*Oil Industry in the ex-USSR*

# Gushers for Some…

By Lynda L. Maillet

## Sector Focus

THE former Soviet Union is well-known as the world's leading producer of oil. In fact, Russia and the other oil-producing republics hold an estimated 40% of the world's reserves of oil and gas, more than double those of the United States. However, the former Soviet republics lag far behind Western and Middle Eastern oil-producing countries in terms of efficient production and capital investment in the oil industry—providing unprecedented opportunities for Western investors. Foreigners can provide the needed capital to develop oilfields, repair existing facilities, and increase production. The volume of oil production has been steadily falling from a record level of 12.5 million barrels per day in the mid 1980s to less than 10 million barrels per day at the end of 1991. Western investment can help reverse this trend as well as provide an alternative to expensive Mideast oil supplies.

The majority of the remaining oil reserves are in more remote areas of Russian Siberia which, if exploited, would be more difficult to reach, subject to a rising tide of environmentalism, and would be located in an area with a tradition of labor shortages and unrest. Outside Russia (which accounts for 90% of oil production in the former USSR), oil fields are also located in Kazakhstan, Azerbaijan, Ukraine, and Belarus with smaller fields in Georgia and the Central Asian nations of Uzbekistan, Turkmenistan, Kirghizia, and Tadzhikistan. A system of pipelines throughout the former Soviet Union carries oil to refineries and distribution points.

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***Republican autonomy & decentralization***

Among other things, the break-up of the Union in 1991 has greatly affected the oil industry. The individual republics have all claimed authority over the oil fields on their territory and in some cases, specific regions, like the oil-rich Tyumen Region in Russia, have defied the leadership in their own republics causing chaos in the supply of oil throughout the former Soviet Union and in their exports to their primary buyers in Eastern Europe.

The distribution of energy resources between republics is extremely uneven, with Russia owning the vast majority of oil and gas reserves. Only three republics have an energy surplus: Russia, Kazakhstan, and Turkmenistan. The rest must rely on other republics to supply their energy needs; by the beginning of the 21st century, Belarus will supply only seven percent of its own energy needs, Moldova nine percent, and Armenia four percent. Uzbekistan may be better off in the near future after drilling at a major new field struck oil in early 1992. Economic treaties between republics have been drawn up and include provisions for the barter trade of fuel for manufactured and other goods. Problems have arisen, however, when Russian exporters would prefer to sell their fuels on the world market in order to gain much needed hard currency. Republics like Moldova cannot afford to buy fuels from either Russia or other oil producing countries for hard currency and must therefore rely on Russia to comply with signed agreements.

The interruption of inter-republic deliveries of energy have caused major energy shortages in Armenia and the Northern Caucasus affecting production facilities as well as daily life. The energy shortage in Ukraine has caused power plants to cut the electricity supplies to certain areas for up to three hours daily, frequently paralyzing the work of enterprises. Latvia had received 95% of its energy resources from Russia up until 1991. The country is now receiving much less energy, particularly gasoline, than before. Latvian officials signed a treaty with officials in Ufa in Russia to provide an unlimited supply of gasoline; however, Latvia must arrange for transportation. During the break up of the Soviet rail system, Latvia was left without tank cars, which they must now purchase. The problems are solved one by one.

Many republics are signing agreements with other nations in order to break away from dependency on Russia. For instance, Ukraine has signed an agreement with Iran which will permit Ukrainian specialists to explore for oil and natural gas in Iran in return for payment in kind. In addition, in 1992 Ukraine will trade machine parts and building materials for 4 million tons of oil from Iran. Azerbaijan and Ukraine will also participate in the building of

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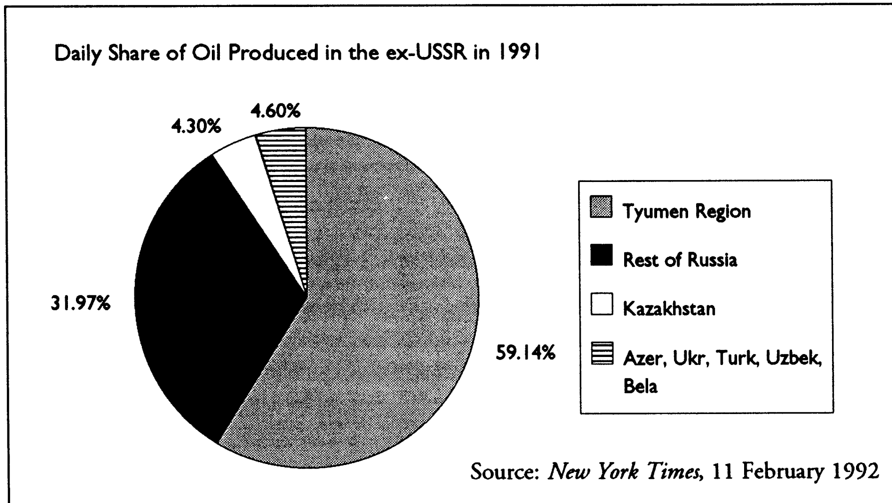
a pipeline from Iran through Ukraine to Western Europe.

*Oil transportation problems*

The centrally managed energy system was organized along geographic lines and was not originally designed around republican borders. For this reason, many of the oil pipelines pass through various republics and are therefore under the control of different republics at different points. Permission must now be obtained to transport oil to a refinery or to the final consumption point—which may be across two republics. For instance, republics which do have oil reserves, like Kazakhstan, must use Russian pipelines and refineries in order to export petroleum products. Agreements will be needed between the two republics to allow use of the facilities for export purposes. Republics participating in the new Commonwealth of Independent States (and any successor organization) will most likely arrange for the efficient transport of oil between republics to fulfill everyone's needs eventually. However, republics not participating will have to either pay world prices for their oil supplies or sign individual energy agreements with the CIS republics, as described above. Western investors will also have to work within this chaotic system or plan to build new pipelines and refineries in the area in which they are developing oil fields.



Source: *New York Times*, 11 February 1992

*The role of oil prices*

With the dissolution of central control also came the removal of state subsidies to the energy sector. The costs of oil production must now be borne entirely by the producers while there are still price ceilings on what producers may charge. The price of oil has been raised numerous times in the last year but has still not been freed. The revenue from the sale of oil is not enough to pay for production costs. In Russia, the most recent price changes in May 1992 increased the ceiling price of oil for industrial users to between R1,800 and R2,200 (or between $18 and $22) a ton (from R350 per ton), still only about 25% of world market prices. Producers must also sell at least 60% of their output on the domestic market at these regulated prices. They are allowed to sell up to 40% of their output on domestic commodity exchanges at market prices.

Current Russian plans call for the freeing of energy prices by the end of the summer 1992 in keeping with IMF recommendations, which call for the full deregulation of energy prices. This has been a sore point, since the IMF has insisted that prices be freed immediately, while the Russian government wants to wait until crops are harvested this year.

*Western investment*

The decline in energy production resulting from all the above mentioned factors has led to major energy shortages in many industrial centers. The oil industry is poorly managed and antiquated; the resources may be tapped, but they are not used effectively. For these reasons, oil output has been steadily dropping.

In order to increase oil production, companies and republican officials, in Russia and Kazakhstan in particular, have negotiated deals with Western companies and are in the process of negotiating even larger ones. Almost all major Western oil companies are involved with some negotiations within the former Soviet Union. However, through the first quarter of 1992, foreign investment in the oil sector amounted to only $200 million in what is typically a billion dollar industry. Through that period, there were only 20 small oil joint ventures registered in the Russian republic with only 16 of these operational. Both Russian and Western oil companies hope to change this trend. Many opportunities exist in cutting down the waste of oil in existing fields rather than the development of entirely new fields. Much oil is lost through leaky pipes, wasteful refineries, and inefficient factories. These areas require considerable investments in technology but could prove to be highly profitable projects. However, many Western companies prefer to start from scratch with new developments than to deal with the environmental, technological, and transportation problems associated with existing fields.

In order to participate in the development of oil fields, Western companies are frequently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Many republics are signing agreements with other nations in order to break away from dependence on Russian oil.

asked to contribute resources to develop the infrastructure of the region. One prime example is the set of conditions put forward by the authorities of the Sakhalin Island oil and gas field, where oil reserves are estimated at 730 million barrels and gas at 400 billion cubic feet. The winners in the bidding to conduct feasibility studies of hydrocarbon deposits off the island, McDermott International and Marathon Oil Company of the United States and Mitsui & Company of Japan, must participate in the development of the industrial and social infrastructure of Sakhalin. Most such negotiations are conducted both with local officials and with the directors of the oil companies themselves (which have become republican owned since the break up of the union ministries) who frequently have responsibility not only for their companies but also for the provision of social services to their employees (housing, food, recreation).

Russia and Kazakhstan are using joint ventures with foreign partners to help develop oil fields and to sell the oil abroad at world market prices. The foreign partners provide the needed capital with which to import technology. One example of this type of deal occurred in May 1992, when Chevron signed an unprecedented agreement with Kazakhstan to develop the Tengiz oil field there; the field has total reserves of as much as 25 billion barrels (equal to the size of Saudi Arabia's entire oil reserves) and recoverable reserves of almost 9 billion barrels (potential reserves in Kazakhstan amount to almost 100 billion barrels). Chevron and the Kazakh government, through a soon to be created joint venture company called Tengizchevroil, will be 50-50 partners in the deal which will likely serve as an example for Western oil companies, such as Exxon, British Petroleum, and Texaco, which are seeking deals in Siberia and elsewhere. Kazakhstan hired advisers from Morgan Guaranty Trust Company and the Government of Oman to help hammer out what they viewed as a more equitable deal with Chevron. They agreed to pay Chevron 20% of the profit, after taxes—less than the 28% Chevron had agreed with the Gorbachev government in negotiations prior to Kazakh independence in the fall of 1991. Chevron is to invest $750 million over the first three years and $10 billion over the 25-year life of the agreement In a decade's time, the field is expected to yield up to 700,000 barrels of oil a day (almost as much as the one million barrels a day that Chevron currently produces world-wide).

In addition to Chevron, other Western oil companies have signed agreements with several of the republics. Elf Aquitaine of France signed an oil exploration and production sharing pact with Kazakh officials and a similar one with Russian officials in February 1992. Because of the vague legislative environment, Elf Aquitaine insisted that the agreement stipulate that the local partners would pay all tax bills no matter what they may come to in the future. Amoco won the first foreign contract in June 1991 to develop oil fields off the coast of Azerbaijan; the reserves may be over 200 million tons. British Petroleum, which is involved with a consortium headed by Amoco, is also negotiating with Azerineft (Azerbaijan's state oil company) to develop a major oil field in the Caspian Sea.

The European Energy Charter, which was signed in December 1991 by European nations as well as Russia, will provide Russia and other oil-producing republics Western capital and technology in exchange for guarantees to deliver crude oil and natural gas. Russia and the republics will provide political guarantees for transporting energy and delivering it abroad. Under the agreement, Russia must comply with the rules regulating and protecting the investments of Western oil companies which are seeking access to Russian oil and gas. In addition to the Charter, Russian legislators are drafting tax and other legislation to clarify the situation for foreign investors in the oil industry. Western government backing is critical for investment in the oil industry because of the high risk involved with oil and gas development combined with the existing political uncertainties. Nevertheless, the energy sector, in particular the oil industry, remains one of the most attractive investment opportunities for Westerners. ◊

**Oil Production in the ex-USSR**
**(in millions of tons)**

| | **Russian Federation** | | | **Former Soviet Union** | | |
|---|---|---|---|---|---|---|
| | *1990* | *1991* | *1992 est.* | *1990* | *1991* | *1992 est.* |
| **Gross oil production** | 515.3 | 462 | 396-412 | 570.5 | 516 | 450-470 |
| **Refinery production** | | | | | | |
| Furnace fuel oil | 99.2 | 96 | 90-94 | 161.7 | 163 | 138-143 |
| Diesel fuel | 75.6 | 72 | 70-73 | 111.5 | 108 | 92-97 |
| Motor gasoline | 39.9 | 39 | 35-38 | 62.3 | 60 | 49-53 |
| Jet fuel | 16.4 | 16 | 15-16 | 24.6 | 25 | 19-23 |

Source: *Financial Times,* 6 March 1992

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