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Key Determinants for the Future of Russian Oil Production and Exports

Executive Summary

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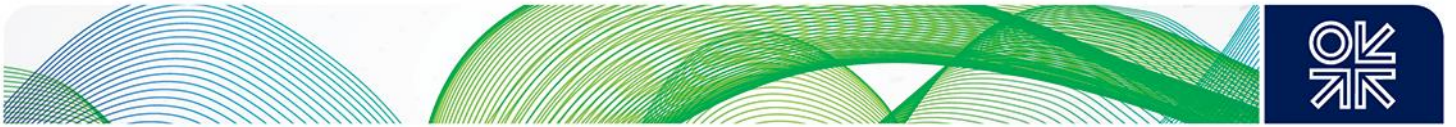
The production and export of crude oil and oil products in Russia is of vital importance both to the domestic economy and to the global energy market. In 2013, oil contributed almost 50 per cent of Russia's exports of goods and services and provided 45 per cent of total budget revenues, while in 2012 oil made up around 15 per cent of total Russian GDP. In a global context, Russia had a 12 per cent share of world oil output in 2013 (second only to Saudi Arabia) and accounted for 12.5 per cent of total crude oil exports, plus 17 per cent of total oil product exports. As a result, shifts in its output can have a major impact on the global supply and demand balance and consequently the oil price.

Russian oil production reached a post-Soviet high in 2014, but production growth has fallen over the past five years as the country's core producing regions have started to go into decline. The Russian government and its major oil companies have realized that there is a need to invest in new fields and new regions, which has led to a focus on East Siberia, the offshore, tight oil, and the Arctic. However, much of this new investment has been put at risk by a lower oil price environment and the impact of US and EU sanctions, raising questions about the future of Russian oil output.

A key issue will be managing the decline in Russia's brownfields, as they currently account for around 9 million bpd of production. The natural decline rate for mature fields in Russia is high, at 10 per cent per annum or more, but the application of Western technology has reduced this to an average of around 2 per cent per annum over the past few years. In a low oil price environment it would seem that a focus on maintaining this decline rate, which is a relatively low-cost tactic, should be the optimal way of sustaining oil output, and the government has provided tax breaks for 'difficult-to-recover' oil and for mature fields that should help. Nevertheless, the downside risk of an increase in the decline rate to 5 per cent or even 10 per cent per annum cannot be discounted if the oil price remains low.

However, Russia also contains a significant number of greenfield projects that have either come onstream recently or are set to start production in the next few years. If all these projects were to come onstream on schedule then it is possible that overall Russian oil output could exceed 11 million bpd by 2020, thus underlining the potential in the country, but recent announcements of cuts in capital expenditure by many companies suggest that delays may be inevitable. The actual outcome will depend upon a number of key assumptions including the impact of ruble devaluation, the ability of Russia to replace imports of goods embargoed under sanctions, the additional impact of sanctions on the ability of companies to raise finance, and the willingness of the Russian government to offer direct financial support and possible changes to the oil tax regime.

Perhaps more important in the short term, though, is the impact of sanctions on the ability of Russian oil companies to raise money on Western capital markets. Rosneft, GazpromNeft, and Novatek have been directly sanctioned, while others are encountering reluctance from some financial institutions who are concerned about the possible extension of the sanctions regime or about upsetting the US authorities even if they are not US companies but still have business links with the country. However, despite sanctions international partnership may also provide support to the Russian oil industry as a



number of companies with long-term histories and relationships in Russia, such as Exxon, BP, Shell, and Total, continue to promise support and future investment where they are legally able to do so. In addition, new investors from Asia, especially from China and India, are being offered opportunities not previously available as their markets and financial strength have become even more attractive to Russia.

One final conclusion from the paper is that Russian crude exports may increase irrespective of the production outcome for three main reasons. Firstly, the recent tax changes have made the most basic refineries unprofitable and as a result they may be closed down or start to run intermittently, which could make more crude oil available for export. Secondly, oil product demand in Russia is likely to decline in 2015 as the economy moves into recession, again freeing up oil for export. And finally, oil producers' desire to generate dollar revenues to compensate for the impact of the ruble devaluation will again catalyse a preference for exports over domestic sales. As a result, a halving of the oil price is very unlikely to see Russia sell less oil on the global market in 2015, and in all likelihood will see it add to the current oversupply.

About the Author

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