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GLOBAL ENERGY DIALOGUE: RUSSIAN OIL AND GAS

While Russia has long been a dominant oil and natural gas player, major changes to global markets, geopolitics, and economics are challenging many assumptions about Russia's future in the world energy mix. The past year has seen Moscow agree to work in partnership with the members of the Organization of Petroleum Exporting Countries (OPEC) to reduce production, rebalance global oil supply and demand, and support global oil prices. Moscow seems to have followed through on a part of its promise. Recent years have also seen Russia—despite its massive natural gas reserves and traditional dominance in supplying Europe—facing challenges in that market from new sources of supply, even as Russian producers develop capacity to export liquefied natural gas (LNG) and pipeline capacity into Asia. In order to foster a more comprehensive understanding of the economic, social, market, and geopolitical factors influencing Russia's present and future in regard to oil and gas, the Center on Global Energy Policy at Columbia University convened a high-level workshop on June 5 under the Chatham House Rule. This note summarizes key elements of that discussion.

RUSSIA'S ECONOMY

Russia's economy and domestic politics are closely linked to the trajectory of oil and natural gas. Russia's economy has stabilized after experiencing a period of recession that began as oil prices collapsed in the second half of 2014. Uncertainty over macroeconomic reform, falling oil prices, soft global oil and gas prices, and economic sanctions all contributed to Russia's period of malaise, in the view of participants. Some, though, expressed very firmly the view that sanctions played a distinctly lesser role than tumbling prices for oil and gas.

Now, however, the question is whether Russia will return to growth and, if so, how robustly. Firmer oil prices provide some basis to believe that moderately better economic times are ahead, despite the continuously challenging geopolitical landscape. Some participants debated the durability of this improvement, noting the importance of structural reforms, which seem unlikely for the moment—at least before the Russian presidential election in March 2018.

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Without broader reforms, the Russian economy is on track for a protracted period of stagnation, in the view of most workshop participants. Even if Russia eventually decides to undertake economic reforms, though, it is far from clear today what would drive a stronger economic recovery beyond oil and gas. There is potential in sectors as diverse as food processing, automotive parts manufacturing, and consumer electronics, but taken together, these are far too small to supplant the oil and gas sector as the primary engine of the Russian economy. After years of sanctions, recession, and economic hardship, it is also clear that anemic consumer demand cannot play a significant role in Russian economic growth going forward. Therefore, Russia's future growth trajectory will largely depend on investment, but uncertain property rights remain a critical impediment to a significant ramp-up of private investment in the Russian economy. Only one thing seems clear: the oil and gas industry will remain central to Russia's overall economic prospects, export earnings, and government revenues in the foreseeable future.

US AND EU SANCTIONS

A central topic of discussion during the entire workshop was the impact of current (and possibly reinforced) economic sanctions instituted by the United States and the European Union against certain Russian entities and individuals in the wake of Russia's military involvement in Ukraine and its annexation of Crimea. Some speakers expressed the view that leaders in the Euro-Atlantic community were stuck in the thinking of the Cold War, and these speakers stated that reactions to Ukraine were distorted through a Cold War lens. The persistence of sanctions related to Ukraine, some speakers said, reinforced the impression within Russia that the United States is an external enemy against which Russian society should be rallied. Others stated that sanctions were a reasonable response to what was seen as an invasion of a neighboring country's sovereign territory, yet they questioned whether their intended goals were undermined by unintended consequences three years on.

On this subject, participants expressed a wide range of differing views. Some noted that sanctions had had a meaningful impact, as intended, in that they had created uncertainty over the climate for future investment in Russia. Others disputed this notion and said that sanctions had no meaningful impact and that Russia's recent economic downturn resulted instead primarily from the drop in global oil prices. It was suggested that sanctions have barely had an immediate impact, if only because they were designed to target longer term projects that likely require technological expertise that might not be widely available in Russia (e.g., development of Arctic resources, shale deposits, and deep-water projects), many of which would be uneconomic to develop in the current price environment anyway. Some stated that the sanctions had actually triggered unintended positive consequences for Russia. Russia's energy companies, said one participant, were exercising much greater discipline before approving major capital investments, and costs had largely shifted to local currency; the devaluation of the ruble, according to several participants, had served as a cushion and helped Russian companies remain competitive in what is globally a much more challenging environment than before the oil price crash that started in June 2014. Other participants said sanctions had spurred a localization of capacity for specialized oil field services, including those needed for the development of shale resources and LNG liquefaction plants. Some participants suggested that, although direct consequences of sanctions on the development of petroleum might have been muted, with a lack of investments, uncertainties about medium- and long-term resource development had grown.

Many participants referred to the possibility that the US Congress would write into legislation existing and even new sanctions, even without coordination with EU partners. Most comments on this topic highlighted the likelihood that legislated sanctions would be more rigid, more enduring, and harder to bring to an end—whenever that might ultimately be viewed as appropriate. Some participants noted that the possible new legislated sanctions amounted to a reaction to the continuing instability in Ukraine and the lack of implementation of the Minsk 2 framework. A number of other trigger points, however, were also highlighted, including concerns over reports of Russian interference in last year's US elections, dissatisfaction with Russian actions in Syria and Afghanistan, and the backdrop of the internal political tussle between the White House and Congress. The fact that the proposed new sanctions could stem from multiple justifications could additionally complicate the removal of sanctions.

COMPETITIVE ENVIRONMENT IN NATURAL GAS MARKETS

In regard to natural gas, many commentators noted that the global competitive environment is very different today than it was even 10 years ago. The United States, which had been expected to be a major gas importer as of the early years of the current century, has now entered into the LNG export business, with shipments from the first export terminal reaching buyers all around the globe. Moreover, in view of US shale gas development, the United States is currently the world's largest producer, and new gas production and LNG capacity are coming on stream in other countries as well—in particular from Australia, the United States, and also Russia.

None of these developments, participants noted, diminish the massive size of Russian gas reserves. Marketing gas in the next decade, however, is likely to be a highly competitive undertaking, even though Gazprom might not meaningfully lose market share in Europe and could, in fact, solidify its position on the continent. In this context, there was a brief discussion of the recent proposed resolution to the anticompetition case brought against Gazprom by the EU. Some participants viewed this as a significant effort by Gazprom to find a resolution to a long-standing source of tension between Moscow and Brussels and as an acknowledgment the company understands that, if it wants to be an active participant in the European gas market, it has to operate within the regulatory framework set by Brussels.

Several commenters noted that Gazprom's export monopoly is increasingly being challenged both legally and practically by new producers, and several producers are lobbying the regime for more flexibility when it comes to the issuance of export licenses.

NORD STREAM 2

Participants in the workshop engaged in a protracted discussion of the merits, demerits, and prospects for the Nord Stream 2 gas pipeline, which is proposed to extend from the Russian coast of the Gulf of Finland to the German coast at Greifswald. A significant number of commenters expressed the view that this project has attracted undue attention, as it is merely a commercial undertaking. Moreover, said these speakers, the project has been found by EU legal authorities to be consistent with existing law. Other speakers noted that prominent European voices continue to express concerns about the impacts of the project on declared goals regarding diversification of the European Union's energy supplies and supply routes. The opposing views on the merits of Nord Stream 2 have been fairly consistent for several years, and many participants noted that the project's proponents and opponents are unlikely to agree on a joint assessment of the project any time soon.

Some participants were of the view that competition between Russian pipeline gas and US LNG—and the Trump administration's goal to support the latter—were behind America's opposition to Nord Stream 2. Others highlighted the importance of Ukraine—and concern about cutting the country out completely from EU-Russia gas trade—as a key factor behind opposition toward Nord Stream 2 on the part of both the European Commission and the United States.

COMPETITIVE ENVIRONMENT IN OIL MARKETS

Many participants highlighted the important role, in regard to Russian oil and gas production levels, that Russia's frequently adjusted fiscal regime has played. One commentator described the adjustments to taxes on oil and gas production and export as shock absorbers that had allowed Russian companies to remain profitable, even in the face of price declines and sanctions.

Participants focused extensively on different factors affecting the competitive environment in global oil markets, which could reasonably exert a major influence on Russian oil development. Several speakers noted that the devaluation of the ruble and concerted cost reduction efforts across the Russian oil field services industry have significantly improved the global competitiveness of Russian crude. Russia's low lifting costs, surpassed only by those of Saudi Arabia and some other Gulf states, also could be relied upon to bolster Russia's place in the global oil market going forward.

Other participants noted that some competing sources of supply, including tight oil developments in the United States, might be fundamentally altering the traditional commodity price swings that one has seen historically in connection with oil. US tight oil projects, some participants emphasized, are no longer high-cost options. Several participants debated whether drilling efficiency improvements in the US shale plays are real or illusory.

Several participants commented that Russian companies have major strategic decisions ahead, such as whether to initiate (at great capital expense) greenfield developments in new regions with little existing infrastructure. Would demand be there to sustain these new projects over their multidecade time frames, some participants asked? It appears that peak oil demand is a question on the mind of some Russian decision-makers contemplating the next generation of greenfield investment projects.

AGREEMENT WITH OPEC ON PRODUCTION CONSTRAINTS

Participants discussed at some length the significance and prospects for success of the May 25 agreement by OPEC and Russia to constrain production. If successful, this arrangement could lead to a reduction in global crude stocks, a rebalancing of supply and demand, and an increase in crude prices over time. Some participants noted the dramatic improvement in relations between OPEC and Russia in the last 18 months. Russia's interactions with OPEC had moved decisively beyond an earlier stage when tempers between the two parties occasionally flared in public; now, heads of state from Russia and the Kingdom of Saudi Arabia engage with each other directly, pledging greater cooperation going forward and entering into other unprecedented commercial and defense deals. Some participants did wonder whether this intensified relationship would stand the test of time or whether it should merely be seen as a marriage of convenience. These participants noted there are other areas where the Kingdom and Russia do not see eye to eye (e.g., in the conflict in Syria or with the latter's long-standing relationship with Iran). That said, the view of many participants was that Russia is adhering to its agreed production cuts, contrary to earlier experience when cuts were not implemented.

UNCERTAINTIES REGARDING US POLICY

At several instances throughout the day, participants expressed uncertainty as to whether the present period is one in which one could foresee changes in American policy toward Russia. Several commentators noted that President Trump had expressed support for a resetting of US-Russian relations during the 2016 US electoral campaign. Others noted the foreign policy landscape in Washington, especially in regard to Russia, is so cluttered that fundamental improvement in relations would take a lot of time.

CONCLUSION

In less than one year, Russia will hold its presidential election. Russia's economy has stabilized after the dramatic drop in the price of oil in 2014 and 2015, but the future of Russia's oil and gas economy, and its precise interaction with global oil and gas markets, are hard to predict. What is clear, given the importance of oil and gas to the Russian economy and given Russia's leading role on the global oil and gas scene, is that the fate of these industries in Russia will significantly determine the country's economic trajectory. In turn, understanding Russia's oil and gas future will be essential for an understanding of broader global energy markets.

POSSIBLE AREAS FOR FURTHER RESEARCH

To what extent have Russian service companies mastered techniques necessary for cost-competitive development of the massive Bazhenov shale?

What would be the energy market and investment impacts of congressionally proposed sanctions?

Are global oil markets reaching peak demand? How can the answer to this question affect the attractiveness of major new oil and gas developments in the Russian Arctic, East Siberia, the Russian Far East, or elsewhere?

If we assume a "new normal" for oil prices in light of developments in the United States, what might that mean for the future development of high-cost Russian resources—in particular those in the Arctic?

What fiscal break-even costs do the Russian regime need to balance its budget, and what role has currency devaluation played in this regard?

As we take stock of Russia's eastern strategy, what progress has been made, what are the main hurdles, and what should be expected in the coming years? How should we more broadly assess overseas investments of Russian oil and gas majors (e.g., in Pakistan, India, and the Middle East)?

Will Russian companies be able to make inroads in the emerging market for bunker fuels (e.g., in the Baltic Sea region)?

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