

# Russian heavyweights

*Lesley Bankes-Hughes assesses how the entry of oil heavyweights Gazprom Neft and Rosneft into the Russian bunker sector may shift the balance of power among the industry's players*

**T**he closing months of 2007 may well have marked the beginning of a significant shift in the balance of power in the Russian bunker market. The disclosure by two of the country's oil industry heavyweights, Gazprom Neft and Rosneft, of their ambitions to enter the bunker sector certainly serves as a timely wake-up call to revisit the nation's marine fuel market and look at how these new entrants to the Russian bunker industry are taking steps to overcome the inherent obstacles in the country's bunker market as well as seeking to exploit new opportunities opening up to them.

So what has prompted Gazprom Neft, the oil offshoot of Russia's gas export monopoly, and the country's leading oil producer, Rosneft, to venture into the niche market of bunker supply? The answer, as is so often to be found in current 'corporate speak', is the quest for total supply chain control or, to use yet another phrase so beloved of industry strategists, complete vertical integration.

Many of the well-established names in the Russian bunker market have already expended time and money in developing their individual refining/storage/marketing operations to which the current buzz word of vertical integration can be conveniently applied. Indeed, the very nature of the oil supply sector as a whole, and the bunker market in particular, lends itself particularly well to this supply chain 'branding' – it is, quite simply, how the industry has always operated.

Whether the two oil giants will manage to make all the pieces of the supply jigsaw fit remains to be seen, but the logic of their respective decisions seems, on paper, to be well-founded. They have refining capacity, storage (owned and leased), and new footholds in the Baltic and Far Eastern markets. Add to this the fact that Russian bunker fuel prices in these days of dizzying price escalations remain significantly lower than in other global markets (St Petersburg marine fuel prices, for example, can be around \$100 cheaper than in the Rotterdam market), then bunker suppliers must (or should) be seeking ways of exploiting this price differential.

Reports that the Russian government is planning to scale back oil exportation through neighbouring Baltic States between 2008 and 2015 should also create opportunities for indigenous suppliers. Russian exports of petroleum products totalled some 84,044,000 metric tonnes (mt) in 2006, with just over a third of this total going through ports in neighbouring states. Estonia, in particular, has been a key exporter of Russian crude oil, accounting for some 500,000 barrels per day (b/d) in recent years. In future, shipments may well be redirected through the north western ports, including Kaliningrad, Murmansk and Primorsk – all locations targeted by Gazprom Neft and Rosneft.

However, if one looks at the historical and geographical issues embedded in the Russian oil supply infrastructure, then the theoretically rosy outlook for the industry's newest players becomes a little more fraught with potential difficulties. True, both Rosneft and Gazprom Neft have refining capacity which they are both anxious to improve and expand. However, years of underinvestment in the nation's oil refineries have resulted in an operational infrastructure which is crying out for modernisation and a dramatic improvement in refining depth.

Transportation of fuel oil (via land and sea) is also a key issue in Russia. Bunker supply is a highly seasonal operation in many of its ports, and even the port of St Petersburg, the largest player in the country's bunker market, cannot accommodate very large crude carriers (VLCCs); even the building of a new terminal and port facilities here will not change this restriction.

The upshot of these inherent geographical/infrastructure problems is that most of Russia's fuel oil is shipped to the large global bunker markets, such as Rotterdam and Singapore, for onward supply, thus eroding the favourable price differential for Russian suppliers. Furthermore, key markets such as Rotterdam have been consistently flat in recent months, so increasing refining output may well further compound the problem of finding customers for Russian suppliers.

The possible rerouting of oil product shipments from Baltic States to north western Russian ports also raises transportation issues. Following the cessation of pipeline

# eye bunkering prize

transportation of supplies, including the closure of the crude oil pipeline to Ventspils in Latvia, oil products are carried by rail which, for the moment, is a much more economical option for Russian companies. However, the ability of an under-funded rail system to cope with the burden of greater supply volumes post 2008 must invite some degree of scepticism. Modernisation of the rail infrastructure is on the cards, but the knock-on effect of the massive investment required may well be an unwelcome hike in transportation costs for the suppliers, thereby making the acquisition of the former Baltic supply business distinctly less palatable and sought after.

Both Gazprom Neft and Rosneft have revealed ambitious and detailed plans for expansion, and, indeed, have moved swiftly to realise them in the early months of 2008. However, the existence of a tightly-knit bunkering community in Russia, particularly in St Petersburg, must be seen as somewhat of a brake on their voracious appetites. Russian bunker suppliers are unwilling to openly voice dissent over the entry of Gazprom Neft and Rosneft into their territory, but these well-established players must be looking at the possible erosion of their respective market shares with some degree of concern.

As *Bunkerspot's* 2007 country profile (April/May, page 36) highlighted, the north west Russian market is home to long-standing bunker players, such as the **Baltic Bunkering Company (BBC)**, **Nevsky Mazut**, and **Bunker Holdings/Transbunker Group**, who all have access to storage and can offer a range of fuel oil grades, including low sulphur.

Archangel and Murmansk, north of St Petersburg, have seen a growth in demand for bunkers although, once again, the arctic/sub-arctic climate depresses the market for many months each year.

Gazprom Neft and Rosneft have expressed their intentions to make inroads into the Far Eastern market where established players such as Bunkerholdings/Transbunker Group and **Pavino Shipping Company Ltd** are well entrenched with significant market shares. The key ports here are Vladivostok, Nakhodka and Vanino, which give Russian suppliers a valuable window on the Asian Pacific markets. However, fuel

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oil shipments and direct bunker supplies are considerably less in volume than in the Baltic/Black Sea ports, thus giving Gazprom Neft and Rosneft a greater mountain to climb in terms of garnering new business or greater untapped business potential to exploit depending on how optimistically or cynically one views future market growth.

So, these two oil giants have to vie for their place in the bunker market with several key players in every port on their expansion 'wish list', and at the very top of the list of bunker suppliers in the key area of north west Russia is, of course, the name of **Lukoil-Neva** with its presence in St Petersburg, Primorsk, Kaliningrad and Murmansk.

As Gazprom Neft and Rosneft herald their move into the marine fuel market, Lukoil has also signalled its intention to drive for expansion in 2008 into ports of the Caspian Basin and on the Azov Sea and Black Sea. It is also looking for opportunities in river ports such as Volgograd, Rostov on Don and Nizhny Novgorod.

The ability of Gazprom Neft and Rosneft to take forward their respective bunkering strategies is largely predicated on the upgrading of port facilities (with a resultant increase in bunker sales) as well as the modernisation of refining operations.

Ports in and around St Petersburg are already the subject of major revamp operations. The **Russian Association of Marine and River Bunker Suppliers (RosMorRechBunker)**, established in 2005 and with a membership of 25 bunker companies (including new recruit Gazprom), reported a 20% growth in bunker sales at

the port of St Petersburg in the first half of 2007, compared with an annual average growth of just 10% in preceding years.

Towards the end of the 1990s, Russia focused on upgrading its Baltic ports with the opening of Primorsk in 2001, and the beginning of work on the oil terminal at Vysotsk in 2003. A new port area at Vistino is planned and new terminals in the port of St Petersburg will come into service – around 10-12 terminals are currently believed to be in operation here, several of which have been adapted from ex-military and research facilities. The Petersburg oil terminal, which is the largest outlet in St Petersburg and currently supplies fuel oil and diesel, has been earmarked for a major overhaul by 2010.

Gazprom Neft, formerly the **Siberian Oil Company**, has done much to overhaul its operations in oil and gas exploration, production, refining and marketing since the mid-1990s. In October last year, a bunker offshoot, **Gazprom Married Bunker** was incorporated by Gazprom Neft in order to supply heavy fuel oil, bunkers and lubes for maritime transport.

The company has said that it intends to sell 1.5 million mt of these products by 2009, and has set itself the not inconsiderable target of taking 30% of the Russian bunker market by 2010. It undertook its first bunkering operation in the port of St Petersburg last December, using rented storage and terminals, when the *Baltic Sky* refrigerated cargo carrier was filled with 700 tonnes of oil.

Gazprom Neft also intends to establish bunker operations in Novorossiysk and Murmansk, and has also said it intends to supply end users in the Far Eastern ports from early 2008. In early March, the company also made a shrewd tactical move into the Baltic Sea port of Primorsk with the acquisition of several companies which are believed to include operations belonging to **Transflot**.

Russian bunkering companies have a strong appetite for a slice of business at Primorsk. Rosneft has also set its sights on the port, and Lukoil is already there following a co-operation agreement with another company in 2003. The port is home to the **Baltic Pipeline System** terminus which is owned by the state

monopoly **Transneft** and, since its opening in 2001, Primorsk has gained ground as a key export facility.

Gazprom Neft does have considerable refining capacity at Moscow and Yaroslavl, but its largest refinery is at Omsk. In 2007, the company increased oil refining volumes across its refineries by some 7.3% compared with 2006. Yaroslavl turned in a huge 33% increase in refining volume, and although Omsk only achieved a growth margin of 1.4%, its output was by far the largest of Gazprom's refining operations standing at some 16.5 million mt. The company claims that production of marine fuel to ISO 8217 standard will begin shortly at Omsk, which will bring the maximum sulphur limit in its fuel oil into line with MARPOL Annex VI, and should, therefore, open up more bunker business opportunities for Gazprom Neft.

If Gazprom has been less than reticent in declaring its hand about its bunker business ambitions, then Rosneft has entered the market with a positive flourish. The company, which purchased the assets of the bankrupt oil group **Yukos** last year, is the dominant force in the Russian oil sector. At the end of 2007, it became the first Russian company to break through the 100 million mt ceiling for annual oil production, and has made the bold prediction of increasing output to 160 million mt by 2015.

Rosneft made a small initial foray into the bunker sector in early 2002 when its subsidiary, **NC Rosneft-Archangelsknefteprodukt JSC** began bunkering operations from its own terminal at Archangel. Its trump card in making inroads into the Russian market, however, may well be its ownership of not just refineries (Achinsk, Komsomolsk, Syzran, Tuapse, Kuibyshevsky, Novokuibyshevsky) but also terminals (Tuapse, Nakhodka, Archangel, Syzran).

Its Tuapse operations are particularly in Rosneft's line of sight at this early stage in its direct bunker operations. Poor refining depth is a problem at many of Russia's refineries, but Rosneft has predicted what seems to be a highly optimistic increase in refining depth at its Tuapse refinery from its current 56.4% to 95%. However, the refinery is well-positioned close to the company's export terminal, and the company hopes that transshipment from the

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port will build from 10.2 million mt to 17 mt per annum.

Last November, Rosneft began shipments of marine fuel from its terminals: the Achinsk refinery supplied IFO 180 grade fuel oil to the Talagi terminal in Archangel and this was then transferred to floating storage off Murmansk. Achinsk also supplied 16,000 mt to the Nakhodka terminal which was supplemented with an additional 5,000 mt from the Komsomolsk refinery.

Interestingly, South Korea's **Busan Port Authority** has just announced a major investment programme at Nakhodka. It plans to develop a container terminal here in 2008, and says that it believes the port is developing as a new Russian economic powerhouse.

Addressing potential business in the Far Eastern ports, Rosneft loaded its own bunker fuel last December in Vladivostok and supplied fuel to six vessels. As with Gazprom Neft, securing a strong presence in the Far East is high on Rosneft's agenda. It has said that it hopes to sell up to 1.7 million mt of bunker fuel in 2008, and up to 50% could be supplied to this region, with up to 25% being allocated to its Archangel/Murmansk operations.

According to the company, modernisation of its terminals is a key component of its medium term strategy, and it has not ruled out buying additional floating storage. Post 2010, it has also set its sights beyond Russia's borders, flagging foreign ports of the Black and Baltic Seas and locations in the Pacific Rim as possible expansion targets.

Rosneft estimates that the potential bunker market in Russia is 10-11 million mt (which compares with the volume of a company such as **Shell Marine Products**).

So, while Gazprom Neft and Rosneft are each doing very well in 'talking the talk' in terms of their bunkering ambitions, how realistic are those aspirations?

There are the cynics amongst industry watchers who think that the presence of Gazprom Neft and Rosneft in Russia's bunker market will, when Lukoil's foothold is taken into account, create what may well be a nationalisation of a major portion of the country's bunker sector. However, the crunch factor for both companies in their search for seamless vertical integration may well be the vital end-of-chain link between the supplier and the end user. Both companies are giants in Russia's energy sector, but the ability to establish relationships with end users in the bunker market takes time to achieve. They do have substantial refining capacity, but analysts continue to point to the fact that Russia's oil revenues are not being ploughed back into modernising its refining capabilities.

Clearly, Russia's established players in the bunker sector are taking stock of the recent moves by Gazprom and Rosneft. Until these two Russian heavyweights match actions to words, then the composition of Russia's future bunker market remains open to speculation. One established supplier voiced a view seemingly shared by other operators in the Russian market: 'We have established our position, and we are ready to meet the challenges posed by the arrival of new players.'

However, they pointed to the nub of the problem for any new ambitious entrant to the country's bunker sector: 'It's not just about the sale of the product; it's a complicated business. It takes a lot of money to get the infrastructure right and the end supply of the product is just a small part of a long chain.'

Gazprom Neft and Rosneft may well have to take onboard that building relationships with end users is just as important as having the building blocks of refining and storage in place. Without a doubt their bold declarations of intent will impel the smaller, independent players in the intriguing Russian bunker market to reassess their operations and consider how their future strategic ambitions should best be shaped. They are certainly living in interesting times.