



# BRIC Spotlight

## Oil & Natural Gas Sector in Russia: Fueling Growth

January 2011

### Fast Facts

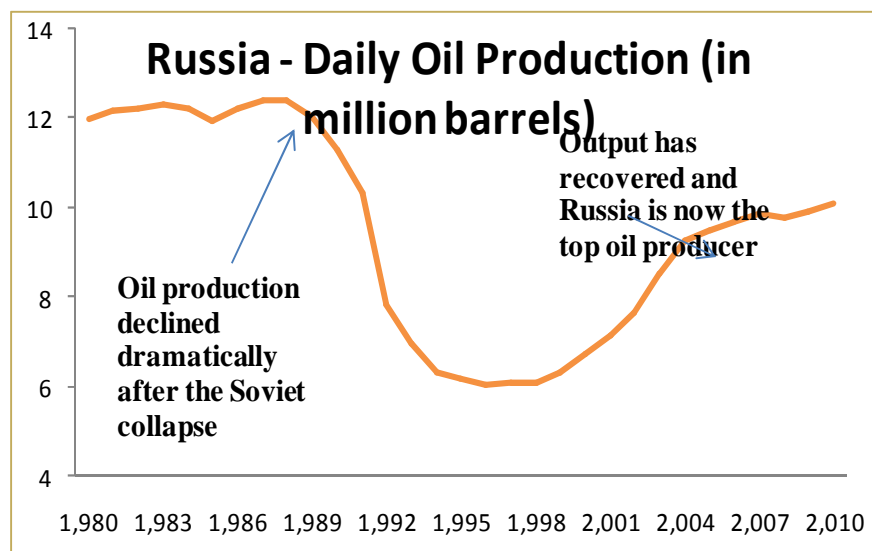
- Russia has the world's largest natural resources, the second largest coal reserves, and eighth largest oil reserves.
- Russia surpassed Saudi Arabia as the world's largest oil producer in September 2009 for the first time since the collapse of the Soviet Union.
- About 65% of Russia's exports are comprised of oil and natural gas.
- More than 70% of Russian crude oil production is exported and only the rest is available for local consumption.
- The oil & natural gas industry brings in 30% of the country's GDP and 60% of its export earnings.
- A majority of the blue chip companies in Russian stock exchanges are represented by the country's oil & natural gas sector.
- The prospects of Russian oil & natural gas sector attract major foreign oil companies.
- The industry is dominated by state-run firms.
- Most Russian oil companies have control over the entire production cycle ranging from exploration to transmission.

**R**ussia made its presence felt on the global energy map in the 1980s when oil production was a completely state-controlled enterprise. However, Russia's oil production fell sharply in the chaos which followed the disintegration of the Soviet Union in 1991. By then, wasteful Soviet oil exploration and extraction techniques had destroyed the oil wells and their potential to produce oil. The greater political and regulatory stability brought by then President Putin's administration was the turning point in foreign investments in the sector. Foreign money started trickling into the industry, which reached a peak in 2003 when TNK and BP announced their joint venture. The state-of-the-art drilling technologies, the rejuvenation of the old oil fields, and favorable oil prices proved to be the perfect recipe for the resurgent Russian oil and natural gas sector.

Between 1998 and 2006, Russian GDP grew by a whopping 57.6% cumulative, while real income recorded 65% growth. Between 2003 and 2007, the

Russian economy registered phenomenal growth, thanks to rising energy prices, good FDI inflows, and macroeconomic reforms. But Russia was hit by a plunge in commodity prices and a

reversal of capital flows, which led to a full-blown recession in mid-2008. Despite suffering a temporary setback in the aftermath of the global financial crisis, the strategic energy sector in Russia has bounced back as oil prices recovered from their abysmal lows. The decline in the production of oil, which began in May 2008, slowly started picking up in March 2009. Following the dismal run in oil prices, Russia took advantage of the OPEC production cuts and surpassed Saudi Arabia in oil production in September 2009, underlining the fact that Russia is still a force to reckon with in the global oil industry. Moreover, oil production in Russia touched 10.145 million barrels per day in 2010, the highest level since the collapse of the Soviet Union. The record oil output was made possible by the growth in the development of greenfield deposits. Significantly, Russia, which is not a member of the oil cartel OPEC, was the only country to produce more than 10 million barrels of oil a day in 2010.



Source: U.S. Energy Information Administration

Though Russia's natural gas production rose by 12% in 2010, it lags behind the United States, which eclipsed Russia as the world's top producer of the commodity in 2009. However, production at Gazprom, the world's biggest natural gas producer, grew 10% after the 16% slump recorded in 2009.

### Market Dynamics: The Key Players

Russia remains a key focus for investment by the international oil and natural gas industry. Though the country has attracted foreign investments in the sector for more than a decade, they pale in comparison to the TNK-BP joint venture. U.S. oil major ConocoPhillips followed suit in 2004, joining hands with Lukoil. Since then, a number of foreign players have attempted to partake of Russia's enormous oil wealth by bidding for projects or partnering with regional firms.

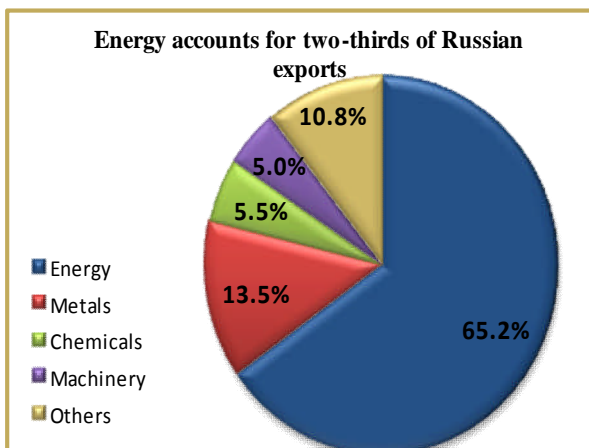
The improving energy prices in 2010 did attract some foreign players who are seeking new growth avenues in Russia. The most significant deal was the recent share swap agreement

between BP Plc and Russian state-owned oil producer Rosneft to jointly explore for oil and natural gas in the Russian Arctic sea region. According to the terms of the agreement, Rosneft will get a 5% stake in BP. The deal is also important in the context of an improving business climate in the industry. BP's joint venture with its Russian partner had run into rough weather some years back.

Yet, dipping your toes into the lucrative Russian oil cache comes at a price. A hostile climate and remoteness of locations make oil exploration a daunting task in the largest country on earth. Moreover, high oil prices are necessary to sustain the interest of investors considering the prohibitive costs involved in transporting oil and gas to consumers in far-flung regions.

Rank	Company	Market Cap (USD)	Proved Crude Oil Reserves	Proved Gas Reserves
1	Gazprom	\$348 billion	5.9 bln barrels	18,200 bln cubic meters
2	Rosneft	\$73 billion	15.9 bln barrels	701 bln cubic meters
3	Lukoil	\$65 billion	15.7 bln barrels	765 bln cubic meters
4	Surgutneftegas	\$36 billion	Does not disclose reserves	--
5	TNK-BP Holding	\$28 billion	10.3 bln barrels	--
6	Gazprom Neft	\$28 billion	6.9 bln barrels	--
7	Novatek	\$15 billion	--	690 bln cubic meters
8	Tatneft	\$10 billion	5.9 bln barrels	37.4 bln cubic meters

Notwithstanding foreign interests in the sector, the federal government still holds a vise-like grip on the industry. In 2007, the Russian administration, encouraged by a surge in crude prices, enacted a law restricting foreign investment in 42 industries, including energy. In his first term as president, Putin offered a flat tax and a streamlined system for registering small enterprises, but unleashed a sweeping extension of state control over oil and natural gas companies during his second term. These government-owned firms have enjoyed market-leading positions in the oil and natural gas industry. State-owned natural gas producer Gazprom has been the poster boy of Russia's energy industry for years, standing head and shoulders above all other Russian producers. The world's largest natural gas company accounts for 83% of Russia's natural gas production and 17% of global gas production. With the exception of Gazprom, most other companies in the sector are predominantly oil producers, with natural gas comprising only a portion of their proved reserves.



### Changing Tack: Lessons Learned

Energy exports have been a major driver of Russia's economic growth over the years, thanks to increasing production and rising oil prices. However, this over-dependence on oil and natural gas exports made the country vulnerable to fluctuations in oil prices as seen in the aftermath of the financial crisis.

The slump in international energy prices since 2008, which was partly responsible for the deep recession in Russia last year, forced the Russian government to reverse its earlier attempts to restrict the operational freedom of foreign investors and interfere in their business affairs. The federal government is now trying to woo some of the multinational energy giants by dangling tax breaks and other incentives.


In September 2009, Prime Minister Putin met with executives of international energy companies such as Royal Dutch Shell and ExxonMobil and sought their cooperation to develop natural gas fields in the Arctic region. The two energy companies expressed their interest to take part in the project. Offering favorable fiscal terms, the administration suggested that Russian and foreign companies could swap assets to promote co-operation. In a sign of revival in foreign interest in Russian energy assets, in 2009, India's state-run Oil and Natural Gas Corp. made a \$1.9 billion acquisition of Russia-based Imperial Energy Plc., which has most of its energy reserves in Russia. In the second half of 2010, the Russian government announced the launch of a \$32-billion privatization of state-owned assets. Among those companies listed for privatization is Rosneft, which is 75% owned by the Russian government currently. The government plans to offer an additional 15% of the company's shares between 2011 and 2013. The developments augur well for foreign companies seeking to invest in Russia.

Moreover, Russia has been cozying up to its neighbors east and west to ensure its predominant position in natural gas exports. A report from the U.S. Energy Information Administration says Russia would need to discuss key issues of pricing and sourcing with China on supply of natural gas. Russia has also been trying hard to convince European countries to stick to Russian gas, notwithstanding the transmission risks involving some of its troubled neighbors such as Georgia and the Ukraine. This underlines the importance of the proposed Nord Stream and South Stream gas pipeline projects, which when completed, would transport Russian gas to Germany and Italy, bypassing the Ukraine.

According to a report from the Financial Times, the country desperately needs the expertise of foreign companies to tap the promising gas fields located in the Yamal Peninsula. Adding fuel to the fire, Gazprom, the world's largest natural gas producing company, is reeling under heavy debt and diminished cash flow because of the falling gas prices in Europe. The importance of natural gas exports to the Russian economy was underscored by the recent talks about liberalizing trade in the commodity. Notably, Russia plans to pump in about \$1.9 trillion to rev up its falling oil and gas production by 2030. The federal government estimates that the volume of Russian energy exports to Asian markets would rise to 25 percent by 2030 compared to a meager 6 percent today.

### **Oil Prices Boost Recovery**

Russia has recovered from the financial crisis, clocking a growth rate of 4.1% in 2010, thanks mainly to the recovery in oil prices. The global financial crisis turned out to be a blessing in

disguise for Russia as it helped the country realize the need to free itself of its reliance on commodity exports. Prime Minister Putin has gone on record saying he wants to make use of the crisis to overhaul infrastructure and reduce the government's presence in the economy by selling stakes in state-owned companies. While a sea change in the Russian oil and natural gas sector may remain a pipedream at least in the near future, small initiatives would go a long way to boost the industry's image in the eyes of investors. Endowed with vast natural reserves, the country would do well to liberalize foreign investment norms and carve a niche for itself among emerging economies. 

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### **Thomas White International, Ltd.**

One Financial Place,  
440 South LaSalle Street,  
Suite 3900,  
Chicago, Illinois 60605.  
Email: [feedback@thomaswhite.com](mailto:feedback@thomaswhite.com)

### **Thomas White India Pvt., Ltd.**

Suite 300, 3<sup>rd</sup> Floor  
Phoenix Towers  
16/1 Museum Road  
Bangalore 560001  
Tel.: 91-80-40187777

[www.thomaswhite.com](http://www.thomaswhite.com)