RUSSIAN PRODUCTION IN THE MIDDLE EAST

Russian oil and gas companies' interests in the Middle East are growing, although their prospects in the region are uncertain.

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In recent years many Russian oil and gas companies have been paying more and more attention to development prospects outside Russia and the CIS. Some of the companies are already active in various parts of the world. While their presence in Venezuela, Columbia and Vietnam is mostly symbolic, the activities of Russian corporations in the Middle East are more substantial. Gazprom, Lukoil, Tatneft and others have already invested and are preparing to invest large sums to secure their access to hydrocarbon resources in the region.

At a first glance, grounds for this kind of expansion are few. More than 6 per cent of the world's oil and more than a quarter of its gas are concentrated on the territory of the Russian Federation. The ratio of proven reserves to current production is much higher than in most Western countries: at current production levels, oil reserves should last for 21.3 years, and gas reserves for 81.5 years. As a comparison, the reserves-to-production ratios in the Unites States are 11.1 and 9.8 years, in Great Britain 6 and 6.1 years, and in Norway 8.3 and 30.4 years.[1]

Nevertheless, Russian companies' amplified interest in Middle Eastern projects is quite justified. In the near abroad, first of all in Kazakhstan and Uzbekistan, capacities for increasing the resource base are not limitless. In Russia, the main obstacle, and correspondingly the main stimulus for leaving the boundaries of the state, is the hardening of tax regime. While in 2001-2002 large oil and gas companies regularly took advantage of various "tax minimization schemes," including internal off-shore deals, transfer pricing and others, which allowed for considerable tax burden reductions, the majority of these schemes were eliminated in the middle of Vladimir Putin's first presidential term. At the same time, against the backdrop of rising world energy prices, the Russian government introduced significant tax increases on oil producers and exporters.

In 2004 the marginal export tariff on crude oil reached 60 percent (at a price of more than $25 per barrel of Urals crude). If one adds to this the natural resource tax (NDPI), which at the current oil price is around 18 percent, and also the taxes on value added, profit, property and the unified social tax, it's not hard to see that the profitability of oil extraction in Russia is headed toward zero. Although in April 2005 the government (after lengthy deliberation) did approve a mechanism to differentiate the NDPI, aiming to stimulate development of new deposits and continued exploitation of existing ones, the suggested discounts apply only to a narrow group of firms.[2]

This unfavorable situation is worsening because of the authorities' political pressure on oil companies (beginning with the Yukos affair and ending with regular attempts to influence the market using command-administrative methods). In fall 2005 the largest companies received an unambiguous order to halt the growth of gas prices until the end of the year. As the result of this "voluntary" decision companies lost the possibility, at least for a time, to develop in one of the most attractive segments of the domestic market (oil refining and trade in oil products).

Energy is also becoming more and more the foundation of Russian foreign policy.[3] The Russian president has called upon domestic companies to "strengthen their international position," and upon the state to offer them all possible "adequate support" in this endeavor.[4]

This article examines the future of Russian business in Iraq and Libya—two Middle Eastern countries characterized by large oil and gas potential, and simultaneously by a high degree of political and commercial risk for foreign investors. Despite the apparently growing interest in both countries from Russian oil and gas giants, these companies' chances of success are not great. In Iraq this is primarily because of political instability, and in Libya because of competition from the titans of the Western oil and gas industry.

Lukoil and Iraq

Lukoil has set the most ambitious goals for developing its activities outside of Russia. These include expanding its resource base in the Caspian and Central Asian regions, first of all in Kazakhstan, as well as realizing new projects in Columbia and Venezuela, countries considered "exotic" for Russian business. In accordance with the strategic development plan approved in 2002, by 2015 Lukoil plans to extract 20 per cent of its oil outside of Russia. (Current extraction outside of Russia is about 5 per cent.)[5]

The Middle East occupies one of most important places in Lukoil's strategy. By 2015 the company plans to concentrate 23 percent of its foreign production here, and its plans are mostly focused on Iraq.

In 1997 Lukoil signed a 23-year contract with the Iraqi Oil Ministry to develop the West Kurna-2 field—one of the largest in Iraq, with reserves of up to 820 million tons. The quantity of oil resources in this field alone is equal to about a fourth of Lukoil's probable reserves in Russia and the CIS. In accordance with the contract Lukoil received a 68.5 percent share in the project, and two smaller Russian companies—Zarubezhneft and Mashinoimport—received 3.25 percent each.

However Lukoil was not able to begin work on the field because of UN sanctions against the regime of Saddam Hussein. At the end of 2002 the Iraqi government unilaterally annulled the contract with Lukoil. According to officials in Baghdad, this resulted from Lukoil's contacts with the Iraqi opposition and the American government, with the goal of receiving guarantees the contract would be preserved after the American invasion.[6]

The Present and Future of the Project

After the fall of Hussein in April 2003, the new Iraqi leadership announced a review of all oil agreements between foreign companies and the previous government of Iraq. Formally the position of the authorities has not changed, but in 2004-2005 Iraqi officials softened their rhetoric toward Lukoil somewhat. The current Iraqi administration recognizes that Lukoil has invested significant resources in preparing West Kurna-2, however it has not yet made any concrete decisions and probably will not make any in the near future.[7]

Two supplemental factors made possible the softening of the authorities' position in Baghdad. First, West Kurna became one of the joint projects of Lukoil and the American company ConocoPhillips in the framework of the two companies' strategic alliance.[8] Second, the Russian leadership introduced an initiative to forgive part of Iraq's external debt in exchange for the authorities' favorable attitude toward Lukoil.

Today both macro-political and local difficulties are working against realization of the project. First and foremost, Iraq's new constitution, adopted via referendum on October 15, 2005, contains extremely diffuse formulations on control of mineral resources. In accordance with the constitution, "active" fields are under control of the central government in Baghdad, but "new" projects fall under the jurisdiction of the provinces. Like many other fields, West Kurna can be considered "active," as extraction is already going on there. But at the same time the Lukoil project would mean a meaningful increase in extraction and use of new technologies, and so it could be considered "new."

The legislative confusion in oil and gas evinces the bitter struggle for power between the Iraqi center and the provinces, and also among the provinces. As is known, the major oil reserves in Iraq are in the north and south of the country, in the regions inhabited by Shiites and Kurds. The centrifugal tendencies in the Iraqi oil sector have been gaining speed since 2004. For Lukoil this means that the role of the Iraqi Southern Oil Company has grown. Formerly a part of the integrated Iraqi national oil company, the Southern Oil Company strives increasingly for independence from the Oil Ministry in Baghdad. In these circumstances Lukoil (like other foreign companies) must maneuver between central and regional players in the Iraqi oil arena. Thus, even the goodwill of Iraq's central leadership will not necessarily lead to palpable positive results for Lukoil.

Meanwhile the key problems for the realization of the project are connected with the political situation in southwest Iraq. Despite the mono-ethnic Shiite population of this region, and the absence of serious ideological disagreements between the main political forces, in 2005 the situation in these provinces did not become much more stable. On the contrary, the past year was marked by outbreaks of violence between warring local Shiite groups. Basra, the administrative center of southwest Iraq and the nearest large city to the West Kurna-2 field, is practically controlled by three armed groups, acting outside the law. Basra's police organs are under the influence of one of these—the "Jamaat" organization. The second group, called "Badr," includes the largest number of armed men. The third—"Sadr"—enjoys better financing. In particular it draws funds from followers of the radical Shiite cleric Muqtada al-Sadr, well-known opponent of the foreign occupation of Iraq. [9]

In practice the activity of the armed groups in the south means that foreign companies cannot set up their personnel and begin realizing oil projects in the region with any expectation of security. Neither the constitution, nor the elections to the Iraqi parliament will lead in the foreseeable future to stabilization. More likely, the political struggle in southern Iraq will only grow fiercer in the second half of 2006. This will be connected both with local elections and with the possible formulation of regional unions consisting of several provinces. The fundamental struggle for leadership in one of these unions will be between Basra and Najaf—the spiritual center for Shiite Muslims. Moreover, one should expect friction between the wealthy provinces, which will vie for the leadership of the newly formed unions, and their poor neighbors, which will not likely want to exchange autonomy for grants. Note that Meisan province, where the West Kurna-2 field is located, is one of the poorest in the country.

Aside from the domestic political problems, the situation will be complicated by the growing influence of Iranian organizations in southern Iraq. After the fall of Hussein financial and economic ties on both sides of the Iran-Iraq border developed with great speed. Iranian companies already play a noticeable role in the economy of the southern part of the country. This creates real difficulties for Lukoil's partner, ConocoPhillips (and for other American companies in Iraq), because the sanctions regime introduced by the U.S. in 1995 forbids American companies from entering into any commercial relationships with Iranian organizations.

Finally, the ecological situation in the area of the field presents a serious non-political problem. In the 1990s the Hussein regime succeeded in draining the marshes in southeast Iraq (this was done mainly to punish the disloyal local population). [10] As a result the regional ecosystem was disrupted and the local population wound up on the brink of starvation. It is possible that Lukoil and other foreign companies interested in acquiring fields in the region will have to finance expensive ecological programs.

Tatneft and Libya

Unlike Lukoil, which has a gigantic resource base, Tatneft operates some of the oldest fields in Russia (the company's main area of oil extraction is in Tatarstan), characterized by a high degree of development and water contamination. Largely because of its limited resource base the company has been unable to increase extraction for the last few years. With each year the problem of renewing its resources becomes sharper for Tatneft. This is why the company has made aggressive attempts to receive access to new fields both in Russia and abroad.

In recent years Tatneft has tried actively to take root in projects on the territory of Iran, Iraq, and Syria. For the most part the company has offered services and provided equipment to the national companies of the aforementioned states, counting on subsequent entrance into extractive projects. So far the company has not achieved real success in these three countries: the service contracts brought Tatneft just a few hundred thousand dollars and it has not yet received real access to hydrocarbon resources.

Libya is one of the most promising directions of the company's activity in the Middle East. In November 2005 Tatneft won an auction for geological exploration and development of block 82-4, with an area of 2.3 thousand square kilometers, in Ghadames province southwest of Tripoli. The corresponding contract on the conditions of production was signed by Tatneft and the Libyan National Oil Corporation (LNOC) on December 8, 2005. Note that Tatneft is the only Russian company that has succeeded in recent auctions for exploration and development of Libyan deposits, even though in 2005 this means was used to distribute rights for several tens of oil and gas blocks in different regions of Libya.

Oil Policy in Libya

The situation in the Libyan oil and gas sector reflects the general political model of the country, where all power is concentrated in the hands of 63-year-old revolutionary leader Muammar Qaddafi. While Qaddafi has not held an official government post since the late 1970s, he makes the fundamental decisions both at the high political level, and often at the middle levels of Libyan bureaucracy.

Qaddafi's style of governance—controlling and cultivating chaos in state structures—is directed toward preventing the emergence of political competition. He arbitrarily dissolves and creates ministries (e.g. the Energy Ministry was dissolved in 2000 and re-established in 2004) and regularly shuffles the high ranks of the Libyan hierarchy. The most recent government reshuffle came in March 2006.

Interestingly, Qaddafi tries to preserve a certain balance in the fundamental spheres of policy and the economy, pairing state institutions and appointing people with opposing views and different tribal origins to lead them.[11] In the oil and gas sphere the functions of the LNOC were doubled until recently by the Ministry of Energy. The head of the LNOC, Abdullah al-Badri, until his retirement in March 2006, consistently advocated attracting foreign investors, while Energy Minister Fathi Ben Shatwan was a furious opponent of any concessions to foreign companies.

The presence of foreign companies in the Libyan oil and gas sector became possible thanks to the lifting of the UN sanctions regime in 2004 and gradual normalization of relations between Libya, the U.S., and the United Kingdom.[12] In these new circumstances foreign companies have received the right to participate in tenders for exploration and development of Libyan fields, and as a result they have obtained licenses for more than 40 blocks.

Prospects for Tatneft in Libya

On the condition that the reformers in the LNOC maintain their positions in the coming years, they will strive to expand the presence of foreign companies in the Libyan oil and gas sector. The main problem for the reformers is this—to begin exploitation of new fields with all possible speed, in order to show the "leader of the revolution" real gains from attracting foreign investors. In that case they will be able to defend themselves from the representatives of the conservative wing in Qaddafi's entourage.

Today the main problem for the LNOC arises from inadequacy of material-technical resources and specialists for formulating and beginning to realize contracts signed in 2005, during two rounds of auctions. Considering that each contract requires a governing committee with the participation of the LNOC and a confirmed work plan, it seems improbable that the state corporation can handle all of the contracts, especially since there are new auctions planned for this year. It follows that the LNOC will have to choose to which of the already signed contracts it will give preference. The remaining projects will not be realized. Correspondingly, Tatneft will be forced to compete with other operators, including such American companies as Occidental—unquestionably the leader in the Libyan oil and gas arena.

It is likely that in 2006-2007 that position of American companies in Libya will strengthen. This is connected with Qaddafi's strong desire to finally regulate relations with the U.S., and with Washington's recent agreement to restore full diplomatic relations with Libya.[13] Although several obstacles remain (first of all, the well-known case of the Bulgarian nurses, arrested in 1999 and accused of deliberately infecting hundreds of Libyan children with HIV[14]), they will not likely halt the growing warmth in American-Libyan relations, which will in turn positively affect the prospects of American companies.

It is revealing that shortly after the British government's decision to restore full relations with Tripoli, announced during Tony Blair's visit to Libya in March 2004, the Anglo-Dutch oil giant Shell signed a contract for construction of an LNG plant on the Libyan coast and development of five large oil and gas blocks in the Sirte field.

This type of large integrated deal arouses the strong interest of both Western companies and the LNOC. Against this background the future of Tatneft in Libya looks cloudy (the company does not have enough material resources and technical possibilities to realize such large projects). The prospects for other operators that are not among the world's largest, including India's ONGC, Japan's Mitsubishi, and Indonesia's Pertamina, are likewise unclear (all these companies won blocks in the auctions). Nonetheless Tatneft has demonstrated its serious relationship to the Libyan project and revealed a readiness to put significant resources into it. The fate of the project will largely depend on Tatneft's ability to get the LNOC on its side and line up political support for its activity among the Libyan leadership.

Notes

[1] These data from the end of 2004. See: *?? Statistical* Review of World Energy 2005 // www.bp.com

[2] The proposed differentiated NDPI will provide discounts for users of fields with more than 80 percent extracted and a ten-year tax holiday for holders of licenses to develop new fields. However only a relatively small number of oil and gas companies will be able to take advantage. As for the developed fields, the

benefits will go to users of the oldest fields of the Volga-Urals region, mostly Tatneft and Bashneft. Many West Siberian fields are not more than 60-70 percent developed, and discounts will not apply to them. The tax holiday will be accessible only for developers of new East Siberian fields (the government turned down a proposal to extend the tax holiday to fields in the Timano-Pechorskiy region and the continental shelf). See: *Government* reduces tax holiday // Kommersant. 2006. 29 April.

[3] Many analysts note the popularity of the idea to create a "oil superpower" in Kremlin circles. See, for example: *Shevtsova L.* Russia 2006: The Logic of Political Fear // Nezavisimaya Gazeta. 2005. 13 December.

[4] *Introduction* of Russian President V. Putin at a session of the Security Council on the question of Russia's role in providing international energy security. Moscow, 2005. 22 December. // www.kremlin.ru/text/appears/2005/12/99294.shtml

[5] See: *Corporate* account of "Lukoil Overseas Holding" (the operator of international Lukoil projects) for 2004 // www.lukoil-overseas.ru/materials/doc/reports/LukoilRUSFINAL.pdf. p. 11.

[6] *Another* Russian Company To Be Awarded Lukoil's West Qurna Contract // Middle East Economic Survey. 2002. Vol. XLV. No. 51/52 // www.mees.com/postedarticles/energy/iraq/a45n51a02.htm.

[7] In particular, Iraqi Foreign Minister Hoshyar Zebari, during his visit to Moscow in November 2005, expressed his understanding that Lukoil had done significant preparatory work around the West Kurna-2 field (see: "Neftianye Vedomosti." 2005. ? 27 // www.neftevedomosti.ru/press.asp?issue_id=99&material_id=837).

[8] In September 2004 ConocoPhillips obtained 7.59 percent of Lukoil from the Russian government and concluded a deal with Lukoil on the purchase of a supplemental stake of company stock. ConocoPhillips' share will grow to 20 percent toward the end of 2006. The agreement also provides for the creation of a joint venture on the base of Lukoil subdivision "Nar'ianmarneftegaz," construction of an export terminal in the village of Varadnei in the Nenetskiy Autonomous Region, and the possible transfer by Lukoil of a 17.5 percent stake in the West Kurna-2 project to ConocoPhillips. See the ConocoPhillips press release from September 29, 2004: http://www.conocophillips.com/newsroom/news_releases/2004releases/092904_moscow.htm

[9] See the Council on Foreign Relations backgrounder "Iraq Insurgency Flare-Up" // www.cfr.org/publication/7800/iraq.html

[10] After its defeat by international coalition forces in 1991 the Hussein regime savagely put down an uprising by Shiites in the southern regions of Iraq. In particular, it forcibly drained the Mesopotamian Swamps, a unique ecosystem in Southern Iraq, and violently displaced much of the local population. Today work is going on to restore the ecosystems of the Mesopotamian Swamps. See: http://www.usaid.gov/iraq/accomplishments/marsh.html

[11] The Libyan leader prefers to set even members of his own family against each other. The best chances to become Qaddafi's successor lie with two of his sons: Saif al-Islam and Mutasim-Billah. The first was educated in Vienna and London, and now heads a charity called the International Qaddafi Fund and serves as unofficial ambassador for special assignments. The second has practically never been abroad; he is an officer in an elite division of the Libyan army. It is apparent that the brothers not only hold different viewpoints on the appropriate political-economic development model for the country, but also that they depend on each other, because their spheres of influence are artificially limited and do not intersect.

[12] The sanctions were introduced after Libya was found to be involved in the explosion of a Pan-Am Boeing aircraft over the Scottish village of Lockerbie in 1988. The UN removed sanctions when Qaddafi agreed to pay compensation to the victims' families and also promised to fully freeze his WMD programs in Libya. Supplemental sanctions introduced by the U.S. against Libya were lifted in September 2004. See Bush signs order lifting sanctions on Libya // CNN News. 21.09.2004. http://www.cnn.com/2004/WORLD/africa/09/20/libya.sanctions/index.html

[13] On May 15, 2006 the U.S. Department of State announced its decision to restore full diplomatic relations with Libya and its intent to remove Libya from the list of designated state sponsors of terrorism. See Statement by the U.S. Secretary of State: U.S. Diplomatic Relations with Libya, http://www.state.gov/secretary/rm/2006/66235.htm

[14] In May 2004 Libya sentenced five Bulgarian nurses and a Palestinian doctor to death by firing squad for deliberately infecting some 400 Libyan children with HIV. In December 2005 Libya's Supreme Court annulled the verdict and ordered a re-trial. Bulgaria, the European Union and the United States have been consistently demanding the release of the medics. See: "Libya death sentence for medics," BBC News,

May 6, 2004, http://news.bbc.co.uk/2/hi/africa/3689355.stm; "Bulgarian Doctors Case: Gaddafi Prepared to Bargain," *Moskovskie Novosti*, December 26, 2005, www.mn.ru/main.php?id=39856.