

Moreover, among these ten vertically integrated companies, several firms –notably Yukos, Tyumen Oil and Sibneft – stood out because their senior managers came from the financial rather than oil sector. As will be discussed later, one of the features of the oil companies falling under the classification of financial capital and financial clique companies is that they also played a major role in achieving the remarkable oil production increases enjoyed since 1999.

Figure 2: Structure of Russia's Oil Industry

- Ten vertically integrated oil companies [exploration, development, production, refining, marketing]
- Lukoil, Yukos, Surgutneftegas, TNK-BP, Tatneft, Sibneft, Slavneft, Rosneft, Bashneft and Sidanco
- Foreign investment merger companies: 135
- Independent companies: 45
- Crude oil pipeline operating companies: State-operated Transneft
- Petroleum products pipeline operating companies: State-operated Transnefteprodukt

So far, two stages in the reorganization of the Russian oil industry system have been completed. Stage one involved the sale of state-owned properties and establishment of vertically integrated companies, and stage two included the purchase and merger-and-acquisition of small firms by the majors and the rise of major oil companies that are managed by financial capital and financial cliques. These developments have led to the preparation for stage three – the latest reorganizations and concentrations between large organizations - which will be discussed later in this paper.

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**Table 1: Changes in Oil Production of Russia's Vertically Integrated Oil Companies
(million barrels/day)**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	Share (%)
Bashneft	0.36	0.33	0.31	0.26	0.25	0.24	0.24	0.24	0.24	2.86
Komitek	0.09	0.08	0.07	0.07	0.00	0.00	0.00	0.00	0.00	
Lukoil	1.12	1.08	1.08	1.07	1.23	1.25	1.26	1.52	1.59	18.7
Onaco	0.15	0.16	0.16	0.16	0.15	0.15	0.00	0.00	0.00	
Rosneft	0.26	0.26	0.27	0.26	0.26	0.27	0.30	0.32	0.39	4.64
Sibneft	0.41	0.37	0.37	0.35	0.33	0.35	0.38	0.53	0.63	7.45
Sidanko	0.46	0.42	0.41	0.40	0.14	0.13	0.18	0.33	0.37	4.42
Slavneft	0.27	0.26	0.25	0.24	0.24	0.25	0.30	0.32	0.36	4.29
Surgutneftegas	0.67	0.67	0.68	0.70	0.76	0.82	0.89	0.99	1.09	12.8
Tatneft	0.50	0.50	0.49	0.49	0.48	0.49	0.50	0.49	0.50	5.85
Tyumen Oil	0.46	0.43	0.43	0.40	0.58	0.62	0.74	0.76	0.87	10.2
East Oil	0.23	0.23	0.23	0.22	0.00	0.00	0.00	0.00	0.00	
East Siberia Oil	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Yukos	0.73	0.71	0.72	0.69	0.90	1.00	1.17	1.41	1.63	19.2
Vertically integrated oil companies total	5.71	5.51	5.45	5.32	5.31	5.57	5.96	6.92	7.67	
Changes from previous year (%)	-3.70	-3.45	-0.97	-2.53	-0.09	4.85	6.95	16.18		
Russian Federation total	6.18	6.07	6.15	6.11	6.14	6.51	7.01	7.64	8.49	
Changes from previous year (%)	-2.85	-1.79	1.46	-0.79	0.59	5.97	7.70	9.06	11.3	
Vertically integrated oil companies production ratio (%)	92.4	90.8	88.6	87.1	86.5	85.6	85.0	90.5	90.4	90.4

Note 1: Lukoil bought Komitek in 1999 and made it a subsidiary.

Note 2: Yukos bought East Siberia Oil in 1998 and East Oil in 1999 and made them subsidiaries.

Note 3: Tyumen Oil bought Onako in 2001.

Note 4: In December 2002 Tyumen Oil joined Sibneft in a successful bid for the privatization of Slavneft. Allocation of finance is now being discussed.

Note 5: At end August 2003, Tyumen Oil and BP set up TNK-BP with equal shares.

Changes of Industrial Systems and the Effect on Oil Production and Exports

Between 1999 and 2003, Russia's crude oil production rose 38%, or about 233,000 b/d, to 8.45 million b/d, which almost matches Saudi Arabia, the world's largest oil producer. There are a number of factors that contributed to the impressive production increase. These include, Russian oil firms' improved cash flow and increased investment in the domestic bases due to the sharp rise in international crude prices beginning in 1999, and the fall in the exchange rate of the Russian ruble brought on by the domestic financial crisis of 1998. The application and development of advanced oil-related technology that was introduced in the late 1990s also had a large impact.

The recent reorganizations within some of the Russian vertically integrated oil companies contributed to reinforcing the operating strengths of these firms. In fact, analysts suggest that the companies' improved operating conditions, combined with high crude oil prices and the introduction of advanced technology, helped lead to the rise in Russian oil production.

On the other hand, observers argue that the actual reorganization within Russia's vertically integrated oil companies did not have much effect on Russian crude oil exports. Of course, as discussed above, it is possible that company reorganizations contributed to a substantial boost in crude oil production and, as a result, brought about the impressive increase in crude oil exports. Reorganization and higher crude exports, however, have had no visible effect at all on the state-operated Transneft, which serves as the country's pipeline operator and exporter. The Russian government responded to the greater influence of the vertically integrated oil companies as they produced higher crude oil exports by recognizing the significance of a government-controlled export administration. Indeed, the emergence of strong vertically integrated companies with independent export plans became a challenge to the state-supervised export system.

Recent Industrial Reorganization and the Effect on the National Oil Sector

Recent Reorganization Trends such as Major Mergers and Affiliations:

- December 2002, TNK and Sibneft successfully bid to privatize Slavneft

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- March 2003, TNK and BP agree to establish TNK-BP (government approved in August)
- April 2003, Yukos and Sibneft agree to merge
- November 2003, cancellation of Yukos-Sibneft merger due to the “Yukos incident”

Although plans for the Yukos-Sibneft merger collapsed, the Russian oil industry was essentially transformed in 2003 into the “big four” system, consisting of Yukos, Lukoil, TNK-BP and Surgutneftegas. Operationally, these four companies have outperformed the rest of the sector, and the quartet recorded a combined crude oil production of 5.48 million b/d in 2003, comprising 65% of total Russian crude oil production.

Thanks to their operational and management strengths, the four oil powerhouses were the backbone behind Russia’s crude oil production increases. They accounted for 76% (1.78 million b/d) of the 2.33 million b/d rise in Russian crude oil production from 1999 to 2003.

The “Yukos incident” could affect whether Russia’s vertically integrated oil firms continue to expand their oil output. The Russian government is expected to take a stronger hand in the administration of the vertically integrated oil companies, beginning with the possibility of expanding the role of state-operated vertically integrated oil companies such as Rosneft. Also, there is speculation that the government will no longer tolerate challenges to state-administered export plans by private companies such as Yukos.

Business Trends and Strategies of the Main Oil Companies

The following is a simple outline of the operational and management trends of the four major vertically integrated oil companies, Yukos, Lukoil, TNK-BP and Surgutneftegas, as well as Transneft and Gazprom.

Yukos

Yukos crude oil production reached 1.62 million b/d in 2003, up 16% compared with the previous year. With a 19.2% share of Russia’s crude oil output, Yukos beat out Lukoil to the

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country's top producer. The company also recorded 2003 crude oil exports of 595,000 b/d, a 21% increase compared with the previous year, making Yukos the largest exporter that year. The company refined 621,000 b/d of oil, about the same as the previous year.

Yukos' main production base is in West Siberia. The company will continue to emphasize development of this traditional production base, but also focus on development efforts in Yurubcheno-Tokhomskoeye (Eastern Siberia) and the northern Priobskoye mining area.

In the transportation sector, Yukos had plans for exports from Murmansk under a memorandum of understanding between Lukoil, Sibneft and TNK in November 2002 and pipeline exports for Daqing. However, as previously mentioned, the future of these projects is uncertain.

Yukos is implementing strategic development policies that place great importance on Russia's upstream development. It was the strength of Yukos' large crude oil production increase that enabled the company to formulate an independent export plan. Yukos possesses important properties in Western and Eastern Siberia. The arrest of Yukos CEO Khodorkovsky and his trial for fraud and tax evasion charges has left the future of the company uncertain. Should the government seize Yukos shares owned by Khodorkovsky and his business associate Platon Lebedev, who was also arrested on fraud and tax evasion charges, it could have a sizable stake in Yukos ownership unless it passes these shares on to another state company or sells them publicly. As a top-ranking vertically integrated Russian company, the future development of Yukos is being watched closely.

Table 2: Yukos Crude Oil Production (barrels/day)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Crude Oil Production	730,000	710,000	720,000	690,000	900,000	1,000,000	1,170,000	1,410,000	1,630,000
Samaraneftegaz	180,000	180,000	170,000	160,000	150,000	160,000	190,000	230,000	250,000
Yuganskneftgas	540,000	530,000	540,000	520,000	530,000	610,000	730,000	860,000	1,000,000
Yukos	0	0	0	0	10,000	10,000	10,000	20,000	10,000
Tomskneft	220,000	220,000	220,000	210,000	210,000	220,000	230,000	290,000	320,000
Gas	0	0	0	0	0	0	0	0	10,000
Vostosibneft	0	0	0	0	0	10,000	10,000	0	0
Arcticgas	0	0	0	0	0	0	0	0	0
Zapadona	0	0	0	0	0	0	0	0	20,000
Marabarinskoye	0	0	0	0	0	0	0	0	0
Urengoy	0	0	0	0	0	0	0	0	0
Crude Oil Export	210,000	220,000	240,000	310,000	310,000	380,000	460,000	490,000	600,000

Source: Prepared from Russian Petroleum Investor, etc.

Lukoil

Lukoil's crude oil production in 2003 totaled 1.58 million b/d. The rate of increase compared with the previous year was little more than 4%, and its share of the total Russian production was 18.7%, similar to that of Yukos. Lukoil's crude oil exports in 2003 of 544,000 b/d - a 6% increase from 2002 - also placed it in second place in Russian oil exporting companies. Lukoil's top rank in crude oil refining volumes was maintained in 2003 at about the same level as the previous year at 688,000 b/d (up 1%).

In the upstream sector, Lukoil is concentrating on increasing production at its existing main domestic oil field in Western Siberia. At the same time, however, it is also enthusiastically tackling other developments, including at Timan-Pechora. Moreover, in the overseas upstream sector, it is pursuing developments in Azerbaijan (including the Shah-Deniz field) and Kazakhstan (including the Tengiz and Karachaganak fields).

In the transportation sector, Lukoil participated in promoting the Murmansk export plan. Also, characteristically, Lukoil is participating in overseas downstream operations with shares in

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refineries in Ukraine, Bulgaria, Rumania, and in the Kazakhstan CPC pipeline. Further Lukoil is involved in the marketing sector through its purchase of U.S. Getty Petroleum.

While the Russian upstream sector is the base of Lukoil's operations, it is one of the most active Russian company in overseas activities. Compared with Yukos, Lukoil's potential for growth and expansion including crude oil production and transportation is steadier, but the firm's future attention is on "omni directional" diversified strategic development.

Table 3: Lukoil Crude Oil Production (barrels/day)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Crude Oil Production	1,119,205	1,083,178	1,075,315	1,073,096	1,234,795	1,252,110	1,264,603	1,524,164	1,589,014
Kaliningradmorneftegas	15,096	14,493	14,301	13,890	13,096	13,479	13,479	13,096	12,685
Astrakhanmorneft	1,616	2,027	1,616	192	192	1,397	1,397	1,397	NA
Nizhnevolzhskneft	52,164	62,630	66,247	65,836	61,205	59,616	59,397	59,205	60,000
Permneft	172,164	113,562	113,370	111,562	108,329	107,726	108,137	106,740	105,726
Kogalimneftegas	526,986	502,630	540,082	533,836	536,849	546,521	552,356	559,205	579,342
Langepasneftegas	264,795	246,274	253,123	263,178	120,219	118,822	117,397	113,178	112,767
Pokachevneftegas	0	0	0	0	143,178	145,178	146,795	146,384	149,616
Uraineftegas	86,603	83,562	86,603	91,233	90,411	90,630	91,616	92,630	94,438
Komitek	91,233	65,644	72,301	70,685	73,096	79,534	84,575	49,342	118,603
Komineft	NA	NA	NA	NA	NA	NA	NA	NA	NA
Lukoil Western Siberia				888,055	800,055	900,932	908,192	914,219	938,384
Crude Oil Export	258,356	210,438	279,699	373,151	324,822	406,767	441,808	513,507	545,918

Source: Prepared from Russian Petroleum Investor, etc.

TNK-BP

TNK-BP's crude oil production in 2003 reached 1.24 million b/d, an impressive 15% gain over the previous year. Its share also increased and accounted for 14.6% of the Russian total production, surpassing Surgutneftegas to rise to the third top position as Russian producer. TNK-BP's crude oil exports grew to 542,000 b/d, just behind Lukoil. TNK-BP refined 408,000 b/d (up 1%) of crude oil in 2003.

In the upstream sector, the company is placing greater importance on production and development, with higher production efficiency and improved recovery in existing regions such as Western Siberia (Samotlor) and Ural (Orenburg). Equally as important for TNK-BP and these

existing properties is the development of its properties in Eastern Siberia, in particular, the Verkhnechonskoye and Kovykta fields. In the transportation sector, TNK-BP is joined with the aforementioned companies in the Murmansk export plan.

Analysts are eyeing TNK-BP with much interest now to see what the benefits of BP's participation will be following the merger in August 2003. The company was able to increase production due to the wider application of advanced technology and improved efficiency and productivity. Moreover, some of TNK-BP's long-term projects such as the Kovykta development are of particular interest in how they will impact the Northeast Asian energy market.

Table 4: TNK-BP Crude Oil Production (barrels/day)

	1999	2000	2001	2002	2003
Sidanko	135,726	133,918	183,863	325,014	374,740
Tyumeni Oil	582,356	621,014	738,822	755,151	865,096
TNK-BP	718,082	754,932	922,685	1,080,137	1,239,836

Source: Prepared from Russian Petroleum Investor, etc.

Surgutneftegas

Surgutneftegas recorded a 10% increase in crude oil production to 1.08 million b/d in 2003. The company's share in Russia's total crude oil output for Russia is 12.8%, putting it as the fourth largest producer in Russia. Surgutneftegas raised its crude oil exports in 2003 by 5% to 367,000 b/d. The company refined 307,000 b/d in 2003, up 4% from the previous year.

Surgutneftegas has a business system that is completely different from that of other large companies. It has one production subsidiary - Western Siberia: Surgutneftegas - and one refining subsidiary. It is unlikely that Surgutneftegas will deviate from the current path of having its production subsidiary strengthen its operations focused on prospecting, development and production.

The company has followed a reliable "independent route," but is also prudently pursuing tie-ups with overseas projects and other companies. Recently, Surgutneftegas has agreed to participate in Eastern Siberia development in collaboration with state-operated Rosneft and Gazprom.

Table 5: Surgutneftegas Crude Oil Production (million barrels/day)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Crude Oil Production	0.671	0.670	0.683	0.704	0.757	0.818	0.887	0.990	1.088
Crude Oil Exports	0.175	0.153	0.235	0.282	0.327	0.387	0.326	0.352	0.368
Test Pits (number of)	16	26	33	52	65	66	86	NA	NA
Exploitation Wells (# of)	678	627	645	587	585	851	NA	977	NA
Production Wells (# of)	10,928	11,553	11,754	12,466	13,385	14,044	14,770	14,640	NA
Suspended Wells (# of)	2,487	2,301	2,379	2,040	2,036	2,041	1,389	2,278	NA
Oil Produced per Production Well (Barrel/Day)	61.5	57.8	58.1	56.4	56.5	58.1	60	67.6	NA

Source: Prepared from Russian Petroleum Investor, etc.

Transneft

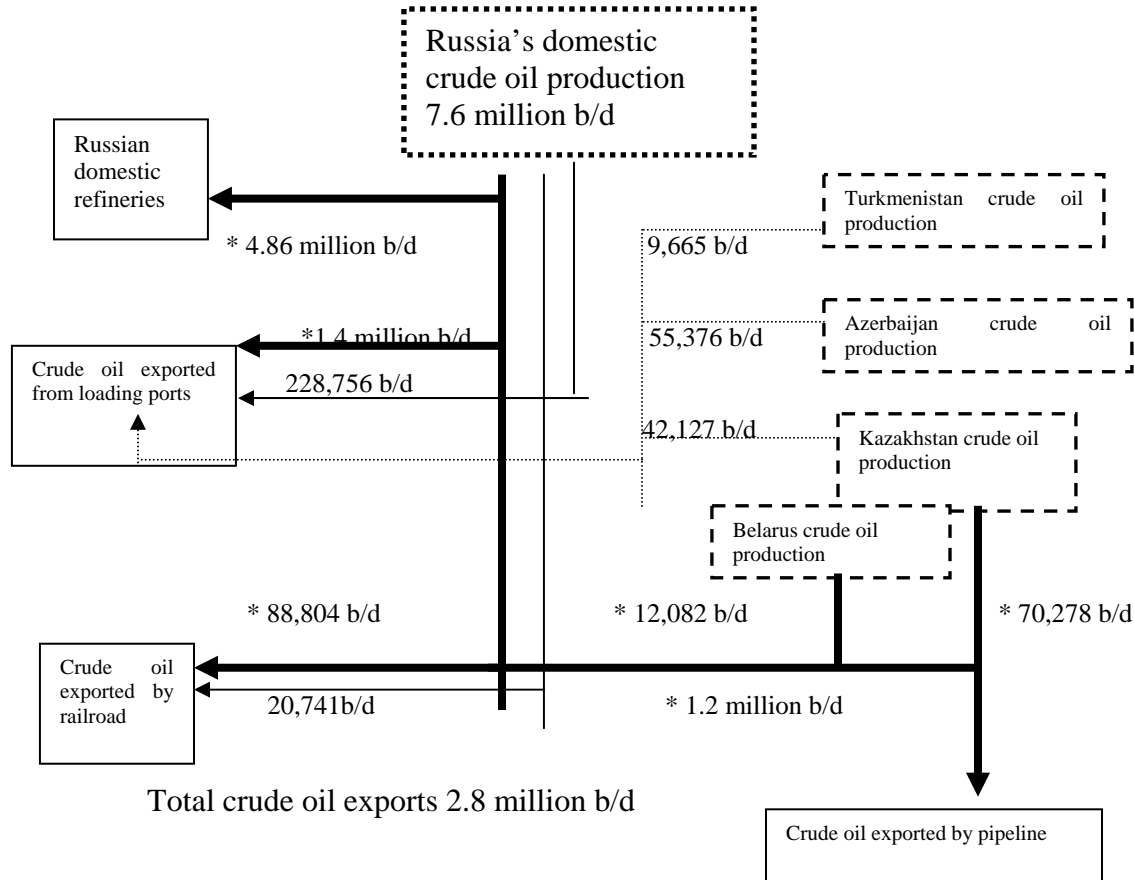
Transneft is the state-operated pipeline company that operates Russia's oil exports and pipeline network. The company was established in the same manner as the vertically integrated oil companies through the privatization of the Russian oil industry beginning in 1993. The Russian government holds all of the company's shares with voting rights. As a result, of the thirteen Transneft directors, ten are associated with the Russian government.

Transneft pipelines transported 4.82 million b/d of the 7.62 million b/d of Russian crude oil produced in 2002 to domestic refineries. Moreover, 2.67 million b/d of the 2.77 million b/d of Russian crude oil exports were transported through the Transneft system. (See figure below). As these figures demonstrate, Transneft handles nearly all of Russia's crude oil exports and transportation.

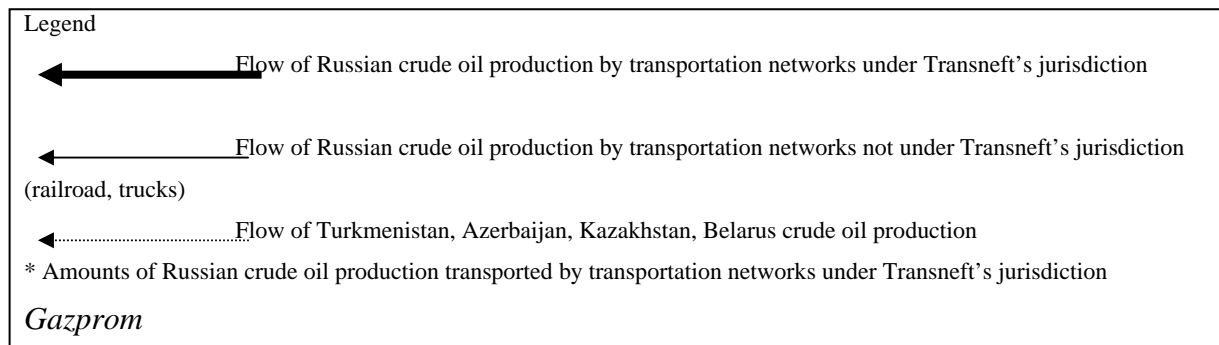
Transneft's transportation capacity is nearly full, thanks to the substantial rise in Russian crude oil production since 1999, making the issue of transport infrastructure an urgent one for the government and the oil industry. There are the previously discussed export plans proposed by the vertically integrated oil companies, but Transneft is also promoting its own infrastructure plans. The company recently expanded the Baltic Pipeline System (BPS), more than doubling the transportation capacity from 367,000 b/d to 843,000 b/d. Transneft is studying other pipeline

route options, including reversal of the Druzhba-Adria pipeline and construction of the Angarsk-Nakhodka pipeline to Asia.

Figure 3: Russia's Crude Oil Flowsheet (2002)



Source: Prepared from Russian Petroleum Investor, March 2003, pp 7-8



Gazprom is a partially state-operated monopoly that controls Russia's gas industry including exploration, development, production, domestic and export transportation, and wholesale gas

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marketing inside Russia. The company is a business system that includes twelve gas-production subsidiaries, fifteen transportation subsidiaries and one export subsidiary. As of March 2003, the Russian government held 51% of the company shares. Accordingly, six of the eleven company directors are associated with the Russian government.

Gazprom's natural gas production totaled 540.2 billion cubic meters (BCM) in 2003, up 4% from the previous year. Although gas production from independent firms and vertically integrated oil companies has also increased, Gazprom's production accounts for about 90% of Russia's total gas production. Gazprom's 2003 gas exports to Europe, which are the company's greatest source of revenue, amounted to 133.5 BCM of gas, a 4% increase from 2002.

Gazprom has additional European export contracts in place that will begin transporting between 175 and 205 BCM of gas by 2007 and is also examining and promoting several natural gas export pipeline plans. These include the north Europe gas pipeline plan and Yamal gas pipeline plan. The former, with a targeted carrying capacity of 20 BCM per year, is slated to begin operation in 2007. The Yamal gas pipeline plan, with a recommended pipeline capacity of 52 BCM per year, is a huge project, but is facing a number of obstacles including the need to remove restrictions in the European gas market. Although it was planned to be operational in 2010, its progress has been delayed.

Russia's plan for exporting gas to Turkey has also hit snags. Although the Blue Stream pipeline carrying Russian crude across the bottom of the Black Sea became operational in December 2002, exports were almost immediately halted following a collapse in Turkish gas demand. This prompted the two sides to negotiate on readjusting prices and volumes.

Gazprom is also targeting non-European exports as a long-term goal, including potential exports to Asia. The Russian government has nominated Gazprom as "coordinator," with regard to the development and export of Eastern Siberian gas. However, it is still not clear how Gazprom specifically is to be involved in the development of Eastern Siberian gas.

Gazprom is facing a serious problem in the domestic gas market, given the difference between extremely low domestic gas prices and international prices. Domestic sales, which account for about 60% of Gazprom's production, are unprofitable, forcing the company to consider improving its financial situation by raising domestic gas prices, but the issue of increasing domestic gas prices is a politically sensitive problem for Gazprom and the Russian government.

Table 6: Gazprom's Natural Gas Production and Exports (billion cubic meters)

	1995	1996	1997	1998	1999	2000	2001	2002	Jan-Sep 2003
Natural Gas Production	588.7	600.6	569.5	589.6	592.0	583.7	581.3	594.9	452.6
Gazprom (total)	559.5	564.7	533.8	553.7	545.6	523.1	512.0	521.9	389.0
Gazprom (W. Siberia)	519.2	526.9	496.4	515.6	507.0	483.9	NA	NA	NA
Oil Companies	29.2	29.5	29.5	29.0	31.6	32.7	32.3	34.6	NA
Independent Gas Companies	0	6.4	6.2	7.0	14.7	27.9	31.5	37.1	NA
Natural Gas Exports	190.6	196.5	189.2	202.7	204.5	211.7	180.2	226.6	140.2
Outside CIS	117.4	123.5	116.8	120.7	126.8	130.3	131.6	128.7	105.3
Inside CIS	73.2	73.0	72.4	82.0	77.7	81.4	48.6	97.9	34.9
Domestic Consumption	346.7	337.3	336.0	293.7	339.5	348.9	406.9	319.1	NA

Source: Prepared from The Almanac of Russian and Caspian Petroleum, etc.

The Role of Foreign Investment in Russia's Oil Industry

Details and Current Status of Introduction of Foreign Capital

Moves concerning the law on production sharing agreements (PSA) in Russia are outlined below.

- December 1994, Presidential decree relating to production sharing projects
- January 1996, production sharing agreements come into effect
- January 1999, amendment to the law
- January 2003, further amendment to the law

There are twenty-six production sharing agreements (PSAs) currently in place in Russia. Only two of these, Sakhalin 2 and Kharyaga, are actually producing barrels of crude oil. The amount of output from these two projects in 2002 averaged 36,000 b/d, no more than 0.5% of total

Russian crude oil production. In other words, the current contribution to Russia's crude oil production made by foreign investment (production sharing projects) is almost negligible.

In June 2003, an amendment to the law on PSAs went into effect, stipulating that a field may become available for PSA development only after: an auction for the development of the field on the standard license and tax terms has been held and has been declared void due to the lack of bidders; this field complies with certain additional conditions introduced in the PSA Law, such as the fields are located in hard-to-reach areas lacking transportation and other infrastructure; and this field has been included in the list of fields eligible for PSA development.

The new rules were to apply to those that have already been included in the list of fields eligible for PSA development by previous laws but where no PSAs have been concluded and to those where PSAs have been signed, but where the taxation provisions of such PSAs have not become effective.

The fields exempted from the new regime for incorporating PSAs include the following: fields that were already contained in the list of fields eligible for PSA development, fields for which investors have already obtained mineral licenses, and fields that are located on the continental shelf of Russia within the exclusive economic zone of Russia or on that part of the seabed of the Caspian Sea which is within the jurisdiction of Russia. Also excluded from the new PSA regime are the fields which are subject to PSA development on the basis of an international treaty and the fields operated on the basis of PSAs that had been signed prior to the adoption of the original 1995 PSA Law (namely Sakhalin 1, Sakhalin 2 and Kharyaga), since these projects are protected by the "grandfather clause" in the PSA Law.

Stance of Russian Oil Industry and Companies Regarding Foreign Capital

Generally speaking, Russian oil companies are not enthusiastic about the full-scale introduction of foreign investment. The large production increases and high international crude prices have meant the companies have available cash to proceed with core upstream development projects.

Reorganization of Russian Petroleum Industry and its Effect on Business Strategy

Russian PSAs were designed to protect a foreign oil companies from arbitrary changes in fiscal regimes by specifying a share out over the life of a project. Russian companies, subject to changing tax rules, argued that foreign companies should bear the same risks and costs as domestic firms. Heavy lobbying in the Duma by Russian oil firms against foreign company advantage in oil field development helped create the amended PSA law.

By raising hurdles for foreign entry into PSAs and making it difficult for full-scale foreign investment, Yukos and other Russian majors improved access for their own direct investment in these projects.

Current Evaluation of the Foreign Investment Side and Future Outlook

Opportunities to add to production reserves and increase output are extremely important for the international majors, which seeks to increase shareholders' profits. Foreign oil firms are eyeing Russia's recent production expansion and potential for greater output with high interest.

However, having been frustrated with the birthing pains associated with introducing foreign investment in the Russian upstream oil sector since the early 1990s, the international majors are well aware of the difficulties of business development in Russia. These include issues of stability and consistency within the Russian legal system in addition to a variety of political and financial risks. BP's full participation with TNK in establishing a new company is noteworthy and is being watched closely by other potential foreign investors.

The recent amendment to the PSA law suggests that foreign players will have to overcome even more hurdles to enter into upstream projects with Russian partners. Moreover, improved Russian oil company performance and the Russian government's desire to exert stronger administration and control over the oil companies make it improbable that there will be a full-scale entry of foreign investment in the Russian energy sector over the short term. However, it behooves the foreign companies to maintain a presence in Russia in case there develops a new recognition of the need to introduce foreign investment, brought about by a change in the business environment such as a dramatic crude oil price drop.

Future of Russian Oil Industry/Companies and the International Oil Market

There are a number of trends that have emerged from the Russian energy sector in recent years that could have an impact not only on domestic issues but also on the international market. Since 1999, the impressive increase in Russian crude oil output has not escaped the attention of international investors as well as other producers. That production increase is largely attributable to the Russian majors, who strengthened their operational performance. There are encouraging signs that the rise in production will continue, led by the “big four,” Yukos, Lukoil, TNK-BP and Surgurneftegas. There are, however, significant differences in these companies’ investments and operational strategies. How these Russian majors pursue future investments and development plans will determine the future of Russian crude oil production.

The Russian government may well use the “Yukos incident” as an opportunity to strengthen its hand in overseeing the oil industry and oil companies. It is unclear how government participation and supervision will affect the performance of the Russian oil companies and oil industry. Of course, government involvement in the control of the Russian oil sector and in the operational performances of the major oil companies could easily impact the future involvement of international oil companies within the Russian oil industry as well as the international supply and demand balance.

There is little doubt that state supervision of Russian oil transportation will be maintained through Transneft and that government participation and supervision will play a major role in the selection of routes for oil export infrastructure. The new export pipeline for Russian crude oil from Eastern Siberia is highly economical, and the Russian government is expected to look upon the development of this pipeline favorably.

Development trends in the Russian oil industry will continue to influence the global supply and demand balance as well as have important implications for Russian energy and political relations.