



The Russian Oil and Gas Industry in Transition

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Preface

In 1991-1992, the University of Houston, through our Law Center, engaged in the Russian Petroleum Legislation Project, a significant and highly visible project to assist with the development of a code of law for oil and gas development in that country. The results of work on the project were published in a symposium volume of the *Energy Law Journal*. The Project involved extensive interaction with corporate and government interests in both the United States and Russia. Many recommendations were provided through the Project with respect to prices, royalty and taxation design and, of course, while some recommendations were accepted many were not. In large part, any explanation for the current status of oil and gas development in Russia relative to expectations flows back to experiences we had with this Project.

Dr. Paul Gregory, author of this paper, served as a coordinator for the Project. Dr. Gregory is well known for his work on the Russian and Soviet economies, which includes comparative and historical approaches. This paper here represents the beginning of our effort at the University of Houston, through this Institute, to actively explore post-Soviet energy developments, in perspective with developments in other parts of world in which we are involved through the Institute. We are committed to comparative studies of energy sector reform, in order to determine through rigorous examination the reasons for success or failure. Dr. Gregory's extensive work on, and deep understanding of, the Former Soviet Union is an important component of our overall effort.

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Executive Summary

Russia currently accounts for five percent of world crude oil reserves and 34 percent of world natural gas reserves. At its peak level of production in 1988, the Soviet Union was the world's largest producer of crude oil at 11.8 million barrels per day and the second largest exporter at 4.1 million barrels a day. The Russian Republic accounted for 95 percent of total Soviet production. The Soviet Union was also by far the world's leading producer of natural gas at 817 billion cubic meters per year in 1990. The Russian Republic accounted for 78 percent of the Soviet Union total natural gas production. The potential of these resources places the Russian energy industry in the role of a leading sector for the Russian economy. In addition to being an important engine of recovery in the short-term, the Russian energy sector will be expected to play a major long-term role in eventual Russian economic growth.

However, the Russian energy industry, especially the oil sector, contracted along with the rest of the economy after the collapse of the Soviet Union. Oil production in 1996, at less than 6 million barrels a day, was *almost half* of pre-1990 levels. This contraction is due to inefficiencies inflicted upon the Russian economy during the administrative-command system of the Soviet Union and the reluctance of post-Soviet governors of Russia to implement policies that would remedy these inefficiencies in an era of otherwise open market conditions. Some of the issues are discussed further below.

- During the Soviet Union period, oil and gas were produced by regional production associations that were under the supervision of the Ministry of Oil Industry and the Ministry of Gas Industry. Particularly, production quota system used by central planners resulted in poor reservoir management, excessive drilling and flooding, among other conditions, that lowered the productivity of existing fields.
- Soviet enterprises and consumers paid such low prices that energy was considered almost a free good. Although Russian prices were generally liberalized after January 1992, Russian authorities maintained ceilings on fuel prices given their importance to Russian consumers and to fuel-inefficient Russian industries. In early 1993, the highest domestic sales price of Russian oil was approximately \$6 per barrel, while the world price was around \$18 per barrel.
- The Russian energy industry was affected as well by a rash of non-payments for its products. Russian oil and gas producers were pressured by government officials to continue delivery due to the overall importance of these products to consumers and industries. As domestic prices continue to remain significantly lower than world prices, oil and gas continue to be “overused” by domestic consumers.
- The Russian oil and gas industry suffered from a severe collapse in investment spending. Foreign investment in Russia's oil and gas industries is limited by domestic opposition, either for political or economic reasons, by various powerful groups. Also, the investment climate of Russia is uncertain. Laws are either inadequate, remain to be written, or, if written, are poorly enforced. Russia's political system remains shaky, and the conflict between the presidency and the legislature shows no signs of being resolved. The cumulative dollar volume of direct foreign investment in the Russian oil and gas industry had reached slightly more than \$1.6 billion by the end of 1995 -- an insignificant sum of direct investment given the size of typical infrastructure investments in the industry. Only six percent of total oil production was carried out under joint venture agreements in 1995.
- The Russian energy sector was singled out by tax authorities as a major source of tax revenues. Special energy taxes discouraged production, exports, and investment. The current tax system is uncertain and based upon complicated special privileges and exemptions that could be arbitrarily withdrawn. The promised new tax system may not go into effect until the turn of the century and when it does there are no guarantees that it will be more certain than the current system.

Nevertheless, there are substantial oil and gas reserves that remain to be developed in Russia. With advanced technology, these reserves can be developed at a relatively low marginal cost compared to other parts of the world. Management and ownership structures within the Russian oil and gas industry have undergone significant and dramatic change during the process of transition. Whereas the Soviet Ministry of Oil Industry micro-managed the production, sales, and transportation of oil, its Russian successor organizations have less power and control over the energy industry. The most significant changes in the structure of the Russian energy industry have been the privatization of formerly state-owned enterprises. The privatization of the Russian oil and gas industry was managed under separate rules, given the strategic importance of the industry.

Also, the recovery of the Russian energy industry and the recovery of the Russian economy are interdependent. Russia has put into place many of the institutions that are required for growth. Russia now has a constitution, a civil code, a reasonably independent central bank, debt and equity markets, a system of market prices and has completed its first real presidential election. Property has been distributed, albeit unfairly, to new owners. Profit opportunities abound, and enormous entrepreneurial energies have been released. A number of steps remain to be taken to revitalize the Russian energy sector.

- The Russian energy industry *must* complete the transition from a state-planned, owned and operated branch of the economy to market-oriented businesses with at least partial private ownership.
- A climate favorable to long-term investment *must* be created in Russia. This requires the creation of property laws, the creation of an independent judiciary whose judgments are obeyed, and the passage of reasonable tax codes.
- Russian oil and gas reserves *must* be developed according to the latest technology; advanced technology, however, is available only in the West. Russia must therefore find ways to bring in the latest technology to the Russian energy industry.

It is clear that the transition of the Russian economy continues. There are competing regional and industrial interests as well as competing philosophies concerning the future of Russia. No single set of vested interests, however, has established itself yet. There are opportunities in this fluid environment for carrying out policies consistent with above suggestions. The political influence of the growing Russian middle class may help steer the economy towards western standards.