The past year has seen oil prices return to near-record levels and the Russian economy return to growth. It has also seen major Russian oil companies discuss partnerships and file lawsuits, while the state has dismissed two leading oil executives, rescinded tax breaks, and spoken of a new round of privatization. Because of oil’s dominant role in the Russian economy, and because some of the stories make for good copy, there may be a tendency to see these developments as more evidence of Russia’s peculiarities, either as a resource-dependent state or as a post-communist one. If we cut through the drama, however, we may see that the political economy of oil in Russia looks a lot like capitalism as it is actually practiced in many countries: a handful of major companies competing for customers and political influence, alongside a state deeply enmeshed in the sector while trying to appear above it. It is different from the struggle for property in the country over the last two decades in that outright fraud and violence are less prominent tools in the conflict. Nonetheless, the sector is still ripe for upheaval, especially as political and economic actors try to position themselves in the run-up to next year’s elections.

This memo first briefly considers the role of oil in Russia’s economic development, showing it is still the dominant product. It then reviews several of the major players in the sector, particularly the state, the leading oil producers, and the pipeline monopoly. Next, it highlights some major events in Russian oil over the past year, noting that no single player seemed to emerge victorious from each of these incidents. It concludes with a discussion of what this means for how we understand the political economy of oil in Russia today.

The Context
Despite several years of official statements about the need to diversify the Russian economy, oil remains its most important product. One way to see this is by examining
the country’s performance during the recent global economic downturn. The drop in oil prices in the second half of 2008 hit Russia hard, as several years of economic growth and budget surpluses were radically reversed in 2009 (See Figure 1). While growth was positive in every year since the financial crisis of 1998, including a rate of 5.2 percent in 2008, real GDP fell by 7.8 percent in 2009. Expected oil and gas revenues dropped by more than half between November 2008 and April 2009, and the planned budget balance fell from 3.7 percent of GDP to -7.4 percent.

While much of the rest of the world remained mired in recession, however, Russian GDP growth moved back into positive territory in 2010 (growing at a rate of 4 percent), as world oil prices rebounded from an average of about $60/bbl in 2009 to almost $80/bbl in 2010. The pattern appears to be continuing in 2011. The budget is still in deficit, but if oil prices remain in the neighborhood of $100/bbl, official forecasts see Russia returning to balanced budgets by 2015; if prices hover in the vicinity of $90/bbl, the country would run a deficit of one or two percent of GDP.

Figure 1. Oil Prices and Russian Economic Performance, 2003-2010

It is important to recognize that there are significant differences between Russia and an archetypal natural resource economy, such as Saudi Arabia or Kuwait. Significantly, the Russian economy is much more complex, containing opportunities for backward linkages that are not present in other settings. That is, when the Russian oil sector grows, it can (and does) buy inputs from domestic producers, and its employees can (and do) buy goods from domestic producers. Furthermore, Russia has generally followed sound policies in order to deal with challenges such as exchange rate appreciation, which can accompany large inflows of capital from natural resource exports. Most notably, Russia heavily taxes its oil exports and invests those revenues internationally, using such vehicles as Eurobonds or U.S. Treasuries, which reduces upward pressure on the exchange rate and on domestic prices. In addition, while the export taxes perpetuate a split between domestic and world prices for crude oil, they do so in a way that is far less market-distorting than simply decreeing that domestic prices
must be held low. There is no longer nearly as great a temptation to arbitrage the difference between those prices as there was in the 1990s.

Nonetheless, while there is more to the Russian economy than just oil, taxes on and revenues from the petroleum sector (as well as the natural gas sector, which is related to but separate from oil and is not considered in this memo) have been a central component of the country’s fiscal and economic successes since the early 2000s. When oil prices have been high, Russia has grown its economy and balanced its budget. When they have been low, growth has reversed and deficits have returned. This situation will only change slowly, if at all.

The Actors
The participants in the Russian oil sector are numerous and varied. First is the state itself, which affects the system in at least three significant ways, two of them active and one passive. Perhaps most obviously, the Russian government affects the oil sector through regulation, including taxes, privatization plans, allocation of exploration and production licenses, and approval or disapproval of mergers. In addition, the state exerts direct control through its ownership of Rosneft and Gazprom Neft, two of the five largest producers in the country, as well as Transneft, the pipeline company. Finally, the state serves as an object to be lobbied by the major Russian companies, as well as foreign suitors.

In addition to the state, the sector includes several major oil companies that vary in terms of ownership, production, and operation (see Table 1). Rosneft is the largest (in terms of production), although it began its post-Soviet life as essentially an afterthought. When LUKoil, Surgutneftegaz, and Yukos were created as separate, state-owned companies in 1992, the rest of the oil sector was left in a holding company called Rosneft. Over the next several years, additional companies, including Sibneft and Sidanko, were broken out of Rosneft and sold off. It was not until Putin appointed Igor Sechin, his erstwhile KGB associate, as head of Rosneft that the company became a major player. Most importantly, Rosneft became the vehicle for the state’s takeover of Yukos in 2003, vaulting it overnight to the rank of the country’s leading producer. Since then, however, it has also invested in new production (often with state assistance in procuring development licenses) and has continued to grow. The most important greenfield development to date has been the Vankor oil field in Eastern Siberia. It currently produces more than 250,000 barrels a day and is the main source of oil to fulfill a 20-year contract with China that went into effect in January 2011.

The other large, state-owned oil company in Russia is Gazprom Neft, operated by the natural-gas behemoth, Gazprom. Early in his first term, Putin replaced the Yeltsin-era management of Gazprom and strengthened the company’s control over its subsidiaries (especially the trading company Itera, which had siphoned revenues from Gazprom in the 1990s). Originally expected to take over Yukos, Gazprom was outmaneuvered by Rosneft and Sechin, as well as some of the legal tactics of Yukos. In the end, it had to be content with taking over Sibneft from oligarch Roman Abramovich. Since then, the company has not been especially dynamic economically or politically. It
is the fifth-largest Russian oil producer, but its output has been essentially stagnant since 2006. And unlike its parent company, Gazprom, which is able to use the state to push competitors out of natural gas fields, Gazprom Neft has made no such moves.

**Table 1. Major Russian Oil Companies (2010)**

<table>
<thead>
<tr>
<th>Company</th>
<th>Million tons/year</th>
<th>Million barrels/day</th>
<th>Percent Russian total</th>
<th>Ownership type</th>
<th>5-year production trend</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rosneft</td>
<td>115.8</td>
<td>2.3</td>
<td>22.9</td>
<td>State</td>
<td>Increasing</td>
</tr>
<tr>
<td>LUKoil</td>
<td>89.8</td>
<td>1.8</td>
<td>17.8</td>
<td>Private</td>
<td>Increasing</td>
</tr>
<tr>
<td>TNK-BP</td>
<td>87.5</td>
<td>1.75</td>
<td>17.3</td>
<td>Private</td>
<td>Stagnant</td>
</tr>
<tr>
<td>Surgutneftegaz</td>
<td>59.5</td>
<td>1.2</td>
<td>11.8</td>
<td>Private</td>
<td>Declining</td>
</tr>
<tr>
<td>Gazprom Neft</td>
<td>50</td>
<td>1</td>
<td>9.8</td>
<td>State</td>
<td>Stagnant</td>
</tr>
<tr>
<td>Other (&lt;6 percent each)</td>
<td>102.4</td>
<td>2.04</td>
<td>20.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>505</strong></td>
<td><strong>10.09</strong></td>
<td><strong>100</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: Company annual reports; Calculations from GKS data.

Three other large firms – LUKoil, Surgutneftegaz, and TNK-BP – are majority privately owned, although they vary widely in how they operate economically and in how they approach politics. LUKoil was one of the first oil companies to be privatized, with company insiders acquiring a significant stake. Over the last decade, its expansion efforts have focused most heavily on international opportunities, and its political strategy has been to avoid antagonizing the government. (In the wake of the Yukos affair, for example, LUKoil began to advertise just how happy it was to contribute to the social development of the country, perhaps even over-paying its taxes.) It has not been a stagnant company, however. It was once 20 percent owned by ConocoPhillips (although it recently completed a buy-back of those shares); it acquired a 25 percent stake in new fields in the Timan-Pechora basin earlier this year; and its newest effort at partnership involves talk of a joint venture with Rosneft in the Black Sea.

Surgutneftegaz was also privatized to insiders initially, but it has been less dynamic than LUKoil, preferring a slow-and-steady approach. Its business plan has relied on drilling high numbers of exploratory wells in the fields it owns, and it has been very quiet politically. Its risk-averse strategy has not paid great dividends in production rates, but it is still the fourth-largest producer in the country, and it has holdings in East Siberia that show promise of increased output.

TNK-BP, Russia’s number 3 producer, by contrast, has caused much greater stirs in the political realm. Formed in 2003 as a 50-50 joint venture between the Russian group Alfa-Access-Renova (AAR) and the international oil major BP, the company has
conflict built into its ownership structure, and it has not disappointed. In 2008, AAR tried to drive BP out of the partnership and succeeded in pushing CEO Bob Dudley out of the country temporarily. This past year, the group successfully scuttled a joint venture between BP and Rosneft, as will be discussed in more detail below. The company still produces a great deal of oil, but in some ways it seems like the least stable of the Russian majors.

Transneft, which ships 93 percent of Russia’s domestically produced oil through its pipeline network, is another major player in the Russian oil system. Although some of its equity is in private hands, all of its voting shares are still owned by the state, and it exhibits the lack of transparency often associated with such enterprises. (Minority shareholder, lawyer, and blogger Alexei Navalny has leveled sensational embezzlement charges against the company, which the government has so far unsuccessfully tried to sweep under the rug.) Its behavior, however, is driven not only by its state ownership but also by its position as a profit-seeking monopoly, demonstrated most clearly in its efforts to raise transportation tariffs.

The Action
The Russian oil sector has made headlines several times this year, as players have negotiated over redistributing assets and changing the rules of the game. The most famous conflict over assets involved state-owned Rosneft, international oil giant BP, and BP’s Russian partner AAR (AAR and BP together own TNK-BP). In January 2011, BP and Rosneft signed an agreement to give Rosneft 5 percent of BP and BP almost 10 percent of Rosneft, in conjunction with plans to jointly explore in the Russian Arctic. The deal had the support of Igor Sechin—deputy prime minister and then-head of Rosneft—as well as at least the tacit support of Prime Minister Putin. In March, however, AAR won an injunction against the deal in a Swedish court, because the TNK-BP charter says all of BP’s Russian activity has to take place through TNK-BP, and the BP-Rosneft deal would cut AAR out. Several efforts were made to resurrect the deal, including a rumored buyout of AAR by BP, but it now appears dead.

Not all mergers in the sector were scuttled, however. As noted above, LUKoil purchased a 25.1 percent stake in the Trebs and Titov fields in the Timan-Pechora basin, thereby forming a partnership with Bashneft, a company now owned by the Sistema group in Russia. LUKoil is also in talks with Rosneft to form a joint venture for offshore exploration in the Black Sea. Those talks, however, are evidence of another setback for Rosneft, since they are only possible because Chevron pulled out of its joint exploration plans with the company. Rosneft’s only major transnational venture that is still ongoing is with Exxon in the Black Sea.

On the international stage, a conflict has simmered between Transneft and China’s CNPC. The Chinese company (and government) has argued that Transneft is charging too much for the oil it ships through the ESPO line and has unilaterally underpaid. Transneft argues that it is simply charging the price agreed upon in the contract. China has repaid some of the difference, but Transneft has recently threatened
to repay its $10 billion loan from China early and to work with Rosneft on taking CNPC to court in order to resolve the dispute.

In addition to these inter-company negotiations, the sector has been changed by new state policies on taxes, pipeline access, and management and ownership. Regarding taxes, the government gave concessions two years ago to new oilfields in Eastern Siberia in order to encourage production to fill the ESPO pipeline and fulfill commitments to China. This year, however, those concessions were removed for the three fields in the region—Rosneft’s Vankor, TNK-BP’s Verkhnechonsk, and Surgutneftegaz’s Talakan—on the argument that the fields were up and running and could operate profitably even if they paid the same export tax as older fields, especially with world oil prices being so high. (The Vankor breaks were already scheduled to expire this year, but those for Verkhnechonsk and Talakan were phased out ahead of schedule.) At the same time, the state eliminated extraction taxes for new projects in the Black and Okhotsk Seas and the northern Yamalo-Nenets region.

In the transport sector, the government in May of this year changed its policy regarding the re-sale of pipeline quota allocations in May. Transneft argues that preventing re-sales will make its system more transparent, preventing politically connected oil companies from hoarding quota allocations for the most desirable export routes. Others, however, see a heavier state hand involved, pointing out that one of the companies most negatively affected by the change so far appears to be TNK-BP—the company that thwarted state-owned Rosneft’s plans to create a joint venture with BP.

In the past few months, the government has also begun to restructure its ownership and control in the sector, although how far this will go remains to be seen. At the end of March, President Dmitry Medvedev announced that government officials would have to leave corporate boards. Although the order was directed at more than the oil sector, within two weeks Sechin stepped down from his position as CEO and board member at Rosneft. Likewise, Energy Minister Sergei Shmatko was forced to resign from Transneft’s board of directors (although his replacement by former East German intelligence officer and Nord Stream manager Matthias Warnig represents a continued presence for the security services). In June, Medvedev said the government should revise its privatization plans for several enterprises, including Rosneft, calling them “too modest” and suggesting the state could be left with only a minority stake in some instances. In August, Transneft was added to the list of companies to be partially privatized, although the state seems set to retain an overwhelming share.

The Implications
What are we to make of these developments in the Russian oil sector over the past year? The ouster of Sechin and Shmatko from the boards of directors of oil companies was a striking move. The presence of high-ranking government officials on the boards of major companies was an important part of Vladimir Putin’s re-centralization of economic and political authority, and Sechin epitomized that strategy. His removal could represent a significant change (and not just in the oil sector; it could mean a general decline of his influence in politics). Likewise, if privatization continues in the
direction Medvedev has pointed, the state’s direct control over these companies will decline further.

Of course, it is too early to know for certain how these and the other policies discussed here will affect the sector or the country, especially since some of them may simply reflect political maneuvering in the run-up to next year’s elections. Nonetheless, they shine enough light for us to see that, at least in this sector, Russia’s political economy looks like what we might call “really existing capitalism”—not a textbook form, but something like what we see in other capitalist political economies. Enormous companies (but not just a single monopoly) face the market, each other, and the state as they compete for wealth and influence. The state has some independent power, but it also relies heavily on the individual companies and the sector as a whole. The system is not always conducive to grassroots democracy or broad-based economic growth, but even the most powerful vested interests may not be able to control its development.

In the Russian case, however, these arrangements are all still new and poorly institutionalized. Even the United Russia party, which was intended to systematize the Putin regime’s hold on power, is still in flux. Such a system is vulnerable to shocks, such as the rise or fall of a major player, a rapid change in oil prices, or an election (even if the winner is not a surprise, the campaign or the aftermath may be destabilizing). Likewise, the policies of replacing members of corporate boards or selling off shares of leading state-owned enterprises may have unintended consequences. Those results, in turn, will help determine the continuing evolution of the political and economic systems in Russia.