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OPEC dethroned, Putin's "KremPEC" arrives

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For the past year, oil analysts, politicians, and investors have been bewildered by the Kremlin's legal assault in Russia's largest privately own company – oil giant Yukos. For most observers, attacking and driving Yukos into bankruptcy, particularly as petroleum markets are experiencing volatility, is irrational for both Russia's domestic and international interests. However, there is a method to Putin's "madness" – he intends to completely re-order the nature of international oil politics, with Russia playing the leading role.

The "Yukos affair"

The "Yukos affair" is often described as a politically motivated Kremlin attack against the country's super-wealthy known as the "oligarchs," particularly Yukos' core shareholders – Mikhail Khodorkovsky, on trial for tax evasion and other serious charges, is the most notable. Khodorkovsky, Russia's richest man, is believed to have meddled too much in politics and even might have had political ambitions of his own. Thus, using this logic, Khodorkovsky, a person of considerable means, was a political threat to Vladimir Putin and the Kremlin.

There is nothing particularly wrong this with interpretation, but it does overlook what motivates Putin's Kremlin. If the Kremlin had aimed to cut Khodorkovsky down to size, it easily could have done so without assaulting Yukos – Russia's crown jewel oil producer controlling two percent of the world's known oil reserves. The Kremlin's interest in Yukos goes far beyond the personal conduct and ambitions of Khodorkovsky. It is determined to re-order Russia's oil patch to serve national and international interests.

The Kremlin's assault on Yukos is not an impulsive act of political and economic terrorism against property rights and enterprise. Compared internationally, Russia is the only major oil exporter (and the only major oil producing country with the two exceptions of the US and UK) where the state is not the major operator in the upstream sector. Thus, the Kremlin is re-ordering Russia's oil sector to roughly match international norms.

The way the Kremlin is re-ordering the oil sector rightfully raises concerns that all the chaotic privatization of the 1990s will eventually be targeted the way Yukos has been. However, these concerns are exaggerated. Other oligarch empires, such as non-ferrous metals, probably will be challenged by the Kremlin as this sector, like oil, is considered of strategic importance. One thing appears to be clear: the Kremlin and the next targeted oligarch will not play out the "Yukos scenario" again – the Kremlin has shown its determination to get what it wants and the rest of Russia's oligarchs will certainly avoid a head-on collision with the state.

Yukos as a company will soon vanish from Russia's corporate environment. Unable to pay up to $10 billion in back taxes, the company will most likely declare bankruptcy and eventually have its assets parceled out to other Russian oil companies. However parceled out, there is no doubt these valuable assets will be in the hands of Kremlin-friendly entities.

"KremPEC" (Kremlin Petroleum Export Corporation)

Putin is looking to the future. Since 1999, Russia's petroleum production has increased 48 percent, primarily on the back of flows from new wells. Producing 9 million barrels of oil a day, Russia is the world's largest producer. With that in mind, Putin has called upon his oil ministers to finalize plans increasing the number of export pipelines to increase output to 11 million barrels a day by 2009. Russia's expected export increase, in conjunction with other world suppliers, is hoped to lower the cost of crude as early as 2006.

Due to almost unprecedented global demand, the Kremlin's coffers receive an additional $1.5 billion per month, and a number of petroleum market experts claim high prices last year comprised about 3 percent of Russia's 7.3 percent gross domestic product growth. Experts also estimate that each dollar above the yearly average of $22 per barrel adds 0.25 percent to GDP.

Putin has stated that, "The government must base its decisions on the interests of the state as a whole and not on those of individual companies." These are not just words -- Russia's oil giants LUKoil and Sibneft are acutely aware that Putin means business.

LUKoil, Russia's second largest petroleum firm, has already understood Putin's message, and is more than willing to pay more taxes and work as a loyal energy foreign policy conduit for the Kremlin.

Sibneft, third-ranked oil producer owned by oligarch-English football enthusiast Roman Abramovich, has also caught the Kremlin's attention. With investigations of Sibneft and Abramovich mushrooming, it appears only a matter of time before Sibneft will be under the Kremlin's heel as well.

What will happen to Yukos' assets after it is forced into bankruptcy is open to speculation. The smallish government-owned Rosneft Oil Company is rumored be the Kremlin's favorite – some of Putin's key aids are on Rosneft's board of directors. The natural gas monopoly Gazprom, government-owned as well, is also thought to be in the running. In the end it does not really matter. Yukos' transformation will essentially create what has been the Kremlin's goal from the advent of this affair: the creation of "KremPEC" (Kremlin Petroleum Export Corporation).

Russia as international petroleum kingpin

"KremPEC" has ambitious international goals. Terrorism threatens oil export giant Saudi Arabia, a barrel of oil hovers around $45, in the US a gallon of gasoline costs up to $2.50 and far more in Europe, and "weapons of minor destruction" limit the prospect of Iraqi oil significantly impacting international oil markets any time soon.

Add to this situation the fact that energy-hungry China and India are also actively interested in sourcing new and secure energy export markets to support their rapid economic growth.

The Kremlin has also carefully thought out what the future might hold if Saudi Arabia becomes a target of larger and increased terrorist attacks. Without Saudi exports of crude, OPEC would lose its influential powerbroker. Russia, as the largest producer in the world, might rethink its position concerning membership in the international petroleum cartel if Saudi exports were to face long-term risk.

Russia, with OPEC observer status, has flirted with the idea of joining OPEC in the past. However, regaining the former market share of international exports held by the Soviet Union has been the primary goal. With the domestic oil sector soon to be completely under the Kremlin's thumb, that goal is close to becoming a reality.

Additionally, Russia has had little incentive to work closely with OPEC when oil prices are high. However, with future supplies in doubt and prices uncertain, the Kremlin has reason to reconsider its position. Being the world's new energy kingpin most certainly appeals to Putin -- intent on returning Russia to its former great power status.

Putin is on top of the world. He is in the process of creating his own oil cartel at home, "KremPEC," and just might land himself the prize of sitting at the very center of international oil politics. Putin also looks forward to a steady cash flow to pay for domestic reforms and fight the poverty so pervasive in Russia.

Russia and the world: a "win-win" scenario

The "Yukos affair" will quickly become part of history and it is doubtful another Kremlin-business confrontation of its nature will occur again. In the wake of this affair, Russia's oil patch will become more secure, attracting international petroleum investment, as well as providing Russia needed cash flow to continue the reform of its economy. Instead of partnering with an oil oligarch, negotiations will take place behind Kremlin walls. For an energy hungry world, doing business with "KremPEC" will become almost risk-free and will eventually make OPEC's current hold over world petroleum markets irrelative. OPEC is about to be dethroned with Putin's "KremPEC" as its successor.