IHS Senior Director Thane Gustafson says oil is Russia's biggest challenge—but also its greatest hope for reform

Russia faces a looming oil crisis that places the country at a crossroads. Production could well be in decline by 2020 even as the state's dependence on oil as its primary source of income continues to grow. Yet oil also offers Russia's best hope for continued progress if the state's precarious relationship with the industry can be reformed, said IHS Senior Research Director Thane Gustafson, who discussed Russia and his new book, Wheel of Fortune: The Battle for Oil and Power in Russia at the inaugural IHS Forum in Washington, DC.

As oil becomes harder to find and more expensive to produce, Russia's growing dependence on oil revenues, along with its traditional management of the industry, is unsustainable, Gustafson said.

"Russia is not running out of oil, but it is running out of 'cheap oil,'—as the 'legacy' assets inherited from the Soviet Union begin to decline," Gustafson said. "They have come to the end of one chapter and moved on to another. And so far that new chapter is full of blank pages."

Wheel of Fortune—excerpted in the current November/December issue of Foreign Affairs—is based on intensive research, first-hand observation, and interviews with key players over the course of two decades and offers a detailed history of the oil industry's evolution since the breakup of the Soviet Union and a look at its uncertain future.

- Additional information about the book HERE
- See the excerpt in Foreign Affairs HERE
- Additional information about the IHS Forum HERE

Russian oil production is on track to increase by about one-and-a-half percent this year, but only at the price of a sharp rise in capital spending. Investment in the oil fields increased 34 percent in 2011 to a record $31 billion and could exceed $35 billion this year. To prevent declining production the industry will have to expand beyond its Soviet-era fields to more remote, geologically complex and cost-heavy areas, such as the arctic offshore, where it has little experience and know-how.

"Over the past twenty years, the oil industry and the state have fought for control," Gustafson says. "The result today is an industry that is overtaxed, overregulated and undermotivated to prepare for the challenges ahead."

The state's heavy tax burden and restrictive regulations have reduced companies' incentive to invest in new technology or to improve efficiency, Gustafson said. Oil currently provides nearly 40 percent of the government's tax revenues. If the industry fails to evolve, costs will continue to rise; spelling lower profits and, ultimately, lower revenues for a state that is increasingly dependent on oil income.

A decline in oil revenues could usher in a major crisis, forcing cutbacks to major spending programs such as pensions and subsidies that underpin the stability of the Putin regime. In such a crisis the state would be forced to confront the difficult choice it has avoided for so long—whether or not to lessen the tax burden on the oil industry and enable it to invest in the next generation of fields and technology.

Gustafson said that many in Russia's government realize that trouble lies ahead but that consensus is lacking on how to move forward. A reduction in oil revenues could devolve into a power struggle between interest groups over shrinking oil rents. Or Russia's leaders could pursue a course of comprehensive reform to reduce the state's dependence on oil revenues while stimulating changes in the oil industry itself, so as to encourage the innovation and entrepreneurship that will bring about its renaissance.

Thane Gustafson is IHS Senior Research Director for Russian and Caspian Energy and Professor of Government at Georgetown University. He holds a B.S. from the University of Illinois and a Ph.D. from Harvard University. He was formerly a professor at Harvard University and a research analyst at the Rand Corporation.

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