

# Rosneft Is Foundation of Putin's State Capitalism

By [Anders Aslund](#)

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State-dominated Rosneft announced Monday that it had bought all of TNK-BP for about \$55 billion at the expense of the Russian state. Nothing is more important in the Russian economy than oil, which accounts for about 40 percent of export revenues, 35 percent of tax revenues and 12 percent of gross domestic product.

Fortunately, Russia has a reasonably sophisticated oil strategy, but it has weaknesses. The greatest concern is that much of the oil policy strangely depends on President Vladimir Putin's personal relationship with Rosneft chairman Igor Sechin. This is too subjective a way to manage Russia's most important industry.

Several of the key policies make sense. Unlike the gas sector, which is completely regulated by a state monopoly, the oil market and its prices are relatively free and competitive. So far, it has been dominated by private enterprises.

In practice, government policy is based on four principles. First, given the importance of oil for budget revenues and exports, Putin is determined to keep oil production at least at 10 million barrels a day, or 500 million tons a year. Currently, it is at a peak level of 10.4 million barrels a day.

Second, Putin and Sechin believe that the successful brownfield revival in Western Siberia is approaching its end. Russia needs to open new oil fields, and they are convinced that most of the new oil will have to come from Arctic offshore fields.

Third, it will be very difficult to develop the country's Arctic offshore fields. The only companies able to do this are five supermajors. Rosneft has sensibly already concluded exploration agreements for specific offshore blocks with ExxonMobil, Statoil and Eni. BP is also likely to conclude an agreement with Rosneft on Arctic offshore drilling.

Fourth, the Kremlin has realized that supermajors will not invest billions of dollars in exploration if they are not reassured of stable economic conditions. Therefore, the new proposal of guaranteed low taxation for 15 years is vital. Actual ownership for the majors of oil licenses will probably also be necessary to entice them. The state must also guarantee that it will not confiscate the enterprises as it did with Yukos, Royal Dutch Shell on Sakhalin Island and BP in Kovykta.

It makes a lot of sense to engage the global oil majors in separate Arctic offshore fields on attractive conditions, but as policy this is a very limited vision. By focusing on state corporations, large foreign companies and large fields, this approach misses out on private domestic companies, small enterprises, small fields, new technology and Russia's international integration.

The gravest concern is that TNK-BP, a well-managed and successful oil company, may be nationalized for no other reason than Kremlin intrigue. The Russian state is not the best candidate to become a successful owner of this behemoth. What are Sechin's merits for gaining this prize? The only two are that he reportedly led the confiscation of Yukos and placed its assets in Rosneft and that he has close contacts with the president, which means that "Sechin can get things done." But nobody is talking about economies of scale in the gigantic deal, as Rosneft will almost double its size.

The other legitimate question is: Has he managed a company and has he made profits for anybody? The answer is no.

More important, nobody believes in the merits of state ownership. As long as Russia's oil industry was state-owned, production collapsed from 10 million barrels a day in 1987 to 6 million barrels a day from the mid-1990s. From 1999, oil output increased to 9 million barrels in 2004. But it was precisely the newly privatized oil companies, Yukos and Sibneft, that drove that expansion by bringing in international expertise, such as the oil service companies Schlumberger and Halliburton. Notably, both Yukos and Sibneft were nationalized in 2004 and 2005, respectively. Since then, oil output has risen little, and it has now stagnated.

Even today, Russia has four major oil companies: Rosneft, LUKoil, Surgut and TNK-BP, each of which produces about 2 million barrels a day. When Rosneft takes over TNK-BP, the ownership balance will be disturbed, and the state will dominate the oil sector. Moreover,

Surgut is so closely linked to Putin that LUKoil would be the only large independent oil company left in Russia. With such a state dominance, the Russian oil sector could gradually deteriorate toward the gas sector's dismal state.

The usually cautious LUKoil has protested loudly over this nationalization. So have First Deputy Prime Minister Igor Shuvalov and Deputy Prime Minister Arkady Dvorkovich. A top state manager must not be allowed to cause so much damage to the country. Thus, if the eminently productive company TNK-BP must be sold, it would be in Russia's national interest to sell it to anybody but the Russian state.

A topic almost missing in the debate is the dearth of small oil companies. Some exist, but their conditions are terrible. Russneft is one of the few companies successfully developing small fields, which requires extraordinary lobbying skills. A major aim of the Kremlin's oil policy should be to protect small, independent producers — foreign or Russian — which can exploit small fields that the big companies are not interested in. Infrastructure already exists in the regions where these fields are. With a smaller oil production than Russia, the United States each year drills several times more wells, which has led to an unexpected rise in production from old fields.

Shale oil is the other large factor in the equation. The U.S. is now seeing a shale oil boom in North Dakota, which suddenly has become the second-biggest oil-producing state. Shale oil has turned U.S. oil production up. Undoubtedly, Russia has large unknown reserves of shale oil.

Russia's private sector is quickly pursuing global integration. One of the champions in this sector is LUKoil, which claims companies in 42 countries, including the United States. Presumably, LUKoil is so global that no Russian government can nationalize it. By contrast, Russian state companies have pursued much less international investment, and they are not very welcome after Gazprom's widely publicized abuses involving monopolistic price gouging and politically motivated delivery cuts. Putin is rightly concerned about the rights of foreign investors, but by prompting state capitalism, Putin limits Russia's international integration.

Why nationalize a major oil company if nobody even suggests any advantage?

Anders Aslund is a senior fellow at the Peterson Institute for International Economics.

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