

How Putin Is Turning Russia Into One Big Enron

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In a few quick decisions, President Vladimir Putin has devastated Russia's energy policy. This daring radical change of strategy will primarily hit state revenues. The essence of these policy changes is renationalization, a massive increase in capital expenditure and reduced efficiency.

For years, Gazprom has carried out too large capital expenditures, 70 percent of which investment analysts euphemistically with call "value detracting," which really means corruption or waste. Now, Putin has decided to drive it to new heights. This month, Gazprom went ahead with its South Stream project, which is supposed to cost \$20 billion, but will probably cost twice as much. Its sole purpose is to circumvent Ukraine. For the same reason, Gazprom plans to build two more Nord Stream pipes at a cost of probably \$20 billion, but neither is needed. On top of this comes the massive investment program in Yamal. None of this adds any value.

Suddenly, on Oct. 29, Putin decided that Gazprom should develop the giant virgin Chayadinsk

field in Yakutia, build a pipeline to Vladivostok and construct an LNG plant there for export to China. Officially, this project is supposed to be completed by 2017 and cost \$40 billion, but investment analysts assess it at \$65 billion.

Putin's explanation was that Gazprom had lost out on LNG for China. But Chayadinsk gas would cost \$15 per million British thermal units, while the price of natural gas in the U.S. is \$3 million British thermal units. Thus, this project will probably never become profitable. The Chinese prefer much cheaper Turkmen gas, which already flows to China through a pipeline.

Altogether, Gazprom's capital expenditures will be about \$45 billion a year for the next five years, equaling its 2011 profits. But the shale-gas and LNG revolutions are likely to wipe out all its profit. Moreover, Gazprom usually exceeds its plans for capital expenditures while missing its production targets. In 2011, it planned for \$27 billion of capital expenditures, but in the end it spent \$53 billion to its shareholders' dismay.

Strange as it may sound, these recent investment decisions may drive Gazprom — formally the most profitable company in the world in 2011 — into bankruptcy within a few years. With its ephemeral profits, it is starting to look a lot like Enron. Currently, Gazprom contributes 7 percent of total state revenues, but this will not last. Russia may have half the shale gas assets in the world, but it is losing out on that revolution out of sheer passivity.

The oil sector has been much healthier. In Georgetown professor Thane Gustafson's new book "Wheel of Fortune: The Battle for Oil and Power in Russia," he argues convincingly that Russia's oil production is secure until 2015 because of new fields coming on line.

Profitability and state revenues are another matter. Putin's decision to allow Rosneft to buy TNK-BP for \$55 billion augurs a serious deterioration. At the Valdai Club, he deplored this deal at length, expressing his "mixed feelings." He claimed that the disagreement between AAR, the Russian owners of 50 percent of TNK-BP, and BP had forced him to accept the deal. "But ultimately, we nevertheless agreed with Rosneft and BP's suggestion." His only positive statement was that "this will ensure additional transparency in activities of our biggest oil company." Is Putin suggesting that he is not in charge?

The damage will be great. First, Rosneft's financial sustenance will be endangered. Its current market capitalization is \$73 billion, and its debt will now rise to the same level, which undoubtedly will raise its borrowing costs.

Second, the expanded Rosneft will account for 40 percent of the country's oil production and state companies for at least 56 percent, which will guarantee a decline in competition, efficiency and profitability. Putin said he regretted "that a company with mainly state participation was increasing its presence on the market through a foreign partner."

Third, Rosneft just announced capital expenditure plans that make Gazprom look bashful. Last year, it spent \$31 billion. Rosneft President Igor Sechin is now speaking vaguely of huge increases in investment.

While concentrating on very long-term, uncertain and complex Arctic offshore projects with the help of major foreign oil companies, the Russian oil policy is ignoring the intensive

development of old and smaller fields with new technology and small, independent companies. This makes no sense.

By contrast, former Finance Minister Alexei Kudrin commented on Rosneft's purchase of TNK-BP in Vedomosti: "An inefficient company absorbs an efficient one ... [and] unfortunately, the company will be managed by the old Rosneft management." When a rotten apple is put on top of good apples, they will all rot. Through this purchase, "Rosneft contributed to the outflow of capital," Kudrin writes. Finally, "Rosneft will ask for tax benefits." Somehow, the Russian treasury will be forced to pay for Rosneft's purchase of TNK-BP, its misdirected investment program and its reduced profitability. This can cost the Russian state tremendously, and the oil sector has steadily contributed 40 percent of state revenues.

Putin's recent energy decisions are probably the most costly for the Russian energy sector since the de facto confiscation of Yukos in 2004, and they contradict Russia's national interests. Why did Putin do anything so harmful?

The most plausible explanation is that Putin's cronies want to rob Gazprom empty and turn Rosneft into their new slush fund. After one national champion has been robbed empty, a new one is created. But Rosneft is likely to fail as spectacularly as Gazprom. Because of Gazprom's unwise investment decisions, some people will extract tens of billions of dollars from Gazprom, while Novatek and Rosneft may pick up Gazprom's pieces for pennies after its collapse. This can be the robbery of the millennium.

If this is the case, corruption has gone completely out of all control. The recently exposed corruption cases of \$100 million in the Defense Ministry, \$200 million in the Glonass program and \$500 million involving the funding of the APEC summit would appear to be diversionary maneuvers to hide the real catch.

Yet this cloud has silver linings. The extraordinary mismanagement of the Russian energy sector might actually speed up the country's economic diversification. The decline in energy rents will likely expose more corruption in the energy sector and weaken Putin's hold on power.

In all likelihood, Putin has just made the greatest mistakes of his political career. The biggest question is why Putin is carrying out this massive destabilization of his own political and economic regime. Has he lost his mind? Or does he desire destabilization to alter the nature of his regime?

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