



The corporate landscape

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The Russian energy sector has experienced a dramatic transformation in its corporate structure during the last two decades with, rather surprisingly, the different branches of the energy sector – oil, gas, coal, and electricity – undergoing changes that differ markedly from each other in nature.

The oil and coal sectors were privatized and deregulated in the early 1990s, according to the concept of ‘market reforms’ promoted by the liberal block in the government. By the end of the twentieth century they had already become quite competitive markets with many players. In contrast, the infrastructure-dependent gas and electricity industries – regarded as ‘natural monopolies’, critical for the energy security of the country – were consolidated in large-scale country-wide state-controlled holding companies (Gazprom and RAO UES) in order to turn them round and provide them with protection in the painful period of non-payments and vast investment deficits. Reform of the electricity market

took place later – generating companies were privatized, the market liberalized, and non-payments were tackled – while the gas industry was still monopolized by Gazprom.

In the last five to seven years, however, new trends have begun to emerge, with the oil sector gradually becoming increasingly dominated by state-controlled companies (above all by Rosneft). This process started in 2003 with the Yukos case when, for the first time, the government showed its increasing interest in controlling growing oil revenues. Introduction of the ‘strategic fields’ concept in 2008 marked a new era in the Russian oil sector, with state-controlled companies getting priority access to the most attractive hydrocarbon resources. Industrial performance supported this paternalistic trend: all major investments are carried out by state-controlled companies, justifying the state’s perception that private companies are focused solely on their profits, rather than on supporting the economy of the

country as a whole. This strategy was also strengthened by the personal ambitions of Rosneft’s CEO Igor Sechin, who has been consolidating assets in Rosneft since 2004, turning it into Russia’s national champion.

A similar move towards an oligopoly of state-controlled companies can be seen in the electricity market; this trend is driven both by market logic (large diversified generating companies have a better competitive position in a turbulent market than small independent companies) and by the state’s desire to remain in charge of this strategically and socially important sector. Conversely, the gas sector – which has already demonstrated all the disadvantages and inefficiencies of state monopoly power – is seeing increasing competition mainly driven, amazingly, by Rosneft.

Oil

By the late 1990s/early 2000s, following a very contradictory transitional period, all the key Russian oil production assets

found themselves concentrated in the hands of private corporations such as Yukos, Sibneft, Lukoil, and Surgutneftegaz – which had become world-class vertically integrated oil companies (VIOCs). All regional markets were divided between these private VIOCs, while state-controlled Rosneft accounted for less than 5 per cent of the country's production and an even lower share of the oil products market. In the course of the last decade, however, oil production has started to become concentrated in the hands of state-controlled companies such as Rosneft and Gazprom Neft, while just two major private companies (Lukoil and Surgutneftegaz) remained by the end of 2013.

After a series of acquisitions (initially assets from Yukos, then from TNK–BP) Rosneft's share of total Russian production reached 40 per cent in 2013 (excluding Slavneft, half of which also came under Rosneft's control after its acquisition of TNK–BP). Rosneft is not the only state-controlled asset in the Russian oil sector, however. Since 2007, Gazprom's oil assets have been consolidated in Gazprom Neft, which provides about 6 per cent of Russian oil (again, excluding Slavneft's share). Following Rosneft's acquisition of TNK–BP, Slavneft itself may also be considered to be a completely state-controlled asset, as it is now half owned by state-controlled Rosneft, and half by state-controlled Gazprom Neft. As a result, the proportion of state-controlled production (Rosneft, Gazprom Neft, and Slavneft) has increased more than 13-fold to 50 per cent in the course of the past 10 years.

According to the Russian Energy Ministry, production of oil and gas condensate in Russia in 2013 was carried out by approximately 300 companies (including eight VIOCs, each combining exploration, production, refining, distribution, and retailing – about 110 subsidiary companies in

total) which provided 87.4 per cent of total Russian liquid fuel production. Four out of these eight companies – Rosneft, Lukoil, Surgutneftegaz, and Gazprom Neft – were responsible for about 70 per cent of total output; 180 independent companies accounted for 9.9 per cent of total oil production; while three consortia working under production sharing agreements (PSAs) – Sakhalin-1, Sakhalin-2 and Kharyaga – provided about 2.7 per cent of Russian oil production.

Private companies currently provide about half of total liquid fuel production in Russia, but this share will probably decrease in the medium term as Gazprom Neft and Rosneft are likely to be the main engines of oil production growth in the coming years. All major new investment projects and the majority of oil production growth is provided by state-controlled companies. Therefore today, when oil accounts for the largest share of the country's federal budget revenues – 35 per cent in 2013 – and the state needs this money badly, it is reasonable to expect that the state will continue to use this powerful tool to control such a key industry, generating a 'multiplication effect' for other industries.

Gas

Gazprom, the state gas concern, was formed in 1989 on the basis of the Soviet Gas Industry Ministry. This huge holding (including gas exploration and production, pipeline transportation, and gas sales in domestic and external markets) initially controlled 94–95 per cent of total Russian gas output. There were several independent gas producers (Itera, Novatek) in the 1990s, but their role in the market was insignificant.

The situation began to change after the global financial crisis of 2008, with Russian gas producers being compelled to limit production volumes due to lower domestic and

external demand. Gazprom has had to fundamentally dampen down its activities and has gradually started to lose ground to independent suppliers (Novatek and vertically integrated oil companies, primarily Rosneft), who increased their share in Russian production from 15 per cent in 2008 to 27 per cent in 2013. There has been a huge increase in the number of contracts awarded to producers other than Gazprom by major industrial gas consumers. The rise in production from independents has been assisted by a more favourable regulatory and taxation environment, which includes the right to sell gas at non-regulated prices: in recent years these companies have been offering a 3–10 per cent discount on prices set by the Federal Tariff Service (FTS), while Gazprom is obliged to sell gas at regulated prices without any discounts. Rosneft and Novatek have also managed to do away with Gazprom's gas export monopoly, though so far only for LNG.

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In total, in 2013 there were about 260 companies producing natural and associated gas in Russia. This figure includes: 16 Gazprom subsidiary companies (providing 71.3 per cent of total Russian production); 97 companies belonging to the eight VIOCs (11.4 per cent); two companies affiliated to Novatek (7.9 per cent); 140 independent gas companies (just 5.3 per cent); and three PSA operators (4.1 per cent).

The growth of production by gas producers other than Gazprom does not necessarily imply the formation of a competitive market – they are, in fact, creating regional monopolies. For example, Novatek accounts for nearly 100 per cent of gas supplies to Russia's largest industrial area, the Chelyabinsk



region. Rosneft, through its acquisition of Itera, has also secured the position of 100 per cent gas supplier for the Sverdlovsk region. As was the case in the oil industry in the 1990s, the companies are dividing up the market.

Electricity

As for the electricity sector, an electric energy holding company, Unified Energy System of Russia (RAO UES), was established in 1992. Most of the state-owned electric energy assets – such as thermal and hydroelectric power plants, transmission lines, and state-owned shares in power, research and engineering, and construction companies – were transferred to RAO UES, with the exception of any assets related to nuclear energy. Only four regional energy systems – Bashkirenergo, Tatenergo, Novosibirskenergo, and Irkutskenergo – did not join RAO UES. The Russian Federation directly or indirectly owned over 52 per cent of shares in RAO UES, while Gazprom owned 10.5 per cent, and Norilsk Nickel 10.5 per cent, the remainder being held by minority shareholders.

The industry was facing numerous challenges, above all, aging and deteriorating assets and a chronic lack of investment. Market reform was initiated in 2006 in order to overcome this, and by 2008 all subsidiaries of RAO UES had been spun off. This was a massive privatization of generation assets. As a result, RAO UES ceased to exist after its merger into the Federal Grid Company. Altogether, six private wholesale generation companies (OGKs), 14 territorial generation companies (TGKs), state-controlled RusHydro and Rosatom, the Federal Grid Company, the System Operator, RAO UES of the East, and Inter RAO UES started to operate as independent entities.

However, within a few years of the splitting up of RAO UES, the sector started to consolidate again: non-

stop changing rules of the market and remaining non-market mechanisms (like Power Supply Agreements) gave the companies significant lobbying power, which represented a much stronger competitive advantage than their economic efficiency. Currently just four generating majors provide 55 per cent of national power generation. This trend towards the sector being concentrated in fewer hands is likely to intensify as generation margins become narrower and an oligopolistic system evolves in which two state-controlled companies, Gazpromenergoholding and InterRAO (of which Igor Sechin is Chairman, combining this position with the role of the President and Chairman of the Management Board of Rosneft) hold a dominant position.

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Coal

The coal sector was also initially consolidated into a state corporation, Russian Coal (Rosugol), in 1991. However, with the deregulation of coal prices and faced with numerous challenging issues (such as lack of modern mining equipment, closure of unprofitable mines, and exposure to global markets) further development of the industry would have required higher state subsidies, which the Russian government could not afford, and the decision was therefore made to reform and privatize the Russian coal industry.

More than 150 coal producing companies were closed down during restructuring between 1993 and 1997. In 1998 the state-controlled Rosugol was liquidated, while all profitable coal mines were privatized. During the last decade, therefore, all coal in Russia has been

produced by private companies, with 11 large companies currently accounting for roughly 70 per cent of Russian coal production. The main producers are: SUEK, with 27.4 per cent of total coal production, and Kuzbassrazrezugol, producing mostly steam coal and focusing mainly on exports, with 12.8 per cent. Coking coal is mainly controlled by vertically integrated metallurgical holdings; these produce 90 per cent of the total, with the main groups being Evraz, Severstal, and Mechel.

Conclusion

The Russian energy sector is experiencing contradictory trajectories in the transformation of its corporate landscape. Only the coal sector, with its low margins, can be regarded as being more or less competitive, while the oil and electricity sectors, which experienced massive privatization, are becoming more concentrated under state control. Meanwhile the gas sector, the most monopolistic of all, is demonstrating a different pattern. But these battles between the state-controlled giants (Gazprom and Rosneft) should not mislead: this situation is not about increasing real competition, it is about division of power within the state itself.

Increasing opposition between Russia and the West due to the Ukrainian conflict and Crimean reunification, together with, in particular, the threat of new sanctions against Russia (especially in the energy sector), are pushing the Russian government towards further mobilization and centralization of the economy, with an increasing role for the state ‘in the face of external enemies’. The era of the liberal block in its government is over, the conservative block holding out for strong Keynesian policy is now in power. The Russian energy sector might therefore see a further increase of state involvement, together with further consolidation.

