

Russia's Financial Market Meltdown: Energy Security Implications

Written by Kevin Rosner

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The global financial crisis has by definition wrought havoc on all the world's economies: although the pain is not evenly distributed. The Russian economy, a darling of emerging market investors over the past 8 years had been until May 2008 one of the world's best performing markets. But since then the combined Russian exchanges have fallen more than 70% making Russia "one of the world's worst performers over the past few months." It is yet not clear how the implosion of Russia's financial market will affect that nation's oil and gas sectors and in turn Europe's overall energy security. There are however a few indicators to consider.

On July 11 2008 global oil prices peaked at \$147 a barrel, but since then they have fallen by more than 60% closing out at \$52 a barrel by mid-November. In an economy where approximately 25% of GDP is generated by the oil and gas sectors, with over 50% of all Russian exports oil and gas related and with 50% of federal government revenue dependent on these exports global negative pressure on oil and gas prices is dire news for the overall Russian economy and even more so for Russia's energy industries.

Russia's response thus far has been nuanced albeit altogether on the negative side with respect to oil and gas supply movements. Concurrent with OPEC's October decision to cut production by 1.5 m/bd, Russian Deputy Prime Minister Igor Sechin has stated, ""The Ministry of Energy is considering creating an oil production reserve, which would allow it to work more efficiently with prices on the market," Sechin told Reuters. When asked how big the reserve should be, he said: "Enough to reach efficient pricing parameters."

The incentive in Russia for higher prices is there but in the past the rush to crude accompanied by higher export prices has prevented oil from being taken off-market. Now with prices falling and revenue off, producers may agree collectively to something they have never abided by individually that is to limit exports though hoarding. This may also be accomplished de facto by simply defaulting on the numbers for projected production.

Another consideration is that effective Russian oil storage could allow Russia to become a quasi swing producer and therefore add muscle to its image as an energy superpower. It also reflects another line of Russian thinking. The currency Russia has used to re-enter global politics as a major player rests on its claims as an energy superpower. Once these finite resources are exhausted, in short once this currency is spent, then this major source of power and influence evaporates. Therefore keeping oil and gas in the ground extends this run while power continues to accrue to those who have successfully harnessed the energy power of the state to promote Russia's national interests.

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To date there has been no resulting agreement to follow through on these discussions but this time things may be different. Any withholding of Russian oil exports from the market would have a negative, upward affect on oil prices and yet another worrying sign for countries already turning towards recession. This includes the United States. While direct US imports of Russian hydrocarbons are negligible less oil from Russia, which is the world's largest non-OPEC oil producer and exporter, would negatively impact global oil prices and in turn put upward pressure on US oil import prices.

On the gas side of the equation the news is no better. Whether perceived or real, October's meeting in Teheran where talk of a gas cartel was bandied about is a worrisome development for European consumers. Hemmed in by pipeline infrastructure and limited diversification in regional gas availability, efforts to coordinate natural gas production and upstream development by Russian, Iran and Qatar would tighten Russia's stranglehold on the European gas market and deepen European gas dependence. Coming out of the meeting Gazprom's Alexi Miller proclaimed the era of cheap hydrocarbons over and the creation of a "gas troika." In Miller's words, "We are united by the world's largest gas reserves, common strategic interests and, which is of great importance, high cooperation potential in tripartite projects," he explained. "We have agreed to hold regular - three to four times a year - meetings of the gas G3 to discuss the crucial issues of mutual interest."

Of long term strategic interest to Gazprom is the tightening of European gas prices and the avoidance of competitors in what it considers its market. Qatar is barreling ahead with LNG development and global transport capacity. Iran has geographic advantage to export gas across Pakistan to the Indian subcontinent theoretically through the Iran-Pakistan-India pipeline. These realities reflect each of the G3's individual competitive advantages. Dividing world markets into military like "gas commands" e.g. Russia with its western command, Iran with its eastern command and Qatar with a global LNG transport reach, if respected, would prevent competition in each other's markets and hence put further upward pressure on regional gas prices. OPEC and the G3 call this cooperation. The US Security and Exchange Commission calls this price fixing.

A development, equally worrying for European security concerns and one that actually preceded Russia's financial market woes, has been stagnant output in both Russia's oil and gas sectors. Even prior to the current financial crisis, Russia's oil majors in particular were suffering their own liquidity crisis. In 2007 while export revenue from oil totaled some \$121.5 billion Russian oil must operate under a tax regime that can only be described as punitive. According to data from the IEA's February 2008 Oil Market Report a theoretical \$75 per barrel price of oil renders, though a basket of taxes on crude oil production, oil and oil product exports, and corporate taxes, returns of \$65 in tax revenue to the state. For a capital intensive industry such as oil, this tax regime represents

(1) a policy choice to dampen necessary upstream exploration as the revenue isn't there to fund it,

(2) to maximize tax revenue to the federal government for redistributive purposes,

(3) and to limit the wealth generating effect of oil revenue to a handful of Russian oligarchs.

Secondly, Russia's oil and gas sectors—along with the federal government—have been maximizing rent seeking for years. They have preferred to invest outside of the country in expensive and often non economically rational transportation projects such as the Nord Stream project and in mid-and-downstream foreign acquisitions to benefit from, if not control, the entire energy supply chain where Russian energy flows. This has deprived the Russian energy sector from necessary investment in important domestic upstream green-field development, in infrastructure maintenance and in improvements that would enhance not only Russian but also European energy supply security. This past summer Leonid Fedun, vice president of OAO Lukoil Russia's largest privately held oil company warned that "Russia's oil industry needs \$1 trillion of investment during the next 20 years just to maintain production of 10 million barrels a day."

Already by April 2008 the IEA confirmed that Russian oil output had declined for the first time in a decade and in June it was confirmed that output for the first 5 months of the year was down 250,000 barrels a day. In fact Russian oil exports were down 5.9% for the first 8 months of 2008. Chris Gaddy of the Brookings Institute notes this fall in exports (not output) is in part the result of, "the country's recent effort to process more of its own oil and export the refined products instead of crude." However this doesn't account for the overall fall in production which has plateaued and which is likely to decline over the medium term without further investment.

As far as prospects for an uptick in Russian gas output, according to Gazprom Russian gas production is no longer growing but will remain constant for the years 2007 through 2009. In fact, output growth slowed down and stopped altogether after 2006. In 2006 gas extraction was 556 BCM/y, just 1 BCM more than in 2005. The extraction decreased for the first time in 2007 to 548.5 BCM/y, or 1.3% less than in 2006. Russia's estimated domestic share of gas consumption in 2007 was 69.71% or some 373 BCM leaving 175 BCM for export. It is important to note that domestic Russian demand for gas has been increasing over the past several years in response to the country's economic growth and comparatively low fixed prices for residential consumers. While demand may fall in step with a decline in industrial production, the potential

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increase in additional gas available for export is marginal at best.

The well informed Bank of Finland is sanguine about Russia's near term prospects for weathering its financial storm but less so over the longer term. The country has the third largest foreign currency reserves of any other country in the world (topping out easily over \$550 billion earlier this year) but it is an educated guess at how long these reserves can last without new revenue injections from oil and gas based exports. Already in August the Russian economy lost between \$20-\$30 billion in capital flight due to Russia's invasion of Georgia and altogether over the past 4 months Russia may have lost \$170 billion alone to the confluence of war, the weakening of its own financial market and the near certainty that the Russian Central Bank will not be able to sustain the value of the ruble versus foreign currencies. The central bank's support of the weakening ruble has already cost it a conservative \$37 billion. However Russia's foreign currency reserves are not infinite and they may have already burned through 20% of the country's overall currency reserves. Additionally, the federal government has promised an additional \$50 billion to bail-out a multitude of Russian business interests including Rosneft and Gazprom but this is most certainly the tip of the iceberg.

While Russia's Finance Minister Alexei Kudrin should be praised for his stewardship of the Russian economy, predicating the federal budget on \$90 barrel oil (the Q3 average should be around \$100) he cannot set prices. At \$70 a barrel the Russian budget is balanced but that is history and the government is now deep into negative territory with respect to its spending authority.

With a weakening ruble posited against tightening global credit markets, Russia's weak banking sector is facing its own day of reckoning. According to a report published earlier this year, Russian banks will have to pay some \$54 billion in outstanding foreign debt before the end of 2008 drying up a further source of financing. Gazprom's share value has been halved and itself has \$40 billion in outstanding debt dampening prospects for meaningful domestic investment to increase supply over the medium term. Rosneft effectively the state owned oil company has outstanding debt of some \$21 billion. Lukoil Russia's largest privately owned oil company announced in late October it was cutting its own investment program by some 20%. All of this may add up to what producers want: higher global prices which would help them weather Russia's own financial crisis. At the same time decreases in production or rising prices are of little consolation to European oil and gas consumers.

The degree of Russian government intervention in providing funding to its strategic oil and gas sector will lead to further consolidation of inefficient centralized management over these assets. Russia's oligarchs have already taken a huge hit by the losses in financial markets. "The

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combined wealth of Forbes magazine's 25 richest Russians tumbled 62% between May 19 and Oct. 6, based on declines in the equity value of traded companies and analysts' estimates of closely held assets they own. The loss is four times larger than the fortune of the world's wealthiest man, Warren Buffett." The process of reigning in the oligarchs, started under Prime Minister Putin during his first term as President, may be successfully brought full circle with Russia's financial market meltdown. But as the economy and the oil and gas sectors ultimately recover, Russian energy is likely to find itself under increased influence and control from federal authorities as their future will have been leveraged with government bailouts. By way of example, Oleg Deripaska Russia's aluminum magnate and formerly Russia's richest man may have lost \$28.4 billion of his reported \$28 billion net worth between May and October 2008. The Russian government bailed him out with a \$4.5 billion loan which in turn was due to Western banks at the end of October 2008. Regardless of what happens to Mr. Deripaska's personal fortune this ensures this industry, also considered strategic by the government, remains in Russian hands and in the case of default under Russian (eg federal government) ownership. A predicated renationalization of government control over Russia's oil and gas in the long term means harder bargaining for European commercial interests with their Russian counterparts. Western interests have already been weakened by the successful conduct of Russian foreign energy policy based on bilateralism. This has in turn weakened the prospect for any consolidated common energy policy at the level of the European Union.

One final prospect that the Russian financial crisis brings with it runs contrary to what is actually happening in the Russian oil and gas market today. Should oil and gas prices recover far more quickly than the growth rate in the global economy then a return to this sector's past spending habits on downstream acquisitions and transportation projects can be expected. In turn beleaguered foreign assets will appear cheap and ripe for the taking. In many cases this is exactly what happened during the period of transition which occurred across Russia, Central Asia and Central and Eastern Europe during the 1990s. Newly amassed Russian oil and gas wealth went on a spending spree outside the country buying-up or perhaps more appropriately buying back assets they had lost as a result of the independence of former Soviet and former Soviet influenced states. As Finance Minister Kudrin has suggested it will be several months until the fall-out from the crisis becomes clearly evident. In the meantime, downstream energy dependent European states have little recourse but to sit and wait and hope that yet another shoe doesn't drop.

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