

Shamil Midkhatovich Yenikeyeff looks at Russian oil output

In September–October 2009, Russia made headlines when its oil exports in the second quarter of 2009 surpassed that of the world's largest oil supplier, Saudi Arabia. In April–June 2009, Russia exported 7.4 million barrels of oil per day compared to Saudi Arabia's oil exports of 7 million barrels. In addition, in the middle of 2009 Russian oil output reached a ten-year record of 9.91 million barrels per day.

At first glance, it may appear that the global financial meltdown has not made a severe impact on the Russian oil industry. However, the Russian reality is rather different if not complex. First, it can be argued that the recent increase in Russian oil exports was primarily driven by external market conditions rather than domestic policies. In fact, Russian government policies of the past eight years promoted the stagnation rather than the development of the oil sector. Secondly, although according to official data for the second quarter of 2009 Russia surpassed the other top oil-producing nation, Saudi Arabia, in terms of oil exports, it actually was placed worst amongst all G20 countries in terms of economic performance during the crisis of 2009. Quite notably, in April–June 2009 in

comparison to Saudi Arabia's GDP decline of 0.9 percent, Russia's GDP fell by as much as 10.9 percent. Poor economic performance in Russia is linked not only to the sudden fall of oil prices within the second half of 2008, but also to the manner in which the government's fiscal policies and taxation of the domestic oil sector were implemented from 2004 through 2008. However, before these issues are examined further in this brief study it is essential to establish the actual factors behind Russia's rise to its status as a leading oil exporter in the second quarter of 2009.

Russia and Saudi Arabia

There is nothing new about the fact that Russia surpassed Saudi Arabia in terms of oil production. Throughout the 2000s, these two countries have been producing similar volumes of oil, with Russian output occupying the top position from time to time. This first occurred in early 2002, when Russia produced 7.28 million barrels per day compared to the Saudi daily output of 7.19 million barrels. Subsequently, Russia managed to surpass Saudi oil production again a few additional times. However, what differed in this instance is the fact that Russia for the entire second quarter of 2009 exported more oil than Saudi Arabia, a mark which Russia had never managed to reach since the disintegration of the Soviet Union in 1991.

It is important to note that Russia's historic achievement as a leading oil exporter was possible not so much because of domestic policies towards the oil sector, but mainly because of oil output cuts of 4.2 million barrels a day agreed to by OPEC in the fall of 2008. Saudi Arabia, as OPEC's key supplier, has been especially stringent in implementing oil output cuts in order to stabilise oil prices. OPEC's decision was based on the widely shared assumption that a sudden collapse of oil prices could hurt upstream investments leading to future shortages of oil supplies vital for global economic growth. Russia, as a non-OPEC member, often benefits from oil supply cuts implemented by OPEC. As in the past, Russian

oil producers rallied to export more oil abroad to generate extra revenues while the Saudi-backed OPEC cuts were maintained.

By mid-2009, Russian oil exports experienced a 1.5 times increase in comparison to November 2008 when oil prices fell to their lowest levels in many years. Thus, despite additional export volumes, revenues generated by Russian oil exporters from January through July 2009 were only half of what they were in the same period in 2008 due to oil price dynamics: \$45.8 billion and \$96.5 billion respectively.

Crucial Issues

The issue of oil (and oil price-linked gas) revenues are of paramount importance not only to the Russian budget but also to the future socio-economic stability of this resource-rich nation. In the past five years, Russia's economy (despite earlier proclamations of diversification) became more dependent on oil revenues due to the government's fiscal policies, and will remain so for at least a decade. Therefore, in order to ensure political and economic stability in the country, the Russian government will be required either to diversify the economy (which is unlikely) or to boost future Russian hydrocarbon production and exports.

In this respect, three interconnected issues are important: taxation of the oil sector, availability of investments, and oil price dynamics. While the latter factor is well beyond the Russian government's control, policy-makers in Moscow will face serious challenges in relation to the first two issues.¹

From 2000 through mid-2008, Russian economic development was predominately driven by rising oil prices. Currently, the hydrocarbon sector accounts for 60 percent of Russian export revenues and contributes to over 45 percent of the federal budget. In March 2009, the Russian Minister of Finance Alexey

Kudrin stated that during the period of high oil prices, the government chose to spend extra revenues instead of diversifying the national economy. However, the government's departure from its previous stance on economic diversification was not merely a result of its decision to spend additional revenues on day-to-day needs, but was a part of its policy of transferring extra revenues to the Stabilisation Fund. The significant exposure of the Russian economy and financial system to price fluctuations in the global hydrocarbon markets was the core reason behind the formation of the Stabilisation Fund. From 2004 to 2007 the Russian government used the Fund to accumulate revenues from oil prices which exceeded the cut-off price set at \$20 per barrel (and increased to \$27 per barrel in 2006) in order to balance the federal budget should oil prices fall below the cut-off level. The Fund's resources were then invested into foreign assets, converted into foreign currency or deposited into foreign banks. In January 2008, the Ministry of Finance split the Stabilisation Fund into the Reserve Fund and the National Welfare Fund.

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It is important to note that there has not been a drastic decline of world oil prices in comparison to the 2003–2004 period (when the Russian Stabilisation Fund was formed). Although external market conditions have not changed, the domestic budgetary situation has altered dramatically: for instance, instead of a budget surplus, the government now has limited financial resources at its disposal. A decline in Reserve Fund resources and growing budgetary expenditures are likely to lead to a situation whereby Russia will utilise its accumulated hydrocarbon revenues faster than previously envisioned. The Reserve Fund could

be spent almost entirely by 2010 – a prediction which Russian government officials concur with.

The current situation with the Russian budget evolved out of the 2004–2009 period when the government expanded the scope of budgetary expenditures. The influx of oil and gas revenues, associated with high hydrocarbon prices in external markets, was used by the government to solve pressing social problems mainly by increasing levels of pension payments and basic salaries. From 2000 through 2006, the per capita income of Russian citizens increased four-fold from 2,280 to 10,000 roubles, whereas the standard pension level tripled from 690 to 2,500 roubles. In the 2000s the dependence of the Russian economy and the society on the domestic oil and gas sector increased dramatically. This could explain why, in the second half of 2008 through the first half of 2009, Russia surprisingly showed the biggest decline in GDP and industrial production amongst all the countries of the former Soviet Union.

Astoundingly, over the past eight years, gross revenues of Russian oil companies surpassed \$1 trillion, whereas their net income reached \$150 billion, of which \$50–\$70 billion were invested. During this period, the state received over \$700 billion in hydrocarbon and corporate taxes and duties. However, these large oil and gas revenues did not increase the workforce employed in the Russian economy: if in 2006 the Russian workforce was estimated at 51 million, by 2008 this figure fell to 48 million. As a result, the Russian government completely withheld funds that could have been used for the provision of extra credits to Russian companies and for the development of vital infrastructure projects.

If in 2003 the share of taxes within revenues of Russian oil companies comprised 35 percent, by 2005 these companies had to transfer nearly 60 percent of their revenues to the budget. This sudden change was due to tax reforms initiated by the government in the 2000s when the taxation of the oil and gas sector was substantially increased.

¹ This section is partially based on the forthcoming working paper, ‘Natural Resource Management in Russia’ by Valery Kryukov, Anatoly Tokarev and Shamil Yenikeeff.

Naturally, one would assume that companies, having paid their tax dues, would use a substantial portion of remnant revenues for investment into the sector whereas the state would use the collected taxes as a means of ensuring socio-economic stability and for paying off any external debts. However, in the Russian case, such assumptions are accurate only to a certain degree. The reality was that the largest portion of oil revenues (and a smaller portion of gas revenues) was transferred abroad. The remaining amount was used by Russian oil and gas companies for direct investments, as well as for acquisition of other domestic oil and gas companies. At the same time, the volume of direct investments into the industry never reached a level adequate for the maintenance of oil and gas output and the development of new oil and gas fields.

“The key challenge for the Russian government now is how to meet budgetary obligations while boosting domestic oil production and exports or diversifying the economy”

In 2002, the Russian Accounts (Audit) Chamber highlighted that prior to 2000 the investment situation in the oil and gas sector had been unsatisfactory and in a state of crisis. If in 1990 investment levels in the Russian hydrocarbon sector reached 112 billion roubles, by 1999 it had decreased to 51.3 billion roubles. Equipment depreciation levels reached 50 percent for oil production and 80 percent for oil refining. More than half of the domestic oil trunk pipelines have been in operation for over 25 years, while their average working life is 30 years.

There are several reasons for the lack of investment activities within the oil and gas sector:

- An unstable investment climate, including high tax burdens imposed onto companies;

- A pre-existing industrial infrastructure (developed in Soviet times), which has been advantageous for most Russian oil companies in the post-Soviet era. However, these same companies failed to re-invest financial resources into the maintenance and refurbishment of the aged infrastructure and to meet compliance with technological rules and standards of the industry. Instead, some companies went so far as to use equipment and infrastructure depreciation payments as an additional source of revenue generation;
- A lack of financial resources, particularly for the implementation of key projects essential for reproducing existing assets and resources as well as for developing resources in new oil and gas fields.

It may be argued that a heavy tax burden levied by the government upon the oil and gas sector led to declining investment flows. Yet it is also important to note that from 2000 to 2005, Russian oil companies (such as Sibneft, Yukos, TNK-BP, Lukoil) paid very high dividends to their shareholders, which often exceeded their corporate annual revenues. Simultaneously, these companies transferred most of their financial assets abroad as part of a widespread capital flight. For example, according to the Central Bank of Russia estimates, by 2003 the Russian private sector had invested around \$66 billion abroad. Even still, a number of experts assert that the real figure of Russian capital invested abroad reached over \$300 billion. The Central Bank of Russia is unable to provide accurate figures on the Russian capital flight due to the fact that most of these funds were transferred abroad without the required registration procedure nor with any governmental permission.

Despite differing estimates, it is generally agreed that the Russian capital flight after the collapse of the Soviet Union was substantial. From 1992 through 1995, large disparities between domestic and global oil prices as well as other mineral, metal and chemical products, enabled Russian

trading houses to accumulate tremendous profits. An absence of any state control over such trading activities, as well as high income taxes, also contributed to the capital flight. Thus, the main reasons for Russian capital flight included:

- Macroeconomic instability, linked to political instability, making investors nervous about future revenue prospects in Russia.
- The unstable and confiscatory nature of the domestic tax system, which facilitated tax evasion and the transfer of funds abroad hence away from Russian tax authorities.
- A lack of trust in the domestic banking system, boosting transfer of individual savings to foreign banks.
- Institutional weakness of property protection measures and widespread corruption, discouraging companies and individuals from retaining their financial assets in Russia.

Since 2003 the situation with capital flight has changed: if in the late 1990s ‘pure’ capital outflow was widespread, by 2008 it appeared to take on a new form. For example, the volume of resources used by Russian companies to acquire assets abroad increased threefold, from approximately 23 billion USD in 1999 up to 73.4 billion in 2005.

According to the Central Bank of Russia, in 2008 the ‘pure’ outflow of private capital from the country sharply increased reaching \$130 billion, including the banking sector (\$57.5 billion) and other sectors of the economy (\$72.5 billion). In the first quarter of 2009, capital flight was estimated at \$23.1 billion.

This dynamic of capital outflow has been directly connected with the government’s policy on the taxation of the Russian hydrocarbon sector, as well as the aspiration of the state to accumulate main tax revenues from the oil and gas industry into the Stabilisation Fund.

The key challenge for the Russian government now is how to meet budgetary obligations while boosting

domestic oil production and exports or diversifying the economy. One of the ways to achieve this is by borrowing financial resources through external markets. Another way is to lower taxes imposed on the Russian oil sector, which could promote development of existing and new fields. At the same time, substantial reduction of this tax burden could lead to even greater budgetary deficit and could jeopardise socio-economic stability in Russia. Hence, today the Russian oil sector faces serious obstacles including:

- Increasingly challenging conditions for the exploration and development of new hydrocarbon fields located in difficult-to-reach territories with severe climates and complex geology;
- Lack of incentives for private investors (both foreign and domestic) to develop new fields under the existing legal framework, in a sector dominated by state-controlled companies (which determine whether a given independent company gains access to vital infrastructure and key export routes);
- The substantial tax burden recently imposed on the hydrocarbon sector, coupled with the dominance of state-controlled oil and gas companies, impedes the facilitation of exploration and development of new oil and gas fields. Various tax exemptions and privileges granted by the government in 2008–2009 to companies operating in new fields could not compensate for the high expenditures incurred during their industrial development; for example, in the first half of 2009, Russian oil companies reduced their exploration drilling by over 40 percent in comparison to the same period in 2008.

Despite all the media hype surrounding a recent increase in Russia's oil output and exports, fundamental problems within this sector and the Russian economy at large imply that this is a glitch rather than a trend. Therefore, it is unsurprising that the Russian government forecast indicates the stagnation of the annual domestic

oil production (from 492 million tonnes in 2008 down to 483 million tonnes in 2011) as well as a decline of oil exports (from 245.4 million in 2009 to 238 million tonnes in 2012). Despite this rather pessimistic short-term forecast, the government's long-term forecast for the oil sector sees its gradual recovery by 2030. According to the draft *Russian Energy Strategy* discussed by the government in August 2009, in 2030 Russia's annual oil output is projected to increase to 530–535 million tonnes (with annual oil exports reaching 329 million tonnes).

In order to achieve these targets, the *Russian Energy Strategy* envisages that the domestic hydrocarbon sector will require up to \$2.5 trillion in investment. It is highly unlikely that these financial volumes could be secured through a different system of taxation of the domestic oil sector. Russian oil companies are also unlikely candidates for reinvesting adequate levels of their profits back

into the sector. In fact, oil companies have shown a pattern of using extra financial resources primarily for the benefit of their shareholders instead of investing in exploration and production in new fields. It appears that the only way forward for the Russian oil sector is to secure these vital financial resources through a formation of legal mechanisms conducive to foreign investment.

Successful transformation of the Russian economy from resource dependent into hi-tech and innovative will depend on a successful promotion of incentives for investors and greater opportunities for entrepreneurs, not only in the hydrocarbon sector but also in other sectors of the economy (thus facilitating economic growth and additional budgetary revenues). In the 2000s, the growing tax burden forced Russian companies to compensate their diminishing revenues by borrowing in external markets. This resulted in an accelerated economic decline in Russia during the crisis period.