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Will Russia's liberal technocrats restructure its oil industry?

Grégory Stoupnitzky and Shamil Yenikeyeff [Author alerts](#)  Nov 05 12:23 [Comment](#)



For both liberals and conservatives in the Russian government, western sanctions and oil price volatility present new challenges and opportunities. Both camps hold the key to Russia's economic and political stability.

The conservatives, led by Igor Sechin, dominate the oil industry through the state-controlled national champion Rosneft, where Sechin is chief executive. The liberals, represented by prime

minister Dmitry Medvedev, finance minister Anton Siluanov, deputy prime minister Arkady Dvorkovich and central bank governor Elvira Nabiullina, steer the country's fiscal and monetary policies.

Despite some bitter feuds in the past, the two camps are becoming increasingly interdependent. The conservatives depend on tax breaks, while the liberals are facing declining oil production, threatening to undermine the influx of cash to state coffers.

Both sides realise that new approaches to hydrocarbon management, and oil production in particular, are required. For several years, oilmen led by Sechin have pushed for an overhaul of the tax system. In their view, the existing complex system based on a mineral extraction tax and duties on exports of oil and petroleum products should be phased out in favour of profit-based taxation and greater tax incentives. The liberals controlling the commanding heights in the government economic bloc have agreed to select several pilot projects to test a new tax system.

However, in their drive to revive the industry through tax changes, both liberals and conservatives completely ignore the potential of small and medium-sized oil players. Today large, vertically-

integrated oil majors and the national champion, Rosneft, dominate Russia's oil industry. The role of small players is minuscule, at less than 4 per cent of national output, while their US counterparts make up over 45 per cent of domestic production.

Moscow's policymakers need to foster the creation of new, smaller "independent" oil players who could potentially repeat the success story of private Russian companies of the 1990s and early 2000s.

In the wake of falling oil prices in the late 1980s and a plunge in Soviet oil production, the domestic oil sector was in tatters. Rosneft was partially dismantled to give way to a set of private oil majors. The result of these reforms was impressive: oil production recovered thanks to western expertise and new technological approaches used by private players. Booming oil prices in the late 1990s and early 2000s fuelled the sector's revival, but also made Russia more dependent on export revenues.

In 2011-2013, conservative and liberal forces crossed swords over how the oil sector should develop. Led by Medvedev and Dvorkovich, the liberals pushed for Rosneft's complete privatization as a way of decreasing the state's presence and promoting innovation and efficiency. Sechin rejected such proposals, arguing that to develop the Arctic and unconventional oil and gas in Siberia, the opposite was required. In Sechin's view, Russia needed an enlarged national oil champion that would develop new energy frontiers in partnership with western oil majors. Sechin's point of view prevailed and Vladimir Putin, the president, expanded the state's footprint in the sector following the acquisition of TNK-BP by Rosneft.

With the western embargo on technology transfer and restricted access to external finance affecting most of Russia's oil majors, further decline in oil production seems inevitable. Sanctions imposed on Russia following the conflict in Ukraine, together with lower global oil prices, are forcing Rosneft to revise its plans. Sechin's ambitious acquisitions, capped by the mega TNK-BP purchase, have stretched Rosneft's balance sheet and put in question its strategy and performance.

In June this year, liberal technocrats started to regain influence over energy policy, lost to Sechin two years previously. Andrei Belousov's appointment as chairman of the board at Rosneft that month is an indication of the Kremlin's search for new ways of managing the industry and oil taxes. As a moderate liberal technocrat, Belousov is acceptable to both the conservative and liberal camps.

The liberal wing should support the creation of a new generation of oil players to acquire marginal assets from their larger brethren. These newcomers should focus on sweating brownfield sites on a cost-efficient basis, as many of their international peers do. A greater role for SMEs in Russian oil could help to reverse the projected decline in production, creating more jobs and a new tax base. Concurrently, government should encourage better corporate governance and management practices across the industry, while reducing the foreign policy role of national oil companies. The benefit to Russia will be a stronger, more integrated industry in the global community.

Russia may yet benefit from having a national champion developing complex offshore resources in

partnership with foreign oil majors. But the question for Russia's liberal technocrats remains the same: does Russia, with its maturing resource base, need an industry driven by a national champion? Or does it need a championed industry with hydrocarbon production devolved from oil majors to a multiplicity of independents?

Grégory Stoupnitzky has held management positions in investment banking and the oil and gas industries, having been particularly active in the CIS and sub-Saharan Africa. He is on the advisory board of the School of International and Public Affairs at Columbia University.

Shamil Yenikeeff is a director of the International Energy Center at the European University at St Petersburg and director of Oxford International Centre, UK. He was previously a fellow at the Oxford Institute for Energy Studies.

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