ISN
ETH Zurich

16 January 2015

Western Sanctions and Russia’s Oil and Gas Challenges

Are Western sanctions and falling oil prices working in tandem to undermine the Russian economy? Michael Bradshaw thinks so. Not only are they accelerating the decline in Russia’s oil and gas production, they’re also making it easier for the West to keep the sanctions in place.

By Michael Bradshaw for ISN

Russians do not celebrate Christmas until the7th of January, but no doubt most were wishing for a rapid rebound in the oil price and a significant recovery in the value of the ruble. Unfortunately, neither seems likely anytime soon. Similarly, Western governments—led by the US and EU—are unlikely to lift their sanctions against Russia without significant movement from the Kremlin (which also seems unlikely). The EU’s sanctions will be subject to review later in the year, starting in March, and no doubt some member states will be concerned about the negative impact the current measures are having on their own economies. But the US sanctions are likely to stay in place for some time to come.

Much has already been written about the nature of the sanctions, their content and their intent (see a recent article by Peter Rutland). The EU sanctions, which are aimed at individuals, organizations and companies close to the ruling elite in Moscow, fall into three main areas: financial sanctions against designated Russian banks, energy companies and defence companies; arms embargoes and restrictions on certain dual-purpose technologies; and restrictions on exports of high-tech goods and services in the energy sector. In early December the EU clarified the aspects of the energy sector subject to sanctions:

- oil exploration and production in waters deeper than 150 metres;
- oil exploration and production in the offshore area north of the Arctic circle; or
- projects that have the potential to produce oil from resources located in shale formations by way of hydraulic fracturing (it does not apply to exploration and production through shale formations to locate or extract oil from non-shale reservoirs).

The purpose of this short comment is to consider the impact of the sanctions, together with wider trends in the global economy, on the challenges facing the Russian oil and gas industries. In doing so, it addresses three issues: first, the immediate and short-term consequences for Russian oil and gas exports; second, the impact on the planned development of LNG exports; and finally, the implications for Russian oil and gas production and exports in the 2020s.

A multitude of challenges

Even before the imposition of sanctions and the recent dramatic fall in the oil price, it was widely recognised that the Russian oil and gas industries faced significant, but different, challenges. Since the mid-1990s, the dramatic recovery of Russian oil production has been based mainly on enhanced production from fields inherited from the Soviet industry. Western service companies and the TNK-BP joint venture played a key role in this resurgence. In recent years production has stabilised around 10 million barrels per day, and some new fields—such as Vankor in East Siberia and the Sakhalin offshore projects—have provided new production to enable this (in fact, Russian oil production reached a post-Soviet high of 526.75 million tons in 2014). However, due to the high tax burden and short-term thinking, the industry has not invested sufficiently in exploration and development activity, and it seems inevitable that production will start to fall towards the end of the decade. To counter this, it is hoped that the development of tight oil deposits in West Siberia will provide new production in close proximity to existing infrastructure; while in the longer-term new fields in East Siberia and offshore—both in the Black Sea and Arctic—would provide a boost in the 2020s.

In the case of Russian gas, it is not a shortage of reserves but the inability to find customers willing to pay a premium price that presents the challenge. The domestic market is already liberalised, and Gazprom has been losing market share to Novatek and the oil companies with gas to sell. At the same time, it is well understood that Europe does not represent a growing market for Gazprom. Existing long-term contracts will ensure that sales remain above the 100 bcm level well into the 2020s, but the cancellation of the South Stream project highlights just how difficult things are in Europe. In response, diversification was to be achieved in two ways: first, by expanding LNG production and export; and, second, by accessing new markets for pipeline gas in Asia. The latter has been achieved through the 38 bcm agreement reached with China in May 2014, and Russia hopes that a second 30 bcm agreement will be made in the next year or so. However, the agreement struck in May commits Gazprom to a $55 billion investment programme with questionable financial returns for both the company and the Russian state, particularly since the gas price is oil-indexed. There is no doubt that China has used events in Ukraine to strike a good deal for itself in terms of accessing Russian energy reserves (Rosneft has sold 10 per cent of the Vankor field to the China National Petroleum Corporation (CNPC)).

Targets and unforeseen consequences

Western sanctions against the Russian oil and gas industry were designed—at a time when the oil price was around $ 100 a barrel—so as not to interrupt the flow of oil and gas onto global markets. Instead, the focus on Arctic offshore and tight oil was deliberately aimed at stopping a series of agreements between the international oil companies and Rosneft and Gazpromneft to develop medium (by the end of the decade) and longer-term prospects (by the mid-2020s). This has denied Rosneft billions of dollars in production carries promised by ExxonMobil, Statoil, Total and ENI (BP still owns 19.75% of Rosneft). While it has been relatively straightforward to target high-profile projects such as the ExxonMobil-Rosneft venture in the Kara Sea, where the partners struck oil last summer, much of the equipment needed for tight oil exploration and development is also used to produce ‘hard-to-get’ conventional oil. The net result is that the Western service companies and their suppliers are in an ambiguous situation on the ground in Russia and are siding with caution and withdrawing. This leaves a gap that the domestic service industry cannot fill.

Whether intentional or not, it is the financial sanctions that are having the most significant immediate impact on the oil and gas sector. Rosneft in particular is heavily indebted, is having to rationalise its investment plans, and is calling on the state to help it meet its financial obligations. Gazprom is also

having to pay greater attention to the bottom line, and is probably relieved that the $40 billion South Stream project has been cancelled, which allows it to focus on East Siberia and the Power of Siberia pipelines. While it had banked on receiving $25 billion from China towards the field development and pipeline construction costs, that now seems unlikely. Again, the Kremlin may end up being the bank of last resort. The private gas company Novatek is also betting on funding for its Yamal LNG project from China as CNPC is a shareholder in the project, but it too has secured a $2.6 billion loan from the National Welfare Fund. Rosneft, meanwhile, is seeking a $4 billion loan to finance four of its projects. Thus, the oil and gas sector is proving an unforeseen victim of Western financial sanctions. Indeed, sanctions may well have an immediate impact on the activities of Rosneft—which now produces more than half of Russia's oil—and could accelerate the predicted decline in Russia oil production.

Russia's LNG plans in tatters

A year ago the prospects for the development of Russian LNG were looking bright. The Russian Government had just allowed the limited liberalisation of LNG exports that enabled both Novatek and Rosneft to progress with their projects on the Yamal Peninsula and Sakhalin Island respectively. Gazprom was planning the Vladivostok LNG plant, was resurrecting its Baltic LNG project, and was close to committing to the construction of a third train at Russia's only operating LNG facility on Sakhalin. Now, 12 months on, Novatek is struggling to finance the first train of its three-train project, and progress will inevitably be delayed. Gazprom has all but cancelled the Vladivostok project due to concerns that LNG liquefaction technology might be added to the sanctions list, but also because it recognizes that project finance and customers will be very hard to find. On Sakhalin Island, Rosneft and ExxonMobil continue to talk about the Far Eastern LNG plant, but they have not resolved their conflict with Gazprom over access to the Trans-Sakhalin pipeline and no investment decision on the LNG project has been announced. Likewise, no investment decision has been forthcoming in relation to expanding Sakhalin Energy's LNG plant that Gazprom owns together with Shell, Mitsubishi and Mitsui. Again, problems securing financing and buyers will likely delay both Sakhalin projects. In general, Asian buyers are unlikely to commit to Russian LNG in the current geopolitical climate, and the LNG market is shifting as new production comes onstream in Australia and demand softens. The falling oil price is also leading the International Oil Companies (IOCs) to rationalise their investment expenditure. In such a climate, placing Russian projects on hold may be an easy decision to make. To make matters worse, the falling oil price impacts the price of LNG, which, when combined with the impact of financial sanctions and buyer concerns, has left Russia's LNG plans in tatters.

A market solution for the West

In his first two terms as President, Vladimir Putin rode a wave a rising oil prices and sustained production increases. Russian oil exports played a key role in matching surging global oil demand, compensating for problems in places like Iraq and Iran. Then the 2008 financial crisis struck, but prices quickly rebounded and Russia was able to use its financial reserves to avoid economic collapse. Once again Russia reaped the dividend of high oil prices without promoting diversification or investing sufficiently in future oil production.

But those high prices were also promoting the tight and unconventional oil revolution in North America and the likes of Iraq and Iran were returning to the international oil market. As supply surged, demand failed to keep pace, Saudi Arabia and OPEC refused to constrain production (a policy encouraged by the US), and the resulting adjustment has seen the oil price fall from $110 in the middle of 2014 to less than $60 at year-end.

Much of the current fall in demand is cyclical, but some of it is structural. As oil demand continues to fall in the OECD, efficiency improves and oil faces competition in the transportation sector. This

suggests that those, such as Russia's energy executives, who think that demand will quickly rebound, at which point prices will recover, could be in for a long wait. This means that the market could easily absorb a prolonged period of sanctions against Russia and a subsequent fall in Russian oil exports. The current Russian budget assumed an average oil price of $100 in 2015. Now, the Russian Finance Ministry projects that an average price of $60 this year would see the economy shrink by 4 per cent and the country would run a budget deficit of 3 per cent. Indeed, this may be optimistic, and difficult times are clearly ahead. Whether that will change Russia's position on Ukraine remains to be seen. What is clear is that current conditions make it easier for the West to keep its sanctions in place, while the markets do the rest.

For more information on issues and events that shape our world, please visit the ISN Blog or browse our resources.

Michael Bradshaw is Professor of Global Energy at the Warwick Business School and author of Global Energy Dilemmas: Energy Security, Globalization and Climate Change, published by Polity Press.

Publisher

International Relations and Security Network (ISN)

Creative Commons Attribution 4.0 International
(CC BY 4.0)

---

http://www.isn.ethz.ch/Digital-Library/Articles/Detail/?id=186934&lng=en

---