Anticipating Russia's Energy Market

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Both during and after World War Two, analysts recognized the vital role played by energy resources – petroleum, natural gas, and coal – in calculating national power and a nation's ability to endure an international crisis. Economic development and industrial production are largely determined by success in these crucial energy components.

It has long been recognized that Vladimir Putin's political prospects are increasingly dependent on the pace of oil and gas exports. As Russia's revenue from this commercial activity rises, the more secure the Putin regime will be and, if the price per barrel falls below a certain level, Putin might quickly loss political power. With 40% of the federal budget of Russia coming from the export of oil and gas, the Kremlin is extremely vulnerability to market changes.

This problem is exacerbated by Putin's decision to make the military the primary focus of investment while neglecting fundamental measures to reform the process by which it generates revenue. Because of Russia's military involvement in Ukraine, Crimea and Syria, its dependence on oil revenue represents a long term concern. This worry, however, is currently offset by the low oil production costs in the Russian petroleum industry – they are lower than those of Saudi Arabia - as well as the consequences of the ruble crisis of 2014 which resulted in a weak ruble that helped the country's export situation.

In 2012, Matteo Verda prepared an analysis of the phenomenon entitled "Russian Oil and Gas Sector: Political and Economic Prospects". While most efforts at a comprehensive study have a remarkably brief shelf life, Verda's work has endured and his observations are relevant today as they were six years ago. (www.iapionline.it/it/documents/Analysis_147_2012.pdf) Anticipating the Energy Market (Final).docx

Verda's analysis rests on two basic assumptions. The first is the need for continued development of Russia's European market and the second is recognition that without multi-level diversification Russian cannot maintain its current position within the energy sector. While there is no doubt that Russia will continue to export gas to Europe, there will always be a question about how much it will sell in the European market. As of now, Russia commands about 40% of the European market and, according to a Bloomburg report, is likely to maintain that for the immediate future. ("With an Eye on Record Flow from Russia, Gas Market Braces for Slump", https://finance.yahoo.com/news/eye-record-flow-russia-gas-050021113.html?.tsrc=rss, 3 January 2019)

By 2018, the overall market indicators of most significance to Russia were encouraging after several years of negative indicators. Although the United States has been able to mark new highs in oil production – thus pressuring prices downward – it was apparent from reports in late in 2018 that the price of petroleum was once again rising. The years from 2014 until 2016 were devastating for Russia as the price of crude oil by more than 30%. *("Oil and Gas Trends, 2018-19", www.Strategyand.pwc.com/trend/2018-oil-gas)*

What this means in practical terms is that by the end of 2018, the price of Brent crude has risen from approximately $40 to $50 per barrel to as much as $70 per barrel. After several years in which refinery investments declines, the energy sector now must work to increase production in order to take advantage of a reduced supply and rising prices. Market profitability has also been improved by a move both in Europe and the United States to allow contracts that are not destination defined. As a result, it is now possible to change shipping destinations in order to take advantage of more favorable conditions that might appear in a different market.

However, by late 2018, there were indications that Russia was considering a decrease in its production in order to drive the price up. For this initiative to work, Russia must work in cooperation with the OPEC states. While the year ended with the Saudis having increased oil production to record levels, the Russians would like to convince the Saudis to join them in decreasing output. Of course, a Russian-Saudi agreement to decrease production could be undermined if other countries opt for a production increase in order to take a short-term advantage of the likely higher prices.

One important market indicator is the extent of proven Russian oil reserves. Previous estimates focused primarily on Western Siberian reserves even though they had been exploited since the 1970s. By 2005, Russian authorities were reporting that there were also abundant reserves in Eastern Siberia. However, there has been an assumption that the Russian classification system did not correspond to the standards employed by the Society of Petroleum Engineers. Therefore, beginning in 2016, the Russians began to employ a new classification system that was more consistent with international standards. (*www.gazprom.com/f/posts/12/255042/gazprom-in-figures-2013-2017-en.pdf*). Although this adjustment is a component of technical issues relating to the quantity of Russian oil reserves, it has the additional impact of integrating the Russian petroleum industry into global arrangements. Moreover, the introduction of these standards for evaluation of Russian reserves will improve Russian prospects for foreign investment in this vital sector of its economy.

Finally, another important part of this process of system modernization is the effort to end use of the dollar as the currency of the petroleum trade. Following his 2018 reelection, Putin declared his intention to free the Russian economy from power of the US dollar in the international commodities markets. (Alican Tekingunduz, "How Oil Prices Impact Russia's Economy", [www.trtworld.com/*europe/how-oil-prices-impact-russia-s-economy-22067*](http://www.trtworld.com/europe/how-oil-prices-impact-russia-s-economy-22067)*)* While this initiative is motivated economic concerns, it has an equally significant political objective.

Vladimir Putin intensified this initiative at a time where there were two political concerns. The first concern was Putin's determination to diminish the impact of the US dollar on Russia's economy. As long as the dollar determines to pricing of oil in the global market, Russia will play a secondary role. This is an economic objective that also increases the Kremlin's political stature in comparison with the United States.

A second political concern is that this initiative comes at a time when the Trump Administration imposed anti-Russian sanctions. At the same time, the US has encouraged its allies to import more Iranian crude, an action that would undermine the Russian petroleum industry. In 2018, President Trump encouraged Saudi Arabia to increase its oil production the country responded by increasing its production levels to an all-time high. ("How Oil Prices Impact Russia's Economy", 29 November, 2018, *www.trtworld.com/europe/how-oil-prices-impact-russia-s-economy-22067)*