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How Slumping Oil Prices Hit Russia's Sanctions-Struck Oil Industry

By Alexander Panin

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A view shows facilities of an oilfield on the day of a launching ceremony near the town of Kogalym, western Siberia.

Three screws are tightening on Russia's oil industry.

International banks are calling in multibillion-dollar loans and refusing new ones due to sanctions on Moscow over Ukraine. Western oil companies are barred from handing over advanced drilling technology, also due to sanctions.

And, unexpectedly, the oil price has slumped from a high of $115 in July to around $85 this week — its lowest level in four years.

Russia, the world's second-biggest oil exporter, had been gearing up for a major shift into hard-to-reach oil production as conventional oil runs low. Now these plans look harder to achieve.

Russian President Vladimir Putin said earlier this month that he was confident oil prices would rebound from the nosedive.

"If world oil prices stay at $80, all production will be ruined. No major market participant is interested [in this]," Putin was quoted as saying in Milan by Russian news agency RIA Novosti.

Putin himself represents one very interested party: Half of Russia's budget is financed by taxes on oil and gas, while exporting those commodities also provides a key source of hard currency.

But contrary to Putin's assessment, the mismatch between growing global supply and lackluster demand shows no sign of quickly disappearing, and prices may stay well below $100 per barrel for the near future.

Indeed, Goldman Sachs on Monday cut its oil price outlook for next year from $100 per barrel of Brent to just $85, Bloomberg reported. Russia's oil brand, Urals crude, trades around $2-3 below the Brent price.

Billions of Lost Dollars

Much of the pain of falling prices will be borne by the government, which skims about 70 percent off the export revenues of oil companies through taxation — one of the world's highest tax burdens.

But companies will feel the pressure nonetheless, according to Denis Borisov, head of the Moscow Oil and Gas Center at global consultancy Ernst & Young (EY).

His center estimates that each $10 decrease in the price of oil cuts the revenues of oil companies by about $2-3 per barrel. Last year Russia exported 237 million tons of oil, or 1.7 billion barrels, meaning that the country's oil sector will lose about $4 billion per year for each $10 fall in price.

Much of these losses are compensated by the weakening ruble, which has devalued by a quarter against the U.S. dollar this year as Western sanctions, an economic slump and then the oil price tumble have taken their toll.

According to a report released on Tuesday by investment bank Credit Suisse Russia's oil firms make most of their revenues in dollars, while most of their expenses come in rubles. But the ruble must still decline faster than oil to fully even out the losses, the report said.

Moreover, the falling ruble does not compensate for the need to repay foreign debt and purchase some of the necessary oil equipment abroad, EY's Borisov said. And the high technology equipment needed to mine hard-to-reach reserves is exactly the stuff that is unavailable in Russia.

Future Oil Exploration Questioned

Only 5 to 10 percent of the output of major oil companies currently comes from hard-to-reach oil projects, but the figure is expected to grow as conventional reserves are depleted. Earlier this year, Energy Minister Alexander Novak estimated that Russian firms would pump over 300 million tons of oil per year from hard-to-reach reserves by 2032 — an amount equal to three-fifths of Russia's current output.

Backed by tax breaks and government incentives, that shift has already begun, with new projects gathering pace on Russia's Pacific and Arctic shelves, as well as the vast Bazhenov shale oil formation in Western Siberia.

For Surgutneftegaz, Russia's pioneer in hard-to-reach oil exploration, tight oil already constitutes over 60 percent of new reserves, according to the company's financial reports. Most of the 144 billion rubles ($3.3 billion) invested in oil exploration last year by Gazprom Neft, the oil arm of the state gas company Gazprom, was channeled into developing hard-to-reach reserves, both onshore and on the Arctic shelf. The country's two largest oil firms, state-owned Rosneft and privately owned LUKoil, also have massive plans for tight oil. Rosneft has said it would pump $400 billion into oil extraction in the Arctic, which has estimated reserves to match Saudi Arabia's.

Slumping prices risk making these efforts unviable, according to Sergei Pikin, director of Moscow-based think tank the Energy Development Fund. Even with preferential taxes, Arctic oil becomes unprofitable when prices fall below $100, he said, while the Bazhenov Formation needs prices above $80.

Sanctions Hit Harder

Even so, more important than the oil price may be Western sanctions, which have locked Russian oil firms out of international capital markets, making it harder to finance investment programs and leaving them with billions in outstanding loans to international banks that they cannot roll over.

"Because of sanctions Russia's oil companies have lost access to affordable foreign capital," said Rustam Tankayev, lead analyst at the Russian Union of Oil and Gas Producers. This affects even companies not formally targeted by sanctions: "Since the Ukrainian crisis Russia's rating on financial markets, which was higher than those of all other BRIC countries, has declined substantially and has fallen below that of China," the analyst said.

On top of that, sanctions have banned Western firms from supplying Russia with expertise or equipment for drilling hard-to-reach oil. Without Western financing and equipment, a low oil price is just one more piece of bad news, Tankayev said.

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