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RUSSIA—KING OF THE OIL HILL?

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President Putin arrived early as usual at his Kremlin office. Always anxious to read his *Presidential Morning Brief*—other presidents have morning briefs, you know. He skimmed through the pages, but one section in particular caught his attention. That section reviewed current developments in the world oil market.

What did he find?

- Escalating problems inside Saudi Arabia. Oil infrastructure security was at a heightened level, but nonetheless remained vulnerable to an “insider” attack.
- Spare oil producing capacity was shrinking rapidly.
- Political problems in Nigeria and Venezuela still constrained oil production and exports.
- The handover of power in Iraq was not going well at all.
- It appeared that Iran was not even close in securing a lifting of U.S. sanctions.

- Even though Libya was now open to foreign investment, any surge in output and exports this decade did not appear likely.
- World oil demand was continuing its robust growth.

How was my oil industry doing, he wondered? Turning the page, there was his answer. Oil production in Russia was now approximating that of Saudi Arabia, at around 9 million barrels per day (b/d). If Transneft meets its goal for 2004 and if exports by rail and inland waterway in the second half of this year match first half performance, oil exports may well exceed 6.5 million b/d. Nonetheless, still short of Saudi Arabia.

The *Daily Brief* then posed this question: might Russia ever match Saudi oil exports? Short term, the prospects do not look particularly good. Economic Development and Trade Minister Gref was quoted as stating that Russian oil production growth was likely to slow for the next several years, averaging perhaps 9.5 million b/d by 2006 or 2007. A bit disappointing perhaps, but domestic demand was not growing much either, so that most of the incremental output would become available for export, pushing sales beyond the 7 million b/d limit.

Thinking out loud, and reflecting upon all the uncertainties regarding Saudi, Venezuelan, Nigerian, Iranian and Libyan oil, what does Russia have to offer the world oil market that these suppliers do not? What is it that our oil exports could build upon?

The answer, at least to Putin, was quite clear. We offer reliability, we offer security of supply. In plain language, we are not the Persian Gulf. Yes, we might play politics from time to time with deliveries to republics of the former Soviet Union, but with only minor exception have we ever played politics with oil sales to customers in the West.

And we don't cut oil sales as a way of supporting higher prices. We sell whatever volumes of oil are surplus to our domestic needs, at whatever price prevails at the moment.

The oil-derived income, our reputation as a reliable supplier, are far too important for us to use oil as a political tool.

Could we regain our past glories? Could we return Russia to the days, back to 1988 for example, when we were outproducing Saudi Arabia by millions of barrels every day? If we could do that, and if our domestic needs were not much above where they are today, why, if I played my cards right in the coming years, I could be king of the oil hill. We could shift the center of oil power from Riyadh to Moscow, particularly if I could convince President Nazarbayev of Kazakhstan to coordinate his oil policies with mine.

What a nice sound that phrase has, he mused—king of the oil hill.

Just then, there was a knock at the door. A loud voice exclaimed, "Time to get up, Mr. President. It is 5:30 in the morning."

Putin awoke with a start. His vision of the future, as king of the oil hill, had been nothing more than a dream.

Or, is it?

Seeking the Truth

During the day, despite many interruptions, Putin could not shake the promise of that vision. He was fully aware of the political and financial vulnerabilities faced by oil importing countries and of their continuing efforts to diversify among sources of supply, but especially to reduce dependence on the Persian Gulf.

Putin did not waste any time. He called in his Executive Assistant and directed him to set up two teams, Team A and Team B. Team A was to determine how this vision could come true. Team B, in turn, was instructed to outline why this vision was little more than a dream. Each was given just one week to come up with its brief.

A Dream Blurred by Reality

Precisely one week later, his Executive Assistant laid both reports on Putin's desk. Putin, ever the pragmatist, turned first to the report prepared by Team B. The title of the brief said it all: "A Dream, A Vision Blurred by Reality."

The brief began by posing three key questions that must be asked regarding the Russian oil sector.

- Can the growth in oil production and exports be sustained?
- Or, like all good things, will this growth come to an end?
- Where will the new oil come from?

The brief noted mixed signals coming out of Moscow, and that one could pick and choose among statements by various governmental officials to support whatever position one might want to take on these questions.

The Russian oil sector has been living off its inheritance, that is, what it inherited from the former Soviet Union in terms of producing oil fields, pipelines, and refineries. This inheritance, while providing an opportunity for the Russian oil companies to expand production quickly with minimal investment, has had its drawbacks. Because of this ease in expansion, oil reserve replacement has lagged badly. Companies overproduced some fields, while letting other fields stand idle, undeveloped.

Although questions regarding the oil sector can be easily posed, the writers pointed to a lack of data necessary for answers that could reflect a certain confidence. Although Russia may give the impression that it is much more forthcoming, at least with the basic facts, whatever judgments

formulated nonetheless derive from information that, while not intentionally misleading, fall considerably short of our needs.

The brief then isolated three Russian opinions that foresee limited growth for the oil sector.

- The country's energy regulator, that is, the agency monitoring energy producers, has said: "Growth in oil output is to stop in 2005 as some fields are depleted." Subsequently the regulator modified this estimate by noting that Russian oil production could even slightly dip in 2005.
- Lukoil is on record as noting that annual production in Russia is to peak at between 9.6 and 10.3 million b/d as early as 2007, then stabilize.
- Yukos foresees a steady growth in Russian oil production through 2010 at least, hitting 10.5 million b/d that year, approximating the thinking by Lukoil, but at the same time warning that it was difficult to make credible forecasts beyond 2007 (10 million b/d) because of pipeline uncertainties.

Mr. President, the brief continued, we are inclined to accept oil company assessments and not those of the government. The government record of forecasting oil production levels over the years has not been good at all, and there is no reason to believe that suddenly their vision has dramatically improved.

The question really comes down to this: where will the new oil come from? East Siberia? Offshore? The Russian sector of the Caspian Sea? The potential is there. All it takes is time and money. A good portion of the money may have to come from the pockets of international oil companies. Moreover, discoveries to date have been relatively small, more difficult to produce, and more distant from existing infrastructure and export facilities.

This past January, Russia's Natural Resources Ministry finished a comprehensive review of the oil and gas companies working in the country. Conclusions of the ministry's officials were disheartening, according to what we read. These officials stated that development of oil and gas fields was being inefficiently carried out and that a significant loss to the state had occurred.

The issue is this. In Russian terms it is called "selective production." Under this approach, a company developing an oil field selects the largest and most accessible oil-bearing formations and produces only them. Moreover, associated natural gas is flared off and low yield wells are simply shut down.

The over-arching Yukos corporate strategy has been that of maximizing income and that exploration in new areas would probably not be a primary factor in the near term. The growth demonstrated by Yukos to date has been based largely on increasing efficiency in old fields. Yukos points to benefits derived from horizontal drilling and water flooding, raising average well production rates across the board. All well and good, but does this translate into faster depletion rates? Quite probably.

A Recommendation

We must be realistic, Mr. President, in assessing the prospect of matching Saudi Arabia as an oil power. We would ask, what is it that the Saudi oil sector has that Russia does not have, and likely never will?

That is spare producing capacity, employed in support of Saudi national interests. Indeed, the importance of Saudi oil is based as much on its spare producing capacity as it is on its position as an oil exporter. Even more so in times of supply disruptions.

Might Russia ever rival Saudi Arabia, in terms of production, exports and most importantly, spare capacity? Only in part, for Russia is unlikely ever to deliberately develop spare producing capacity.

Moreover, Mr. President, it is generally understood that production follows reserves. Who dominates world oil, in terms of reserves? It is Saudi Arabia. Recently the Saudi oil minister pronounced that production could be taken to 12 million b/d or even 15 million b/d, if required by the market. Could Russia match that? We think not.

Our recommendation to you, Mr. President is this. Don't waste your oil inheritance in a competition that you cannot win, **that you need not win.**

A Dream Backed By Potential

Team A, charged to take a more optimistic approach, began its brief by noting what a difference a decade can make. 10 years ago China was a net exporter of oil. Today, oil demand in China is driving world oil prices and the country's growing reliance on imported oil, now providing about one-third of total supplies, is raising serious concerns for the Chinese government regarding security of supply.

10 years ago the oil sector of Russia was in collapse, falling from a peak of 11.5 million b/d to some 7.1 million b/d in 1993, a decline that would not be arrested until 1996. 10 years later, Russian oil had regained its vitality and had joined Saudi Arabia as a world leader in production and exports.

These two dramatic shifts in oil supply and demand only underscore that forecasting is an art, and certainly not a science. The brief then asked, what comparable shifts await the world oil market over the coming 10 years? The point being, Mr. President, that Russia does not exist in isolation from the world oil market. Like all exporters and importers, we are vulnerable to any event, anywhere, anytime, that impacts on oil supply and/or demand. That vulnerability in turn may decide our future perhaps as much as any other factor.

With that caveat in mind, Mr. President, we have attempted to respond to these questions. Can oil production be sustained beyond the near term? Could Russian oil be restored to its glory days of the 1980s? Might Russia be able to challenge Saudi Arabia in terms of oil exports?

A headline in the recent Russian press read as follows: “Russia Ready to Take on the Oil World.” The text noted that Russian oilmen have pledged to overtake Saudi Arabia and position Russia as the world’s leader within 5 years. By 2009, Russian crude output could reach 11 million b/d.

Is the Russian oil sector being realistic?

- The geologic potential is there, although much of this remaining potential is found in very inhospitable areas.
- Ray Leonard, a Yukos official, and an American geologist with good international credentials, has placed Russian proven reserves at between 97 to 119 billion barrels, roughly double that level generally accepted and matching those of Iraq.
- The answer is yes, if Russia improves its investment climate, and that means “the rule of law” must be firmly in place.
- The answer is yes, if foreign oil investors respond, and that means the world oil market must be of sufficient attraction to offset the risks of doing business in Russia.
- Infrastructure deficiencies must be overcome, and first of all that means the construction of new export pipelines.

Mr. President, we also took into account that you recently confirmed that all pipelines, old and new, will be owned and operated by the State. Equally important, new routes chosen will reflect national interests, not corporate. Moreover, we understand that the State is moving to ensure that all ports of export come under its control.

Moreover, as long as domestic demand holds relatively constant, export growth will largely be defined by growth in production.

An internal study carried out by Yukos projected production out to the year 2020, and found that the two leading oil producing regions—West Siberia and the Urals-Volga—will both peak in 2010, as will Timan-Pechora.

Given that, where will new oil supplies come from to offset production declines at the older fields? Russia must embark on a major exploration effort, and soon, if new supply is to both offset production declines and provide for continued growth.

Yukos had suggested that:

- East Siberia, which produced just 40,000 b/d in 2001, is to expand to 1.34 million b/d by 2020. Beyond 2010, all the growth is to be provided by undiscovered fields.

- The Russian Shelf, also having produced just 40,000 b/d in 2001, is also presumed to be producing in excess of 1.3 million b/d by 2020. All of the growth beyond 2015 is to be provided by undiscovered fields.

Notably, for both, the future lies in the hands of fields yet to be discovered.

But what if exploration and development is delayed, or unsuccessful? If these two regions fail to come to the rescue, so to speak, then Russian oil production would be around 7 million b/d by 2020, so Yukos projected.

When the United States looks north it sees Canada, their leading supplier of oil and natural gas. When China looks north it sees Russia as a source of oil and natural gas supplies to cover the growing gap between supply and demand. Should we foster that energy relationship, given that political linkages between China and our country likely will follow close energy interdependencies? Would that linkage complicate our relations with the United States? Is that in our national interests?

A Recommendation

Mr. President, we have endeavored to be completely objective in our assessment of whether Russia could match Saudi Arabia, especially in terms of oil exports. That prospect depends fully on the discovery and development of new oil fields and the construction of new export pipelines. To do so will take time and money, and that may require foreign involvement on a larger scale than presently acceptable.

Kazakhstan is on its way to becoming a major player among suppliers to the market. Given little growth in domestic needs, Kazakhstan could well be exporting close to 3 million b/d by that year.

Mr. President, Russia alone cannot today, nor tomorrow, challenge Saudi Arabia on all oil fronts. At the same time, a closer linkage of our oil policies with those of Kazakhstan could provide additional benefits, including a matching of the Saudi oil power. **We would recommend working to that end.**

Putin paused for a moment, turned to his Executive Assistant standing nearby, and said, “Get me President Nazarbayev on the phone.”

He then idly turned to today’s *Presidential Daily Brief*. What caught his eye this time? The first line in a story in *Pravda* of 14 July that read: **Russia has all chances to become the country in charge of the global gas market.** “Wait,” he called out to his Assistant. “Get Team A and Team B back in here.”