PREFACE

As the world confronts a new phase in the oil market with prices not experienced since the early eighties, the question on everyone's mind is which countries will dominate future supply? OPEC, certainly capable and willing to develop new productive capacity, must confront the uncertainty of this new market situation. On one side is demand; although over the long term certain to continue to grow, the recent enormous surge in China's consumption surprised many, as did the related growth in US demand. The uncertainty of policy responses to current fiscal and external imbalances in the USA and unreliable statistics on Asian countries' oil consumption compound the short-term uncertainty of oil demand. Inversely, supply – reasonably certain in the short term – appears less certain further in the future. In the past, non-OPEC producers responded to higher prices by increasing production and displaced OPEC, leaving it with costly shut-in capacity. What can and will they do today? The most important non-OPEC exporter by far is Russia. Understanding Russia and its potential to help meet the growth in world oil demand is a key to postulating the future of the world oil market. In the following pages, John Grace provides a very timely and essential analysis for discussing the role Russian oil might play.

Russia's oil resources are not in question. Its conventional oil reserves are the largest of any non-OPEC country. Since the world oil industry began in the 1860s, Russia has produced more oil than any other country, after the United States. During the Soviet era its production rivalled those of the USA and Saudi Arabia. In 1987 Russia was the largest producer in the world. Nine years later in the chaotic wake of the Soviet collapse, production had sunk to nearly half, equivalent to losing almost all of the North Sea's output at the time. Since then Russia's production has steadily increased; by 2004 it again approximated Saudi Arabia's.

What is behind this recovery? Can Russia continue to expand and go on to exceed its mid-eighties levels? And more important, will it and should it? This book provides the essential framework regarding Russia's oil endowment that is needed before one can consider answers to these and other questions. John Grace reminds us of how central oil has been to the modern economic history of Russia, beginning in Baku on the Caspian Sea in the late nineteenth century. Oil has been the engine pulling the country's material production. But like any engine, its future performance depends on its past maintenance and in many ways oil reservoirs are no different. Key to a reservoir's performance is its pressure. This is the energy that drives the motor. Push a reservoir too hard – release its pressure to get out as much oil as quickly as possible – and early decline and foregone oil are assured. The author provides valuable insights into how geological caprice bestowed on Russia its hydrocarbon riches and critical glimpses of how Russia in turn exploited and abused that endowment. This treatment, grounded in the essentials of its geological setting, why the oil is where it is and what encouraged its exploitation, is a refreshing and far more convincing analysis than those that simply graphically project recent increases of output. Understanding past exploitation of fields is critical if we are to begin to speculate on their future performance.

The history of oil is laced with politics. But Russian oil is also dominated by technocratic bullheadedness in the Kremlin. Keeping a mental image of the path of world oil prices since the sixties, the reader will follow John Grace's description of how the central planners in Moscow pushed its industry to produce more and more. As the Volga Urals fields declined, Moscow dispatched its geologists and drillers to more prospective but more remote and vastly more difficult areas in Western Siberia – such was Moscow's relentless, almost frenetic pursuit of higher output. He paints a picture of the Russian system resembling an athlete on steroids, where the steroids – oil – began to control the athlete. Moscow put its star athlete on an accelerating treadmill; when its heart failed, the system failed with it.

The legacy of communist era management and petroleum production practices are imprinted on today's Russian oil industry and in particular its structure. Understanding this aspect helps us comprehend the ranking and geographic focus of the Russian companies that are quickly becoming household names; which fields constitute their core assets; what their upside might be; and where they might sit as a potential target for re-nationalization or merger. The concentration and size distribution of the companies is reflected in the size of the fields under production and development, mirroring to a certain extent a worrisome structural phenomenon among the international oil companies after their mergers and acquisitions during the nineties. Very large oil companies are not sustained by small oil fields. We also begin to understand why the return of Yukos to state ownership might be about more than reprimanding its principal owner for interfering in politics.

The reader with even a passing knowledge of post-Second World War Russian history will be able to see how this physical background of the Russian oil industry, its endowment and management figured in the command economy. We also might appreciate why, during the Yeltsin interregnum, oil was the target of perhaps the most egregious appropriation of a nation's resources by private agents in history (some have called it a give-away; others have called it theft); and then understand the recent methodical and heavy-handed Kremlinesque restoration of those resources to state ownership.

How the Russian leadership uses oil and gas to gain political legitimacy and leverage both at home and abroad will be a force to understand and watch carefully. Just as Vladimir Lenin saw electrification of Russia and Soviet control as defining communism, perhaps Vladimir Putin sees oil and gas as defining post-communist Russia. Subsidized domestic energy prices and hydrocarbon exports underpin the current Russian economy. While this dependence alone might qualify Russia for membership in OPEC, more relevant is whether Russia and OPEC have competing or convergent interests in the oil market. The following analysis by John Grace provides the basis for beginning to understand what position Russia might take should oil prices ever decline to levels that begin to seriously erode its revenues from oil.

Robert Skinner