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Shale Boom Forces Kremlin to Focus on Arctic

By Luka Oreskovic

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Competition tends to be beneficial for general economic progress and growth. Vagit Alekperov, CEO of LUKoil, is concerned about the competitiveness of the Russian oil and gas industry in light of the development of U.S. shale gas. Recently, he shared his concerns with the Russian government and appealed to Russia to rethink its strategy for the development of its Arctic resources.

Alekperov said that rather than granting monopoly rights to Rosneft and Gazprom, the state-run oil and gas producers, the state would benefit more from licensing, which would spur investment in technological development and increase the competitiveness of national energy companies in the increasingly challenging global market.

Many might agree with Alekperov's proposal to some degree, yet this is highly unlikely to happen. A review of the energy sector reveals that Rosneft's dominance is highly unlikely to be called into question.

Given the fact that almost half of budget revenues derived from oil and gas, Russia's dependence on Rosneft and Gazprom is understandable and offers ample reason not to share the exclusivity Rosneft and Gazprom have over the Arctic shale developments. Yet trouble lies ahead.

Rosneft's Siberian oil fields are facing decline due to outdated infrastructure, while the U.S. overtook Russia as the world's leading gas producer in 2009. This puts great pressure on Rosneft to maintain oil output above 10 million barrels per day. Maintaining current revenue levels from the oil and gas sector is critical for funding the broader Russian state. Unfortunately, Arctic shale reserves might not help soon enough.

The risk of Gazprom losing its tight grip on European gas supply because of shale gas is real. While Europe, Gazprom's major export market, is unlikely to go through a shale gas revolution of its own like in the U.S., LNG from the Middle East is increasingly making its way to the European market. An LNG terminal at Croatia's northern Adriatic port is the latest project to be considered.

Stephen O'Sullivan, head of Asia Energy Consulting, a Hong Kong-based advisory firm, considers Gazprom reactive to the changes in both the European and domestic gas markets. In an e-mail interview, O'Sullivan wrote, "Gazprom seems to be taking the view that it's a temporary change in the market," while the majority opinion views the changes in gas pricing as a permanent shift. "In reality, [Gazprom] offers discounts and rebates of around 10-15 percent against the base price so that if the market normalizes and they regain their place as the dominant gas supplier to Europe, they will be able to revert to the old regime. But that's a big 'if,' and I don't see it happening."

Another peril for Gazprom comes from Rosneft as CEO Igor Sechin explores possibilities in the Far East. "I don't get a sense that he's been discussing Gazprom acting as an intermediary. Rosneft wants its own access to the export market, and that will come down to Kremlin politics" O'Sullivan said.

Yet Rosneft isn't the only challenger to Gazprom's monopoly in gas exports. Novatek's Yamal LNG involvement holds great potential for Russia's LNG exporting ambitions, but financing may be hard to secure if it is forced to go through Gazprom's export monopoly.

The timeline for the development of the large Arctic shale fields is another issue. While very optimistic estimates see production beginning in 2020, perspectives from the Middle East put the date closer to 2025 or 2030. Depletion of Rosneft's Siberian fields, which make up the bulk of its production, raises the question how Russia will maintain oil output at 10 million barrels per day before the Arctic fields are developed.

The acquisition of TNK-BP significantly improved Rosneft's ability to maintain output, but it remains to be seen whether the impact was for the better. Control of BP's technologically optimized Samotlor field, in Siberia, will contribute to Rosneft's ability to produce until the Arctic shelf oil deposits are ready for commercialization. At the same time, the acquisition also depleted Rosneft's cash reserves, which will be necessary for the development of the Arctic deposits.

Possibilities for meeting future production needs before the Arctic fields are developed

include the Vankor field, which still has capacity to increase output, and the east Siberian fields close to the Eastern Siberia-Pacific Ocean pipeline.

While developing Arctic oil deposits in time is a question of sustainability, Arctic gas might make Russia and Rosneft a major LNG player globally. Although the risk of spreading development costs across the right time period is great and Russia's economic future hinges on this, it is likely that Rosneft will deliver in time.

Although competition between private and state-owned Russian energy companies for the Arctic is most unlikely, the competition between the two state-owned firms for more control of the Arctic developments is already under way. Political competition in Russia traditionally has one simple rule: Winner takes all. If Rosneft wins, it will capture colossal production potential. It would be wise if the Russian leadership abolished the rule for this political contest.

Gazprom is still a very important element for Russia's economic outlook, while Rosneft's size might already be a management challenge. Further growth would raise the risk associated with too great a dependence on a single entity. Already too big to fail, Rosneft might also become too big to thrive in the long term. LUKoil's licensing proposal should not be discarded lightly.

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