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How much oil can Russia produce?
- A study in the Russian oil sector



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Contents

Abstract	3
1 The Russian oil sector	4
1.1 Russia in the oil producers' world	4
1.2 Oil and economic growth	6
1.3 Oil and industrial production.....	7
1.4 Russia as an oil exporter	9
1.5 Russian oil companies' production	9
2 Future perspectives for Russian oil production and export	12
2.1 Forecast for the oil sectors impact on Russian Economy	12
2.2 Forecast for Russian oil production and export	12
2.3 Building more export capacity	14
3 Recent developments and the Yukos affair.....	15
3.1 Increased taxation of oil companies	15
3.2 The Yukos saga.....	16
3.3 The impact of Yukos on investment atmosphere.....	18
4 Conclusions	19
References:	21

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How much oil can Russia produce? - A study in the Russian oil sector

Abstract

Russia's economy has recovered after the deep recession in 1998 and the country currently scores high growth figures. One driving force is the booming oil sector, which gains from high world oil prices. Russia is very dependant on raw materials, and especially of the oil sector. The country is close to the limits of oil production and export capacity. Investments in new capacity and improvement of old are desperately needed. Moreover, during the current high oil price period, and especially recently as the largest oil company Yukos has been under attack by the authorities, international observers have become especially alert to fluctuations on the oil sector. The Yukos affair has ensured us that Russia's transition towards a market economy is far from over. However, foreign companies seem to be adapting to the situation, as foreign investments to Russia still continues to grow, despite the conflict.

Keywords: Russia, oil, oil production, oil export, investment atmosphere

1 The Russian oil sector

Russia's economy has recovered after the deep recession in 1998 and the country currently scores high growth figures. A combination of many factors contributes to this achievement. However, without doubt the booming oil sector, which gains from high world oil prices, is a very important one.

As the economy of Russia is so dependant on raw materials, and especially the oil sector, it is also useful to make a deeper analysis of the country's oil production and export capacity and its limitations. How much more oil can Russia produce and export? Can the current rapid economic growth continue?

During the current high oil price period, and especially recently as the largest oil company Yukos has been under attack by the authorities, international observers have become especially alert to all kinds of fluctuations on the sector. Is there more bad news coming? Can Russia deliver the oil which world market so badly needs?

This brief essay brings some further light to the current structure of the oil industry in Russia and its capacity limits. Moreover, the study also analyses the impact of recent developments on the Russian oil sector.

1.1 Russia in the oil producers' world

Russia is the world's second largest oil producer after Saudi Arabia, with an 11.4% share of total production or 421 million tons (8.46 million bpd) in 2003. In 2002, Russia was even the largest oil producer in the world for a while, but later the same year Saudi Arabia retook first position. Although Russia produces a lot, it is only in the seventh position measured by the oil reserves in the world, according to the BP's statistics¹. Russia's 9.4 billion tons (69.1 billion barrels) of oil represents 6.0% of the total reserves in the world. The largest reserves are held by Saudi Arabia (22.9% of world reserves) and Iran (11.4%).

At the current production rate, it would - at a rough calculation - take about 22 years to empty existing oil wells in Russia². Among the five largest oil producers in the world, Russia has the fourth highest reserve/production ratio after the large OPEC producers, but Russia is pumping oil much faster than the other countries with large reserves. In comparison to the ten countries with the largest oil reserves, Russia is the second fastest in emptying its existing oil wells. Only USA does it faster.

¹ The BP's statistical Review of World Energy is usually considered somewhat conservative. However, their estimate, updated in June 2004, of the Russian reserves are higher than that made in the Oil and Gas Journal's 2003 Worldwide Production report from December 2003, which estimates Russia's current reserves to 60 bn. barrels, which would contribute to 4.7% of world reserves.

² Dienes (2004) argues that the current calculation base also includes an as yet unconfirmed component, and when the unconfirmed component is excluded the existing reserve/production ratio for Russia is only 14 years. Moreover after confirmation of any new sources it still takes at least 5-10 years before the reserves can begin to be exploited.

Figure 1a. World oil reserves in 2003

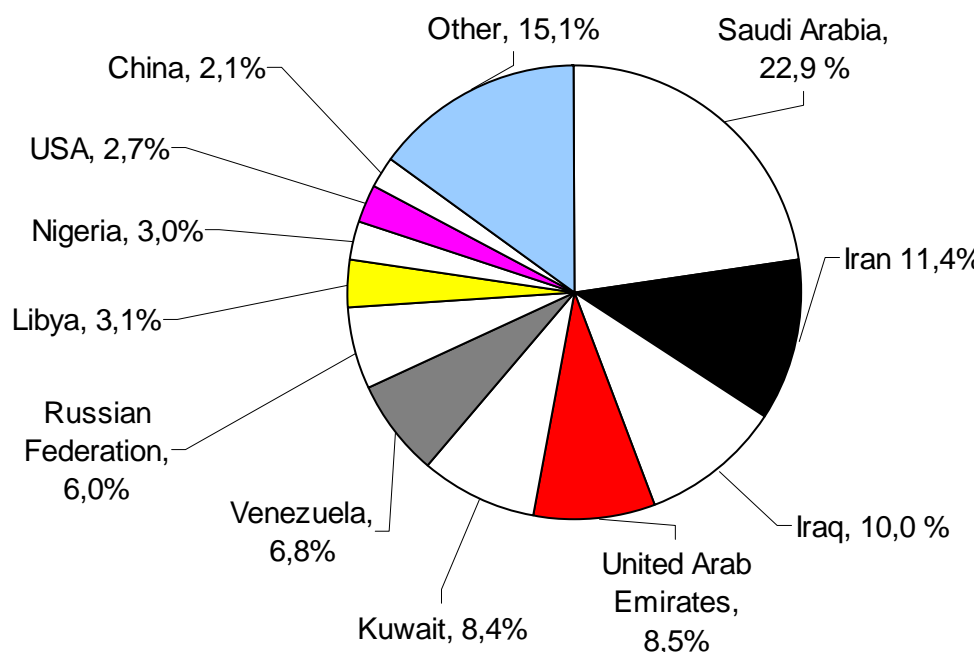
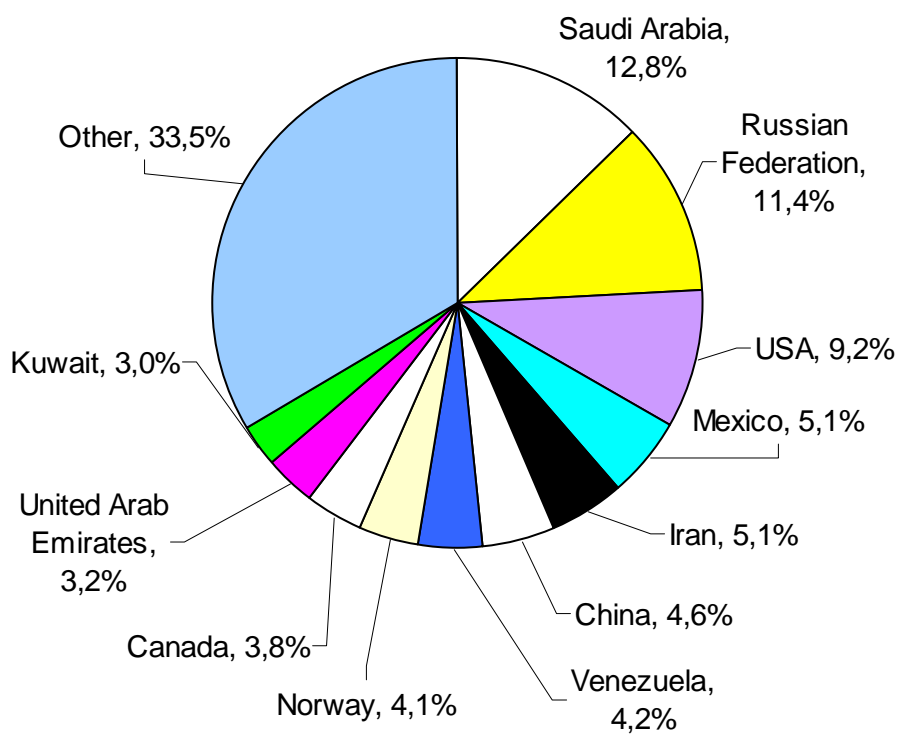


Figure 1b. World oil production in 2003



Source: BP's Statistical Review of World Energy, June 2004

Table 1. The 10 largest oil producers' reserve/production ratios in 2003

Largest oil producers	Reserves	Production (t.bpd)	Shares of production	Years (R/P)
Saudi Arabia	262.7	9817	12.8	73.3
Russian Federation	69,1	8543	11.4	22.2
Australia	4.4	8401	10.8	19.3
USA	30.7	7454	9.2	11.3
Iran	130.7	3852	5.1	92.9
Mexico	16.0	3789	5.1	11.6
India	5.6	3396	4.6	19.3
Norway	10.1	3260	4.1	8.5
Venezuela	78.0	2987	4.2	71.5
Canada	16.9	2986	3.8	15.5

Source: BP's Statistical Review of World Energy, June 2004

Undiscovered reserves probably exist in Russia, especially as the most of the geological research already done is from the Soviet time. After the fall of the Soviet Union, not much new geologic research has been conducted. One of the reasons for this is certainly the short duration of the licenses granted by the state for the oil fields, which does not encourage companies to conduct new geological search. According to Dienes (2004), the privately owned companies in particular have done little exploration for new fields; instead they have focused on maximising their exploitation of the Soviet-built fields. Recently, this has changed and some companies are upgrading their reserves.

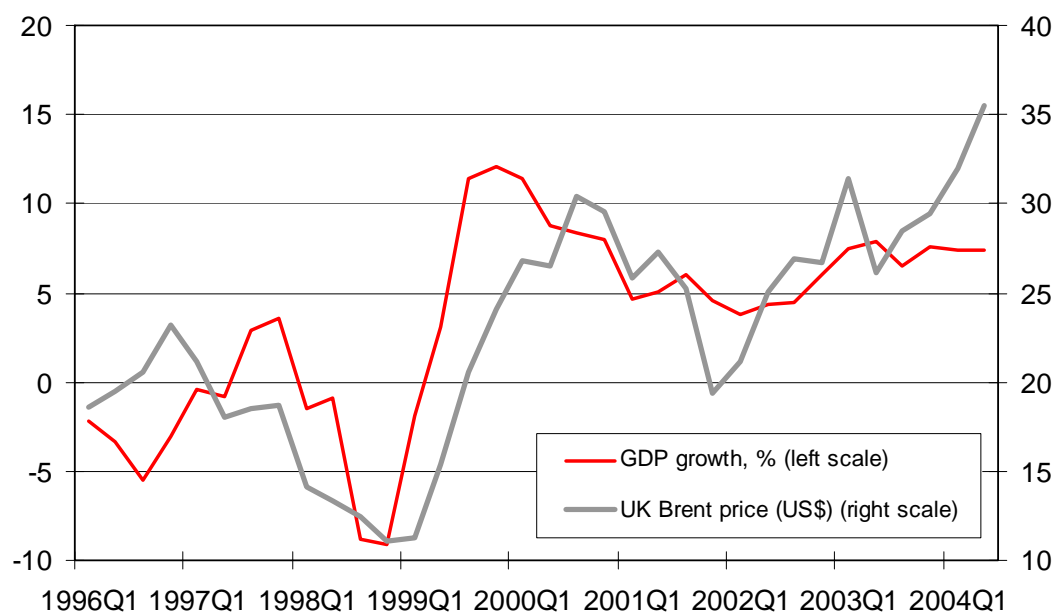
There is no exact estimate of Russia's undiscovered resources, but estimates range widely. One recent estimate by the US Geological Survey concludes that undiscovered oil resources account for an average of about 77 billion barrels of unfound oil (USGL, 2000). At current production levels these resources would last for an extra 25 years.

1.2 Oil and economic growth

Undoubtedly, the oil industry is of crucial importance to the Russian economy. This year's high world oil price has accelerated Russia's GDP growth. Consequently, the Russian Economic Development and Trade ministry recently had to update its growth forecasts for this and the coming years. In 2004, the World Bank estimated that the oil and gas production sector accounts for more than 20% of GDP and 55% of export. A recent OECD (2004) report underlines that though the pure effect of the oil sector is usually calculated by industrial production, it might be underestimated. The effect should be calculated by including the service sector and machine building industry, among other factors.

Rautava (2004) has estimated the impact in the long run of the oil sectors on GDP. According to Rautava, a 10% permanent increase (decrease) in the international oil prices is associated with a 2.2% increase (decrease) in the level of the Russian GDP. Figure 2 gives some further visual indications of the relationship between the growth of GDP and the crude oil price during the last years.

Figure 2. The relationship between the GDP growth and UK Brent crude oil prices



Source: State Statistic Committee & Bloomberg

1.3 Oil and industrial production

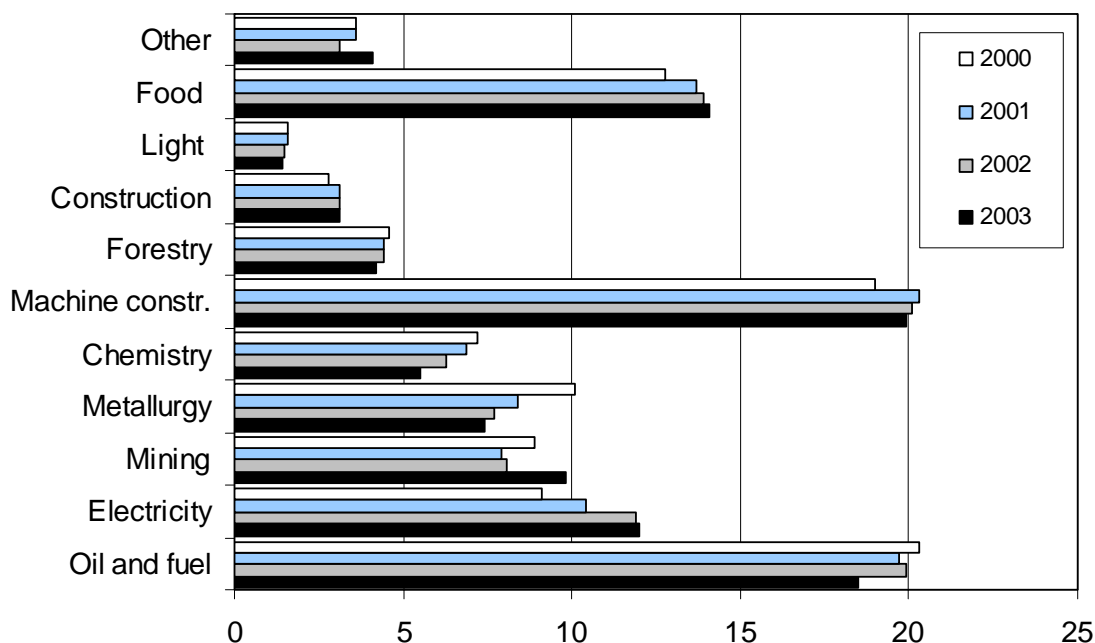
According to the State Statistic Committee the entire oil and fuel sector (including gas) contributes to about 19% of the total industrial production in Russia. However, this figure only indicates the raw industrial production from the sector. Probably, the estimation of the World Bank with up to 25% of industrial production is closer to the truth, as the booming oil sector also increases production and trade in other sectors, such as the chemical, metallurgical and machine manufacturing industries.

In 2003, Russia produced 421 million tonnes (8.45 million bpd) of oil of which 42% was exported outside the CIS and 30% consumed domestically. During the first half of 2004, oil production grew by 10.3% y-o-y and accumulated at 223.5 million of tons (9.2 million bpd) of oil according to the State Statistic Committee.

Although oil and gas production has increased, its share of total production has decreased lately. The total share of the oil and fuel industry in industrial production has declined slightly since 2000, when it was at its highest since the recession. The decline was mostly caused by declining gas production and the rapid increase of other industrial

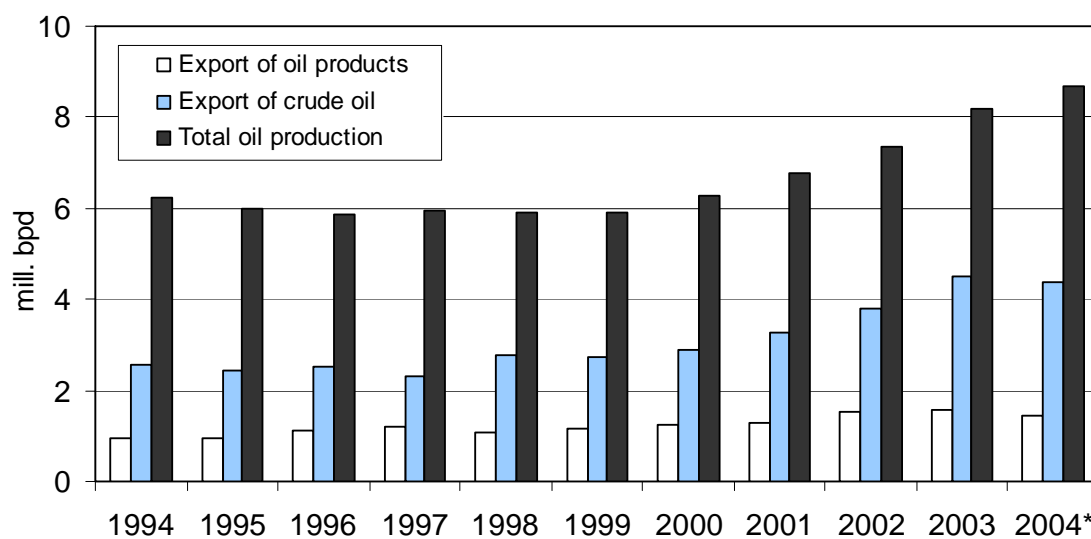
branches, especially the metal sector. However, even a small decline in the dependence on raw materials could be considered as a healthy sign for the economy, as it may indicate a slow shift towards a more heterogeneous industrial base.

Figure 3. Shares of industrial production per industry sector (%), 2000-2003



Source: State Statistic Committee

Figure 4. Russia's oil production and export (million bpd)



*Jan-July 2004

Source: State Statistic Committee

Russia produces mainly crude oil, while refining products count for a relatively small share of overall production. Russia has steadily raised its refining capacity since the 1998 recession, but is still far behind the peak of the Soviet era. In 2003, refining capacity was 190 million tons annually, of which 2/3 goes to domestic consumption.

Figure 4 illustrates the levels of Russian oil production and export. Notable is the fact that Russia's production already is at the same level as 1991, before the collapse of the Soviet Union. However, it is still far from the production peak seen in 1987/1988 of 569 million tonnes (11.4 million bpd) of oil. Notable also is the year-by-year growth in exports, although this stopped on the first half of this year at 2003 levels. Only production has increased. CIS export of crude oil has steadily increased and has grown from the 15.6 million tonnes in 2000 to 34.5 million tonnes in 2003. Compared to the non-CIS oil export, CIS export levels are still low.

1.4 Russia as an oil exporter

Russia primarily exports crude oil (72% of the export), while oil products (gasoline, diesel and fuel oil) counted for a smaller share (28%) of the oil export in 2003. The main crude oil export went outside the CIS countries (83.6%) while only a small share was received (16.4%) by CIS countries in 2003.

During the first half of 2004, Russia exported 110.2 million of tons (4.6 million bpd) of oil, which is about 49% of Russia's oil production. The role of the oil sector in export is much higher than in production. According to the Central Bank's current account statistics, the oil sectors share in the foreign trade has not significantly increased during recent years. The share of oil export rose in 2002 from over 20% to the current level of about two fifths of the export income from the oil sector. However, as concluded earlier, the World Bank argues that indirectly the share of export income is even higher (up to 55%).

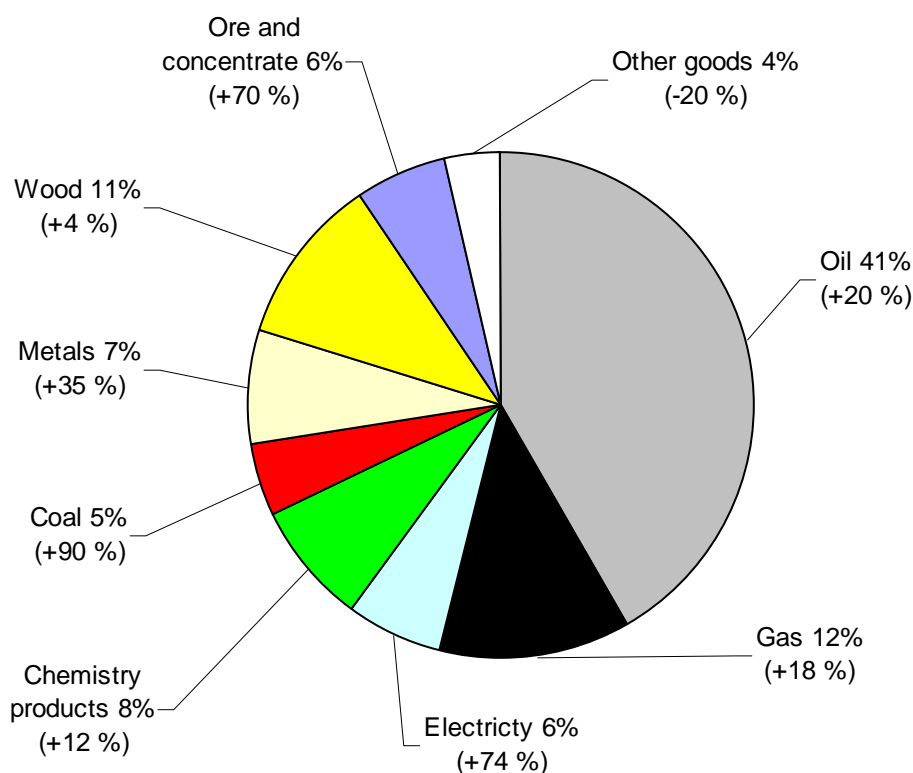
1.5 Russian oil companies' production

The Russian oil sector is dominated by four large producers: Yukos, LUKoil, TNK-BP and Surgutgasneftegaz, all privately owned. Yukos and LUKoil possess the largest reserves of oil. in terms of production, Yukos is the largest Russian oil company, while calculated in terms of assets and reserves LUKoil is the largest.

Oil export to Finland

According to last year's data, two fifths of the Finnish imports from Russia consists of oil products. The value of imported oil has grown during the last year, due to the raising high world oil prices. Most of the oil from Russia to Finland arrives by rail. Russia is Finland's second largest destiny of import. Russia's share of the total import to Finland was 13.9% last year.

Figure 5: Share of import from Russia to Finland in 2003, (%), in brackets y-o-y change



Source: Finnish Customs

Oil export to China

During the first half of this year, Russia became China's fifth largest crude oil supplier, accounting for 8.5% of China's total import. The share has grown rapidly. Last year, Russia exported 5.25 million tons (0.12 million bpd) of crude oil to China. Nearly all of the oil exported from Russia to China, is delivered by the oil company Yukos by rail.

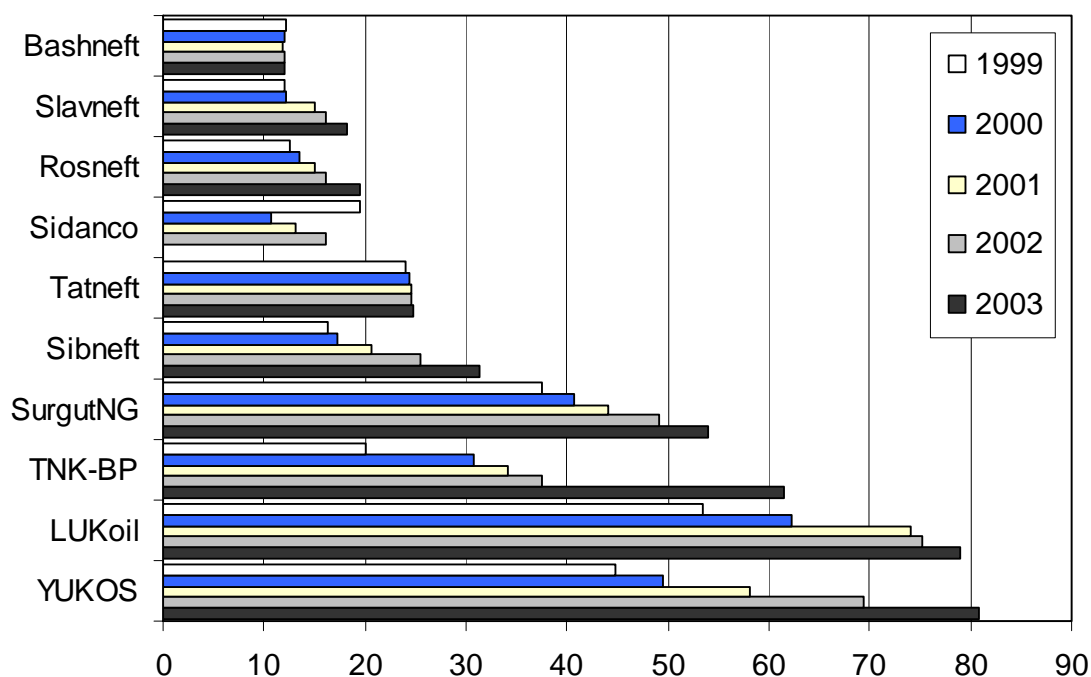
Table 2. Largest Russian oil companies in 2003

Yukos	19% of total oil production 14.7 billion barrels of oil reserves
LUKoil	18% of total oil production 15.7 billion barrels of oil reserves
TNK-BP	14% of total oil production 9.0 billion barrels of oil reserves
Surgutgasneftegaz	12% of total oil production 6.5 billion barrels of oil reserves
Sibneft	7% of total oil production 4.6 billion barrels of oil reserves
Tatneft	6% of total oil production 6 billion barrels of oil reserves
Rosneft	5% of total oil production 3.4 billion barrels of oil reserves
Slavneft	4% of total oil production 2.5 billion barrels of oil reserves

Source: Renaissance Capital – Oil & Gas Yearbook 2004

Due to a heavy investment programme in 2003, Yukos increased its production with 16.3% to 80.747 million tons (1.6 million bpd) and became the largest producer. However, in 2003 the fastest growing oil company was British-Russian TNK-BP, with 64.2% y-o-y. In Russia, there were in total 380 996 oil companies in 2003.

Figure 6. Total oil production of ten largest oil companies in 1999-2003, million tons per annum



Source: Renaissance Capital – Oil & Gas Yearbook 2004

2 Future perspectives for Russian oil production and export

2.1 Forecast for the oil sectors impact on Russian Economy

Due to higher than expected oil prices, the Russian Economic Development and Trade Ministry recently increased its forecast for the economic growth. The Ministry expects the GDP to grow by 6.9% this year, 6.3% in 2005, 6.1% in 2006 and 6.5% in 2007. Their forecast is based on the assumption that Ural-grade crude oil prices will stay at an average of \$30.4 per barrel this year, and decline to \$28 per barrel next years³. The draft budget prepared by the government for the year 2005 is based on the same assumption concerning oil prices. This assumption can be considered somewhat conservative. During the first half of the year GDP grew by 7.4% even if the oil prices averaged at \$30.8 per barrel. At the end of August, the Ural oil price was at \$35 per barrel.

The Ministry estimates that the pure effect of the high oil price on the GDP growth will be 2.9 percentage points this year and 2.0 points 2005-2007. According to the Ministry, 2.0 percentage points of last year's 7.3% GDP growth was directly caused by the oil sector.

2.2 Forecast for Russian oil production and export

The decelerated growth is partly explained by the expectations of decline in oil production over the coming years, expressed by the Russian Ministry of Economic Development and Trade. The Ministry expects oil production to increase only with an average of 3.7% during 2004-07, compared to the forecast production increase of 7.5% for this year. In the first half of year 2004, oil production already grew by 10.3% y-o-y, but the ministry expects the growth to decline in the latter part of the year.

The Ministry expects the export of oil to increase by 2.8% in 2005, while last year oil exports increased by 21.1% and this year the forecast estimates a growth of 13.2%.

Table 3. Forecast growth in oil production and export (million bpd)

	2003	2004e	2005f	2006f	2007f
Production	8.5	9.1	9.3	9.5	9.7
annual growth (%)	11.0	7.5	2.9	2.4	2.1
Export	4.5	5.1	5.2	5.4	5.6
annual growth (%)	21.1	13.2	2.8	3.7	3.3

Source: Ministry of Economic Development and Trade

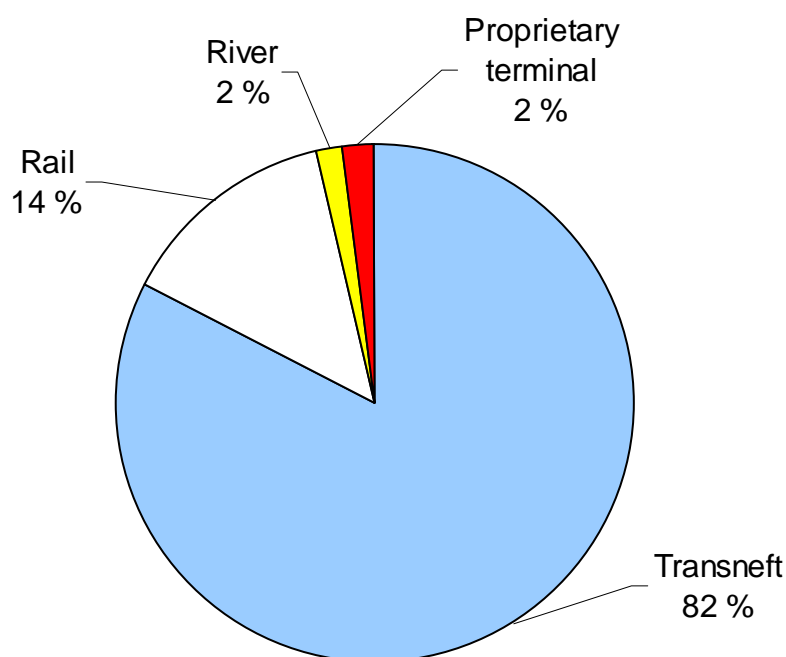
³ Recently the Ministry updated its forecast to \$31.2 per barrel for the remainder of this year, but did not adjust the other forecasts.

Russia's oil producing capacity is close to the same level as it was at the end of Soviet Union, in the early 1990s. Now, in order to increase its capacity significantly, the industry needs to make new investments. Russia needs to build new capacity in addition to renewing existing capacity. Most of the drilling and refining capacity was built during the Soviet time, and some of it is estimated as being up to 30 years old (Fitch Ratings, 2004). To maintain the high growth production figures there must be new investment in the current oil production infrastructure, otherwise it risks failure.

Moreover, according to Russia's Economic Development Minister German Gref, the capacity of the oil transit network is close to its maximal use. The ministry has also estimated that Russia will not be able to benefit fully from high oil prices in the coming years, due to the lack of production and export capacity.

The Minister's warning is supported by the fact that Russia increased its export deliveries by rail by 92% in 2003, despite rail shipments being about three times more expensive than Transneft's transit. This would indicate that Transneft does not have the spare capacity to offer⁴. More evidence of the lack of spare capacity is provided by Fitch Rating (2004) that estimates that the Transneft's pipeline networks utilisation rate was 92.3% and the utilisation rate of oil cargo wagons was 96.5% in 2003. Moreover, Russia's strong reliance on rail transport might become unprofitable when world oil prices decline resulting in a decrease in export levels.

Figure 7. Russia's oil export transport to non-CIS destinations, 2003



Source: Renaissance Capital – Russia Oil and Gas Yearbook 2004

⁴ Various estimations of Russia's real export capacity exist. Some scholars argue that Transneft's capacity is not yet even close to its maximal use, while others argue that it has already reached capacity today.

It looks as if Russia has to enhance its oil-export transport network in order to gain from high oil prices. Although the Ministry had a pessimistic forecast for exports, the investment bank Renaissance Capital has calculated that through keeping to the ongoing projects discussed and planned, Transneft could potentially increase its capacity to non-CIS destinations by 20% in 2004, 12% in 2005 and 8% in 2006⁵. They estimate that Russia could potentially increase Transneft's capacity to non-CIS destinations from the 174 million tons (3.5 million bpd) delivered in 2002 to 348 million tons (6.9 million bpd) by 2010, by implementing all the planned pipeline expansions. However, currently no decisions have yet been made on which larger projects to implement. This indicates that expansion of the current pipeline capacity might be delayed.

2.3 Building more export capacity

Although lately the president has softened up his stand on complete state control of Russia's oil pipeline network, no concrete action has been seen from the government, indicating a policy towards private pipelines. In the near future, we will probably not see any larger pipeline projects outside Transneft's regime.

There are plenty of discussions on how to increase Russia's export capacity. Two recent projects will increase some of Transneft's export capacity, namely the development of the Baltic Pipeline System (BPS) and the reverse of the Odessa-Brody Pipeline, but larger decisions about new construction have yet to be made. The BPS project is aimed at increasing oil transportation to the new Primorsk harbour on the Gulf of Finland. The construction will increase the flow from the 30 million tons (0.6 million bpd) of 2003 to 62 million tons (1.25 million bpd) in 2005 and double the capacity of Primorsk.

The Odessa-Brody reversal pipeline was agreed on between Russian president Vladimir Putin and Ukrainian president Leonid Kuchma this summer. It was originally constructed as part of a joint EU-US bid for taking Caspian Oil to Central Europe. Russia plans to increase Russian oil transported across Ukrainian territory by almost 50% to 85 millions tons (1.7 million bpd) a year.

The decisions on three other major projects that have been planned are still missing. The pipeline to Nakhodka either from Taishet or Angarsk seems to be the most favourable alternative to the Russian government. The alternative route from Angarsk to Daqing in China seems to be too remote for the Kremlin, especially as the driving force behind the project from the Russian side so far has been Yukos. The original capacity for the pipeline to China was planned as being 30 million tons (0.6 million bpd) a year.

The third project, the Murmansk pipeline, lead by a consortium of private Russian oil companies (including Yukos) has faced stiff opposition. However, recently after the U.S. Trade and Development Agency announced its preference in favour of a Murmansk pipeline to the Nakhodka pipeline, the government is now also pushing the project forward by conducting an environmental study in autumn 2004. The study is based on a capacity of 18.8 million tons (0.4 million bpd) a year, as Transneft fears that Russia will not have enough crude oil to fill both the Nakhodka and Murmansk lines.

The latest estimates for the cost of building a Taishet-Nakhodka pipeline are around USD15 bn, which is a considerably higher sum than in the earlier estimate. The estimate

⁵ Renaissance Capital includes the following projects in their estimate. For 2004: Butinge expansion, Phase II BPS and de-bottlenecking. For 2005: Adria pipe and Odessa-Brody reversal. For 2006: Phase III BPS, Atsau-Alashankou and Bratislava-Schewechat pipes, IKL reversal and de-bottlenecking in North Druzhba.

has risen mainly due to high world metal prices. The construction time would be 3-6 years. However, Transneft is still missing necessary funds for the project, although the Japanese government has offered to partially cover the costs. It is unlikely that a final decision on the matter can be expected in near future.

The Latvian oil harbour Ventspils and the pipeline there have a capacity of 16 million tons (0.3 million bpd) per year, but is currently not in use, although Ventspils could easily offer extra capacity for Russia's oil export.

3 Recent developments and the Yukos affair

3.1 Increased taxation of oil companies

As the world oil prices are high, the government aims to increase the revenue it generates. This is being done by increased export taxation and higher customs fees. In April, a new taxation scheme on crude oil exports was approved by the Duma and came to force in August 2004. The export tax on crude oil was raised, but it will continue to be based on the price of Urals-grade crude (table 4).

Table 4. New crude oil export tax scheme

Oil price USD/barrel (Urals)	Tax
< USD15	0
USD15 - 20	35% of market price, of the price over USD15
USD20 - 25	45% of market price, of the price over USD20 + 1.75 USD/barrel
> USD25	65% of market price, of the price over USD25 + 4 USD/barrel
Example: if Ural oil price is USD31, the export tax will be USD7.9 per barrel	

Source: BOFIT

Moreover, the oil production export duties increased from USD37.50 to 45.40 a ton at the beginning of September. The scheme is valid until the end of the year, because the government is undertaking discussions on next year's duties. The higher tax schemes are expected to bring the State an extra USD3 billion of income this year, at least, if oil prices stay over USD30 per barrel.

The new taxation schemes, on top of the back-tax claims on Yukos, have obviously motivated other companies to increase their tax payments. In the first half of the year, oil companies like LUKoil and Sibneft have reformed their accounting procedures and openly reported higher profits than before, which also leads to higher profit taxation. It has been normal for oil companies to use different kinds of off shore arrangements in order to minimise their profits and therefore their tax payments. In this sense the tax claims against Yukos, seem to have had a direct influence on increasing large companies' tax payments.-.

a goal declared by President Vladimir Putin during a meeting with the most influential Russian business leaders this summer in Kremlin.

3.2 The Yukos saga

The Yukos affair started from an investigation by the authorities into unpaid taxes and affairs related to the privatisation of Yukos and its daughter companies. The tax investigation was launched in summer 2003 and shortly afterwards Platon Lebedev, one of the owners of Yukos, was arrested. In October 2003 the main owner and CEO, Mikhail Khodorkovsky, was also arrested. The first tax bill was launched in December 2003, but order to be paid in April 2004. Later more tax suits have been opened, and currently Yukos is facing at least three separate tax claims⁶. On top of which the ministry has announced its plan to sell the companies' core production unit, Yuganskneftgaz' to cover the tax claims.

Table 5. The story of Yukos vs. Russia's Tax Ministry

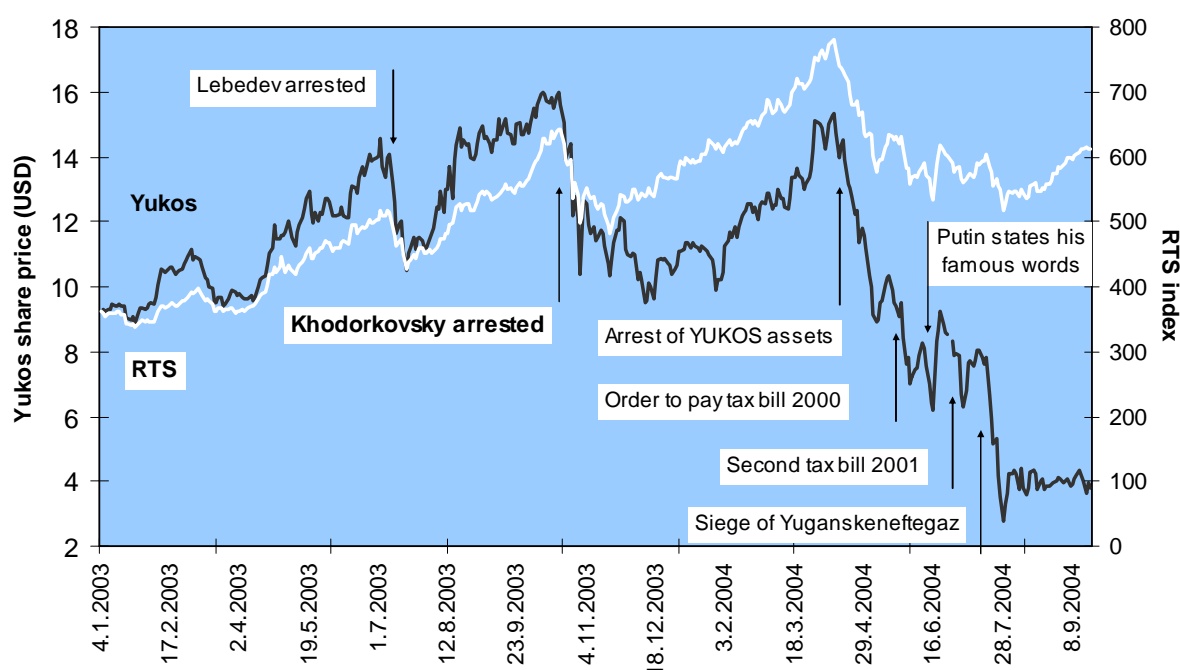
When	What
July 2003	Platon Lebedev arrested
October 2003	Mikhail Khodorkovsky arrested
December 2003	Tax audit open investigations dating back to 2000 of USD3.4 bn.
March 2004	Tax Ministry files lawsuit against Yukos
April 2004	Tax Ministry wins lower court ruling. Assets frozen
May 2004	Yukos loses appeal, debt becomes collectible.
June 2004	Tax Ministry refuses to restructure 2000 debt. Open investigation of 2001 of USD3.4 bn. Putin states non interest of bankrupting Yukos
July 2004	Tax Ministry announce their purpose to sell Yuganskneftgaz.
August 2004	Investigations of 2002 start. Court freeze and refreeze Yukos funds. Tax ministry starts evaluation of Yuganskneftgaz. US and China express worries over the Yukos affair
September 2004	Yukos paid USD2 bn of the claims from 2000 Ministry opens investigation on Yuganskneftgaz of USD2 bn and. on Yukos for 2003-04 Yukos warns of halting operation Tax debt of 2001 increases to USD4.6 bn Yukos warns of stopping export to China Yukos reduces production

Source: BOFIT

⁶ The authorities claims back taxes for USD3,4 bn for year 2000, USD4,6 bn for 2001 and USD2 bn on the Yuganskneftgaz production unit (Situation 30.9.2004)

The Yukos affair has had a clear impact on general stock prices in the RTS (Figure 8). After the turbulence following the arrest of Platon Lebedev and Mikhail Khodorkovsky, the RTS index calmed down and continued to climb until April, when it reached even its highest value ever. The attack on the owners did not largely violate the share price. However, when the harassment on Yukos assets started in April the share prices crashed and since then Yukos has lost about 70% of its value. Yukos' weight in RTS has decreased due to the falling prices, from about 19% in Mid-April to 6% at end of August. Yukos, the frontrunner among the oil companies, earlier had the strongest weight in the RTS but lost this weight after the value of the company crashed.

Figure 8. Yukos and RTS 2003-2004



Source: BOFIT & RTS

The Investment Brokerage Troika Dialog (2004) estimated that Yukos' real value based on reserves and production, without any tax claims, should be at USD42.9 billion and the real share value should be at USD19.80. With the current share value around USD3.8, Yukos' market cap is USD7.3 billion. Moreover, if Yukos lose Yuganskneftegaz, the core production unit, valued between USD13.1-19.1 billion (Troika Dialog, 2004) - depending on which estimate is being used - it might bring the company close to bankruptcy.

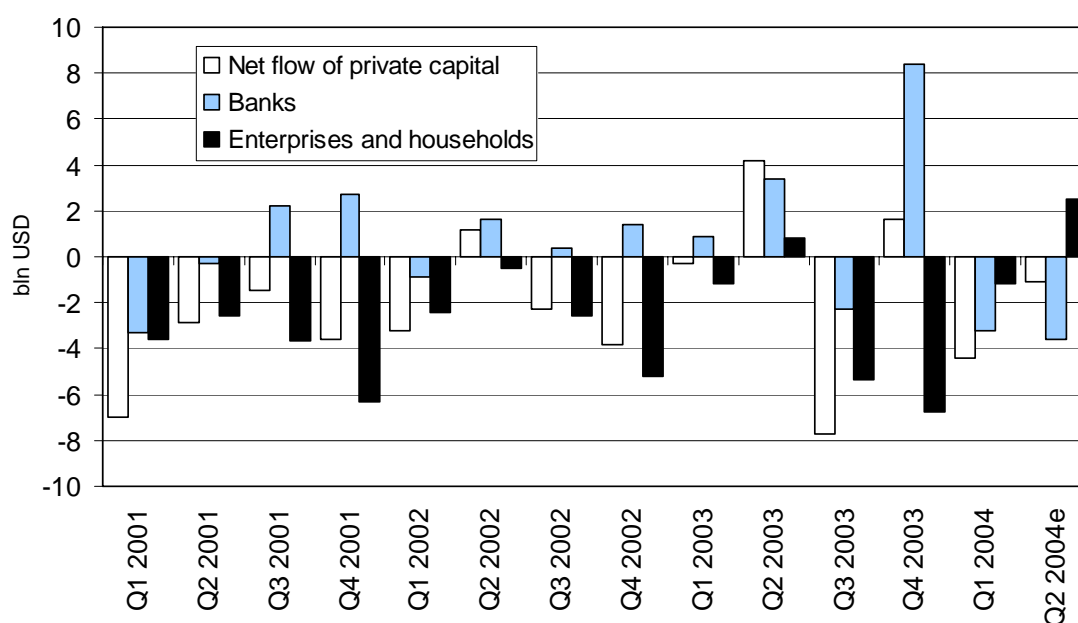
Despite the crisis that forced Yukos to abandon its investment programme, Yukos has kept its production targets fairly well. At the same time that Yukos' production units were being threatened with production cuts world oil prices rocketed. Despite Yukos' production being cut, it is likely to cause only a temporary cut Russian in oil exports. It would probably not take long before some other oil producer acquires the stakes and increase their own production. Currently, the largest problems of the sector are connected with limited production and export capacity.

3.3 The impact of Yukos on investment atmosphere

Although the newspapers have written actively about the capital flight connected to the Yukos affair, no larger evidence for this has been found. Some capital outflows from Russia were seen, but in fact FDI and portfolio investments increased during the first half of the year 2004. Only the banks' net out flow have increased.

Yukos seems to have had an immediate impact, as after the arrest of Lebedev the net capital out flow, measured on private sector (banks, enterprises and households), in the third quarter of last year alone was USD7.7 billion in the negative. Meanwhile the net flow of capital during the first half of this year, was USD5.5 billion in the negative, compared to the whole last years' USD2.3 billion negative flow. If the private capital flight is measured, by excluding the banking sector, private enterprises and households exported about USD12.2 billion during the second half of last year, but during this spring their inflow become positive. The net flow of private enterprises and household was USD1.3 billion into Russia, which is in fact the largest inflow to Russia seen since the fall of Soviet Union⁷.

Figure 9. Net Outflow of Private Sector Capital (- outflow, + inflow)



Source: Central Bank of Russia

⁷ However, one has to be aware of that the private enterprise net flow figure also includes the 'net errors and omissions' which is an estimation of the gray flow of funds. This net error has been USD 1.4 billion to the positive during the second quarter of the year, and the first time in fact there have been more 'grey funds' flowing in to Russia than out.

According to recent estimates by Economic Development Minister German Gref and Finance Minister Aleksei Kudrin, the net private capital outflow could rise to USD15bn by the end of 2004, due to the instability caused by Yukos and the banking sector. However, this estimate could be considered rather pessimistic and politically motivated, as the banking sector has calmed down, and the developments of growing private investments will probably not decrease in the short-term.

The Yukos case reminds us of the role of politics in Russian business environment. Naturally, everyone knows that political connections play a significant role in business in Russia, but it reminds us of how selective law enforcement is and how the rulers brutally use law enforcement for their own gains. The case also shows that the old rules no longer apply. Putin wants to show the world that the oligarchs should stay out of political decision making. Moreover, in order not to meet the same destiny as Khodorkovsky, so-called 'grey schemes' are no longer allowed, taxes have to be paid in full and different kinds of social security need to be offered.

The case also has raised the question of the rights of minority shareholders in Russia. While the dispute has concentrated on rifts between the authorities and Group Menatep, minority share holders have been totally neglected in the process. Some of them have even tried to meet with President Vladimir Putin to discuss how to secure the value of their shares in Yukos. So far the president has neglected all kinds of proposals. Yukos casts a dark shadow on minority share holding in Russia in general.

At the same time as the State is scaring foreign investments by attacking Yukos, it is also trying to show that Russia is still open to foreigners. One recent example of this was how the third largest US oil firm; ConocoPhillips acquired a share of LUKoil in September. Also, Russia's sudden announcement in September of its intention to open up Gazprom's share structure to foreign ownership was welcomed abroad.

4 Conclusions

Russia's oil production is definitely constantly the object of international attention, due to high oil prices and the ongoing Yukos affair. Some conclusions on the current situation can be made. First, there are questions regarding the oil reserves. Russia's high dependence on oil is not sustainable, with only about 22 years' reserves remaining. New investments in the current fields and new fields are needed.

Second, although production capacity is close to the record levels scored towards the end of the Soviet era, the equipment is getting older and less efficient. It desperately needs modernisation. Modernisation of the production facilities would certainly increase production in the short run. The largest company, Yukos, has the most ambitious modernisation plans but these very plans are currently on hold, due to the pending affair.

Third, doubt can be cast on the recently reaffirmed promises made by Russian leaders on an increase in oil exports. Questions have been raised concerning how close to maximum use Transneft's current capacity is. Some new construction can be expected in the near future, but it is doubtful, how much more capacity can be got out of the current pipeline network. The current growth comes mainly from the strong increase in rail shipments, although they are calculated as being about three times more expensive than pipeline transits. One is left to doubt how much more oil it is possible and profitable to ship by rail.

The cautious export estimation from the Economic Development and Trade Ministry gives us some kind of indication that the gloomy days, when Russia could boost world markets by over 10% growth in its oil export, are over. It is doubtful whether if Russia could manage to continue to be a fast growing supplier, responding to the increasing world demand on oil.

Fourth, although the Yukos affair is a purely political process against its main owners, it adds to doubts over Russia's export commitments, especially to China. Moreover, destroying Yukos does not necessary support Russia's image as a business friendly country. However, the affair so far does not seem to have been as harmful as many observes warned it might be. Some short term capital domestic flight has been seen, but Russia still attracts a significant amount of foreign investments. The impact in the longer run is harder to foresee. Certainly, the affair will make larger foreign companies more cautious in their investment plans.

Fifth, the Yukos affair has ensured us that Russia's transition towards a market economy is far from over. The fact that ConocoPhillips prepared its bid for Lukoil by seeking for approval by President Putin indicates that there are new rules in the game. Approval by the Kremlin again seems to be necessary in order to make larger investments in Russia. However, the foreign companies seem to be adapting for these new rules, as foreign investments to Russia still continues to grow, despite the conflicts.

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