

The Russian Energy Sector

Ed 1 2006



The Russian Energy Sector Report Ed 1 2006

“I cannot forecast to you the action of Russia. It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key.”

Winston Churchill, 1939

2006 is a formative year for Russian energy, this report is your key to the enigma

Introduction

- Russia ended 2005 with its seventh straight year of growth, averaging 6.4% annually since the financial crisis of 1998. This year, 2006 is a landmark year
- This report surveys six vital industries and markets in Russia; Oil, Gas, Coal, Electricity, Nuclear and District Heating
- Russia has formidable energy assets; it owns the largest reserves of natural gas in the world, it is the second largest exporter of oil and the sixth largest producer of coal. It also has an enormous but decrepit district heating network and the fourth largest electricity system
- The energy markets have taken erratic steps from centrally planned monoliths to market-orientated industries
- On 1st September 2006 the wholesale electricity market was opened to competition

Key Findings

- The Oil and Coal markets have been restructured and the Electricity market is now being unbundled and opened, with completion by 2008
- The most powerful market, Gas is almost entirely state controlled
- Increasingly it is being used as a political weapon for foreign policy
- The huge District Heating industry is facing crisis, with a 35% loss of custom, as large industrial users establish dedicated CHP plants
- The status of market liberalisation in each sector is reviewed
- The Russian energy sector is in dire need of modernisation and investment

Reasons to buy

- The deterioration due to lack of investment over many years is opening the doors to opportunities for investors in Russian energy
- With a multitude of acquisition targets for energy investors
- And large markets for new equipment and technology to repair and modernise the infrastructure

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Contents

1.	Executive Summary	7
	Oil Sector	7
	Gas Sector	7
	Electricity Sector	8
	Coal Sector	8
	Nuclear power	8
	District Heating.....	9
2.	Economic Overview	10
	Background	10
	The Economy in 2006	11
3.	Oil.....	13
	Reserves	15
	Oil Transportation System	15
	The Early Years of Oil Transportation in Russia	15
	Oil Transportation in 2006	16
	Condition of the System	17
	Export.....	18
	Structure of the Oil Industry	20
	Proposed New Oil Exports Pipelines	21
	Change in Control	23
	Privatisation in 1992	23
	Foreign Involvement in Russian Oil Companies	24
	The VICs in 2006	24
	LUKOIL.....	25
	YUKOS (no longer in existence)	26
	Sibneft (owned by Gazprom).....	26
	Slavneft.....	27
	Rosneft	27
	Surgutneftegaz	27
	TNK BP	28
	Sidanco (Siberian Oil Co).....	28
	Tatneft	28
	Bashneft	28
4.	Gas	29
	Structure of the gas industry	31
	Russia and the CIS	32
	Armenia	33
	Azerbaijan.....	33
	Belarus	33
	Georgia.....	34
	Kazakhstan.....	35
	Kyrgyzstan.....	35
	Moldova	35
	Tajikistan	35
	Turkmenistan.....	36
	Ukraine	36
	Uzbekistan.....	37
	Future output and consumption	38
	Independent gas companies.....	38
	Independent gas producers.....	38
	Transportation, Unified Gas Transportation System (UGS)	39
	Access to UGS, Transmission Tariffs	40
	Export Pipelines	40

Blue Stream.....	40
North Trans-Gas.....	41
Kovkotya.....	42
Yamal-Europe.....	43
Exports.....	44
Itera, independent exporter.....	44
Prices.....	45
Future prospects for Russian gas.....	45
Pricing.....	45
Price setting.....	46
Investment Requirement.....	46
Distribution.....	47
Gasification Programme.....	47
CNG.....	48
5. Electricity.....	49
Regulation and Tariffs.....	51
Capital Investment.....	53
Restructuring of the Russian ESI.....	53
Reform Timetable.....	54
The Leading Major Energos.....	56
OAO Mosenergo.....	56
Irkutskenergo.....	57
Tyumenergo.....	58
Transmission.....	58
The Electricity Supply Industry after Restructuring in 2009.....	58
Liberalisation of the wholesale market.....	59
Asset Restructuring.....	61
Composition of the WGCs.....	62
Regulator.....	64
Physical Characteristics of the ESI.....	64
Generating capacity and generation.....	64
Power Plants.....	66
Nuclear generation.....	68
Capacity Forecast.....	72
Transmission and Distribution, Physical Characteristics.....	73
Distribution.....	74
Interconnections.....	74
Transmission and Distribution, Monopoly Regulation and Investment.....	75
6. Coal.....	77
Coal Reserves.....	78
Geographical Distribution of Coal Reserves and Mines in Russia.....	80
Coal Quality.....	80
Coal Producers.....	80
Consumption.....	82
Exports.....	83
Transport.....	84
Ports.....	84
Environmental Impact.....	84
Outlook for Coal.....	85
7. Nuclear.....	86
Structure of the Nuclear Energy Sector in Russia.....	87
Production.....	89
Design and safety.....	90
The International Nuclear Event Scale (INES).....	90
8. District Heating.....	92
Modernisation.....	93

The Russian Heat Balance	94
Technical Factors.....	94
Transmission and Distribution of Heat.....	95
Modernisation.....	96
Pricing.....	96

Tables

Table 1: The VICs in 2006.....	24
Table 2: Gas Statistics.....	48
Table 3: Principal Gas Companies.....	48
Table 4: Regulated Wholesale process for electricity, 1996-2002.....	52
Table 5: Electricity Utilities of Russia 2005.....	55
Table 6: Electricity statistics of the Electricity Supply System, excluding isolated and captive generators, 1995-2004.....	65
Table 7: Regional generation by energy type, %.....	65
Table 8: Major power plants in Russia.....	66
Table 9: Nuclear plants in Russia.....	69
Table 10: Power Reactors under construction.....	71
Table 11: Power Reactors Planned or On Order.....	71
Table 12: Forecast of future capacity by fuel, 2005, 2010, 2015, 2020.....	72
Table 13: Major Producers in Russia.....	81
Table 14: Nuclear Power Reactors 2005-06 and Uranium Requirements (September 2006).....	88
Table 15: Nuclear power plants in Russia operational in 2006.....	88
Table 16: Detailed criteria defining the levels of the International Nuclear Event Scale (INES).....	91
Table 17: Russian Heat Balance 2000-2001.....	94

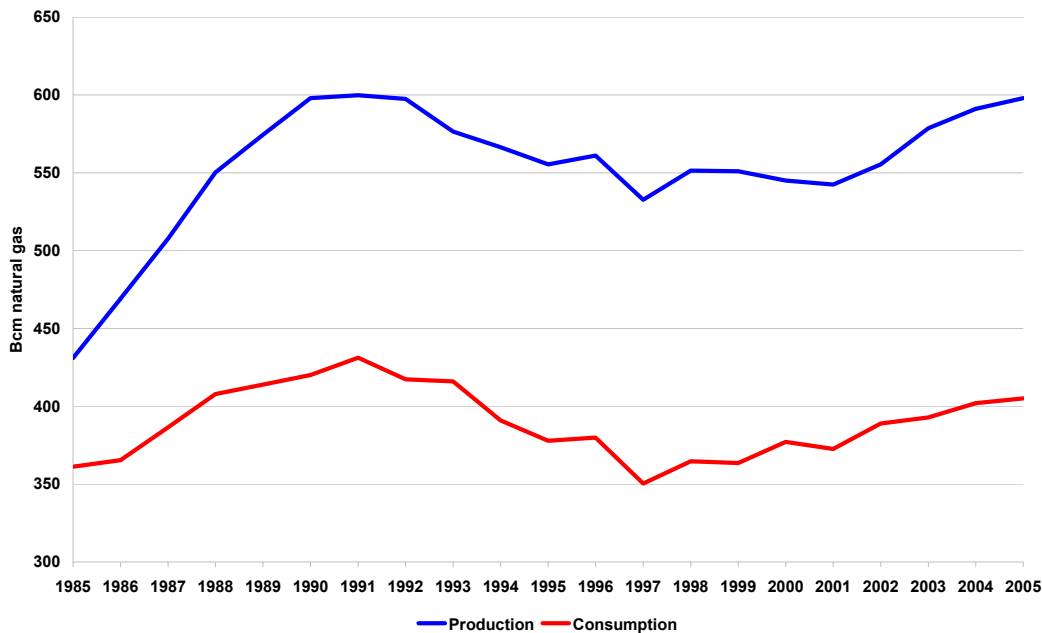
Figures

Figure 1: Oil Production and consumption of oil in Russia, 1985 to 2005.....	14
Figure 2: Location of oil reserves in Russia.....	15
Figure 3: Existing and planned gas pipelines to Europe.....	17
Figure 4: Main Oil Export Infrastructure.....	19
Figure 5: Druzhba and Adria Oil Pipelines.....	21
Figure 6: Selected Northwestern Pipelines.....	22
Figure 7: Proposed Far East Oil Pipelines.....	23
Figure 8: Production and consumption of natural gas in Russia, 1985 to 2005.....	31
Figure 9: Gazprom production in Russia.....	32
Figure 10: Production, imports, exports and consumption of natural gas in the CIS, 2005.....	33
Figure 11: Ukraine's Gas Transport System.....	37
Figure 12: Russian gas market structure 2004.....	39
Figure 13: The UGS, Unified Gas Transportation System of Russia.....	40
Figure 14: Blue Stream Pipeline.....	41
Figure 15: North Trans-Gaz (NEG).....	42
Figure 16: Development in the East.....	43
Figure 17: Yamal Gas Pipeline.....	44
Figure 18: The structure of the Russian electricity sector, 2003.....	51
Figure 19: The Structure of the Russian Electricity Industry after 2008-09.....	59
Figure 20: Main principles of operation of the new wholesale electricity (capacity) market.....	61
Figure 21: Location of the WGCs (Wholesale Generating Companies).....	62
Figure 22: Generating capacity of the USSR and successor states, 1917 to 2004.....	66
Figure 23: Nuclear power plants in Russia.....	69
Figure 24: Forecast of Generating Capacity to 2020.....	72
Figure 25: UPS/IPS - The electrical power system of the Russian Federation, Major plants and transmission lines.....	73
Figure 26: CENTREL network.....	75



Figure 27: Production and consumption of coal in Russia, 1985 to 2005, Mtoe	78
Figure 28: Coal reserves, coalfields and ports of shipment in Russia	80
Figure 29: Coal Consumption in Russia (mn tons of coal).....	82
Figure 30: Projected coal-fired generating capacity of Russia to 2020.....	83
Figure 31: Coal exports (mn tons), 1990 to 2005.....	84
Figure 32: Organisation of the Russian Nuclear Sector.....	87
Figure 33: Electricity generation from nuclear power	89

Figure 8: Production and consumption of natural gas in Russia, 1985 to 2005.



Source: BP Statistical Review of World Energy 2006

Russia's gas sector is dominated by the joint-stock company Gazprom, the largest gas company in the world. Chief among the major sources of pressure for change regarding Gazprom is the need to stimulate investment in gas production in order to sustain output over the long term. Proposals for reform include the urgent need to increase transparency in the sector and transfer many of the regulatory functions now performed by Gazprom to state bodies. Also, there is a longer-term need for much more fundamental restructuring, involving a considerable degree of unbundling of Gazprom. In particular, it would be desirable to remove control of the sector's transport infrastructure from the company and to revise the arrangements governing gas exports to non-CIS states, which are currently monopolised by Gazprom. At the same time, recent increases in domestic gas tariffs must continue until internal gas prices rise above full, long-term cost-recovery levels.

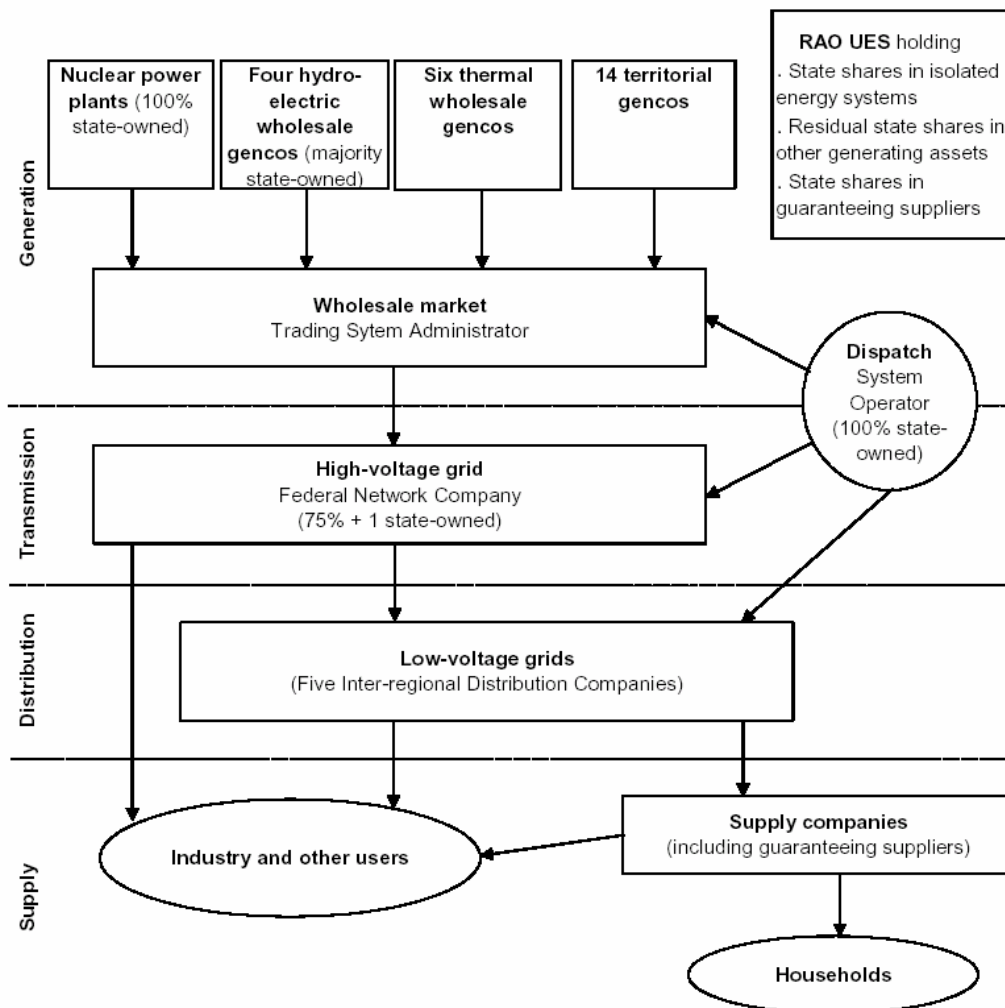
In June 2003, Gazprom signed its first joint venture for the production of natural gas in Russia with Germany's Wintershall. The partners have been developing the Achimovsk formation of Russia's Urengoi field since 2004, with full production in 2008 to yield 8.4 tcm of gas. The consortium, known as Achimgaz, plans to sell 75% of their natural gas production on the domestic market, leaving 25% for export.

Structure of the gas industry

Gazprom is 38% owned by the government of the Russian Federation. It is also Russia's largest earner of hard currency, and the company's tax payments account for around 25% of federal tax revenues. Though constituted as a joint-stock company, Gazprom operates in many ways as an arm of the state, combining commercial and regulatory functions and maintaining tight control over the sector's infrastructure and information flows within it. Gazprom's control over information is particularly important, as it renders opaque much of what happens in the sector.

Gazprom is undergoing the process of organisational and financial unbundling into production, transportation, distribution and supply, and non-core activities. Whereas the immediate objectives of this are greater financial transparency and efficiency, in the long run the unbundling process will enable a relatively quick introduction of deeper market reform.

Figure 19: The Structure of the Russian Electricity Industry after 2008-09



Source: OECD

Liberalisation of the wholesale market

Liberalisation of the wholesale market took place with the introduction of new rules on September 1, 2006. The new rules change the whole system of relations between buyers and sellers of electric power and capacity.

Wholesale sellers of electric power include generation companies and importers of electric power.

The category of buyers includes:

- Consumers buying electric power in order to meet their own production needs.
- Sales companies (including suppliers of last resort), acting in their own right and buying electric power in order to resell it to end-users.
- Exporters (export operators) of electric power: organisations, which are buying electric power on the domestic wholesale market in order to export it to foreign energy systems.

The regulated sector and the free trade sector of the wholesale market will be replaced by the system of regulated contracts to be concluded between buyers and sellers of electric power. These contracts are referred to as “regulated”, because electricity prices under these contracts are regulated by the Federal Tariff Service (FTS).

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