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## Russia Today & Crude – Is the glass half empty or half full?



**Ambassador Sergey Batsanov** is a retired Russian diplomat and international official who has devoted much of his career to arms control, disarmament and international security issues. As head of the Russian delegation to the Conference on Disarmament in Geneva, he participated in many US/Russian negotiations. Between 1993 and 2004, Ambassador Batsanov was a senior member of the Provisional Treaty Secretariat for the Chemical Weapons Convention and Director of the Organisation for the Prohibition of Chemical Weapons. Since 2005 he has been Director of the Geneva office of Pugwash International (Nobel Peace Prize 1995), dealing with a variety of issues including East-West relations, Middle East, Syria, Iran nuclear deal and non-proliferation in general.

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It is challenging to give a comprehensive and balanced picture of Russia today. Like any country, it has its problems and its achievements. But it is a huge country. It has unsurpassed natural resources and a strong potential for technological progress. Nevertheless it has a complicated past and many big problems to face as it progresses on its path to modernity. So the question often boils down to the familiar “is the glass half full or half empty? Any judgment here would be subjective; besides, it has to be based on some sort of base-line.

For me the base-line is the decade of 1990s, when after the dissolution of the USSR, Russia became immersed in a deep and multifaceted existential crisis. The economy did not work. Basic systems, like education and health care, all but collapsed. There was no money for literally anything and inflation ran in double digits. Corruption and asset grabbing were rampant. Massive, usually criminal, privatization of national wealth created a narrow circle of ultra-rich, and led to the pauperisation of millions. The country was rapidly becoming ungovernable due to the break-down of traditional economic ties, the creation of a legal vacuum, and the growth of greedy local elites, often mafia connected. There was also huge foreign interference and lavish financial and other support to separatism in all forms and shades.

Whenever a degree of democracy appeared in the country, it could not take hold and was more often than not superficial. Furthermore, it was quickly discredited by the deteriorating living conditions, social injustice and absence of accountability for the elites (the latter became much worse than anything seen in the Soviet days).

Then came the remarkable shrinking of Russia’s influence in international affairs. There were many reasons for that, including some of them Russia’s own making. But one stands out: it appears that at some point in the middle of the 1990s Moscow’s Western partners concluded that Russia’s internal

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weakness now allowed them to pursue their global and regional agendas without paying attention to Russia's stated interests.

It took Russia another decade to overcome this existential crisis. Many severe national problems were addressed, although not necessarily in the most elegant way and not without trial and error. Politics stabilized and Russia experienced improved macroeconomic and financial management coupled with the rise of living standards. An important role was played by the favorable oil and gas markets, which allowed Russia to re-emerge as a world's leading supplier of hydro-carbons and that, in turn, led to the injection of billions of dollars and euros into the Russian economy.

As a result, Russia's economy got a strong boost, gold and foreign currency reserves grew dramatically and salaries increased. Many families started enjoying middle class lives. Medical care and social support improved, leading to an increase in the birth rate and life expectancy (from 65 years in 2004 to 72 in 2016).

On the other hand, even before the latest economic crises caught up with Russia in 2014-2015, it had become clear that economic growth was slowing down, the efficiency in major industrial and agricultural sectors was low, and more profound economic reform was needed.

This last economic crisis, together with the fall of oil prices and, to a lesser extent, the Western sanctions over the Crimea and Eastern Ukraine, could have dealt Russia a rather heavy blow. But instead it had a much smaller negative effect than many in Russia feared (and many elsewhere wished).

The system, proved to be resilient. Economic growth resumed, led by industries in a higher technological sector than hydro-carbons. While the over-all industrial growth for 2016 was a modest 1.3%, the pharmaceuticals boasted of 24% growth. Furthermore there is now a concerted government policy in place to diminish the country's dependence on oil and gas exports. In 2016 64% of total income generated in Russia came from other than the hydro-carbon sector.

Inflation has reached the lowest point since 1992 and it is expected to go down to 4% towards the end of this year. Unemployment is low (5.5% last year and is expected to go down to 5% over 2017). In the meantime, the inflow of capital for direct foreign investment in the Russian economy has increased five-fold during the last year: from USD 6,8bn to USD 33bn.

The next stage of the Russian economic reform will require huge new investments. This is a problem. Internal sources of investment do not suffice; moreover, Russia is lagging behind many other countries in terms of the share of GNP dedicated to investment (2 times less than China and 1.5 times less than India). This means that Russia should be expected to make an extra effort to complete the upgrade of its legal system on investments.

Another big challenge is low productivity. This may be a symptom of significant hidden unemployment, but there is quite some reluctance to deal with it radically, due to concerns about social stability and traditional mentality.

In spite of all these problems, the country is looking forward to addressing four new and somewhat inter-related objectives.

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The first is upgrading its human capital. The second is digitalisation of the whole economy. The third is improved corporate governance and fighting corruption. And, the fourth is the radical improvement of the environment.

Pulling all of this together is generational change. Russia managed to relatively quickly pull itself out of the existential crisis of the 1990s thanks to the leadership group built by President Putin, which was determined to prevent the country's collapse. The country's resilience in the face of recent economic challenges, was achieved due to the good management of central financial and economic systems by a new generation of business and finance leaders, which just began to reach key government positions. And there is already the next generation of leaders, just starting their careers and not yet close to any key posts, who have at least two university level educations – one in Russia, another abroad – and who are not prisoners of old mentality. This is probably the main reason for me to think that the glass is at least half full.

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The importance of oil and gas to the Russian economy cannot be overstated. In 2012, oil and gas accounted for 16% of Russia's GDP, 52% of federal budgets and 70% of total exports. In 2014, western sanctions devalued the ruble by half and oil prices crashed from \$100 to around \$50 per barrel, providing what could have been seen as the perfect storm for the Russian economy.

But by converting dollar barrels into rubles, Russian producers were shielded from much of the impact of low oil prices – the oil price was around 3,000 RUB per barrel in 2016, as it was in 2011. This allowed major Russian oil companies such as Gazprom and Rosneft to maintain high levels of capex throughout the price crash, with both companies seeing investment grow by 30-45% from 2014 to 2016.

Russia is resilient, a trend which is quite the opposite of what has been seen elsewhere in the industry. This resulted in Russian oil production reaching a post-Soviet record of 11.6 million barrels per day (bpd) at the tail end of 2016, with the Western Siberia basin reversing an eight-year decline to grow production

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by 1%. Rosneft, Gazprom and LUKOIL are all targeting further production growth from new Western Siberian assets in 2017.

President Putin has reversed much of the privatisation of the oil industry that occurred under former president Boris Yeltsin, bringing the industry closer to the stage. The weaker oil market has presented an opportunity for further consolidation and international expansion by Russian firms. Rosneft's executive chairman Igor Sechin is a close political ally of President Putin, and he reportedly heavily influenced state-backed Rosneft's acquisition of Bashneft. The purchase of India's Essar Oil, which is being finalised, will also provide Rosneft with a large downstream footprint in a target export market.

There is also an inflow of private capital, such as a Qatar Investment Authority/Glencore consortium's \$11bn acquisition of a 19.5% stake in Rosneft. Private sector opportunities abound across the energy value chain in Eastern Siberia, which is set to become the biggest centre for oil output growth in Russia and key gas export route to Asia.

Two pipelines are driving Eastern Siberian development, with the launch of the ESPO pipeline providing producers with an affordable oil export routes to Asian markets and the Power of Siberia pipeline, currently under construction, opening up gas exports to China.

As far as Russia's commitment to the OPEC agreement, it should be noted that Russia has achieved just over half of its production cut target to date (170 kbpd vs 300 kbpd target) but one can be sceptical that it will hit its target. It is extremely expensive to stop-and-start production at wells that will literally freeze shut in Russia's northern fields; Russia's industry is not fully state-owned, thus the state does not have the same control of production as, say, Saudi; Russian producers, shielded by the weak ruble, are taking advantage of the new environment with acquisitions at home and abroad; and, finally, a weak oil price harms Saudi, which may provide Russia with a geopolitical advantage in Syria and as it forms closer ties to Riyadh's biggest regional rival, Iran.

These themes of resilience and renaissance are critical. Russia's oil and gas industry has weathered the storm of sanctions and the oil price crash, and with acquisitions and infrastructure investment have set up areas such as Eastern Siberia up for a sustained period of growth. This will provide opportunities for companies across the energy value chain.

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