PetrolPlaza Russia Special. Part 1 – The post-Soviet transformation

PetrolPlaza brings a three-article special series on the Russian fuel retailing market. In this first part, we provide an in-depth insight into the transformation of the country's fuel market since the dissolution of the Soviet Union.

Russia´s current fuel market is clearly tied to the dismantlement of the Soviet Union - a regime that did not organize its industries in order to foment fair competition and equal development, but which operated under the Communist premise of servicing the needs of the people.

At the time of the Soviet Union, the centralized system of production and distribution of oil products was regulated by the Ministry of Petrochemical and Gas Industry, while the State Committee of Oil Products was in charge of the recording, storage and supply of oil products across the vast state.

It was the local governments which, after the breakup of the Soviet Union in 1991, inherited control over all existing gas stations. Without great experience in the fuel retailing market, and faced by the issue of insufficient fuel supply, local authorities chose different ways to manage the gas station business.

The case of Moscow city

“The Moscow authorities chose the most appropriate and right development path, elaborating an effective strategic action plan,” explains Grigory Sergienko, current Executive Director of the Russian Fuel Union (RST). The local government had two key aspects to solve: How to manage the existing gas stations, and how to construct new ones.

Sergienko explains that Moscow decided to lease out the existing 220 filling stations to investors on the condition that the leaseholders would finance the reconstruction and modernization of the leased facilities out of their profits, which would then enable them to acquire the stations at the remaining value. This program enjoyed success for it rejuvenated many of the sites, partly due to a joint-venture with British Petroleum, which brought its Western knowhow to the underdeveloped Russian market.

Additionally, the city government allocated 300 land parcels for the construction of new filling stations on favourable terms. To facilitate rapid and dynamic development, Deputy City Mayor B.V. Nikolski designed a new, fluid decision-making system that kept bureaucracy from interfering in the construction and development process. The ambitious programme was launched in 1993, and as a result three years later there were around 600 filling stations operating in Moscow.

How oil companies came to dominate the market

Up until 1998 most of the regional fuel retailing market was controlled by local authorities, while independent marketers were flourishing around the country. Within the period1993-1998, Russia´s gas station business actually witnessed a kind of free market where oil products reached customers in various ways: product exchange, intermediary firms, independent retailers, and oil companies.

During that same 5 year period Russian oil companies went through various stages where first they benefited from the control of oil fields, later they bought oil producing plants and eventually they entered the fuel retailing market, building vertically integrated systems which covered all aspects of the oil business.

Oil companies gained power over the fuel retailing business in regional areas by forcing the local governments´ hands. They would exchange oil products, including fuel, for land parcels where they could build new filling stations, or for the operational control and future ownership of existing stations. As a result, local monopolies emerged based on the merger of local oil plants and filling station networks. These monopolies have been dominating regional markets till today.

Current fuel giant Lukoil is the best example of the development of the Russian energy companies. Before 1998, Lukoil had only built 5 gas stations in the Moscow area. It was not until the 2000s, after gaining financial independence and political power, that Lukoil and other large oil companies took over the fuel retailing business.

As oil companies came to control all stages of production and supply of oil products, they started to apply pressure on independent Russian fuel retailers. “At that time the independent fuel market was undergoing rapid and sustainable development, and when vertically integrated companies entered the market, the industry witnessed a natural clash of interests,” explains Sergienko.

Under these circumstances the so called ‘first repartition’ of the Russian fuel market took place, when 30% of independent marketers were forced to either go out of business or to sell their assets to major oil companies; thus creating the current large gas station networks of Lukoil or Rosneft. The first repartition (1998-2003) laid the foundations for the modern Russian fuel market structure.

Vladimir Putin and the state´s interest

Modern day Russia is unequivocally tied to Vladimir Putin, who has been in charge of the country, as President or Prime Minister, since 1999 until today. When Putin first came to power he did not feel the need to improve the competitive conditions of the fuel market and went on using the infrastructure which remained after the breakup of the USSR.

Therefore, “all the usual attributes of an economy that transits from a regulatory monopoly status to market relations with free and fair competition (including access to oil products and market pricing conditions) appeared to be inapplicable to the Russia,” says Sergienko.

It was in those years when the major oil companies laid the foundations for the establishment of big energy companies tightly linked to state interest. These companies were regarded by the government as a main source of financial income and a key strategic asset. As the major shareholders of companies such as Gazprom or Rosneft, the Russian government could exercise administrative power and influence the industry.

Keeping the lid on independent fuel retailers through supply

By the early 2000s about 30% of the total number of gas stations belonged to large oil companies, whereas the remaining 70% were operated by independent filling station owners. Since then the number of independent gas station owners has continued to decrease in favour of major oil companies.

The source of fuel has typically been the way for oil companies to weaken the independent fuel retailing sector. Russian gas stations generally had three different sources for fuel: by means of fuel exchange (up to 10% of the petrol produced and around 5% of diesel fuel oil are sold via the fuel exchange); directly from departments of oil companies; and through smaller oil refineries (according to the information agency InfoTEK, as of 2014 there were 211 small, independent oil refineries in Russia). Small oil refineries, however, primarily produce low-quality diesel fuel oil and low-grade petrol for they lack the modern technology and machinery necessary for the production of premium fuels

Thus, whilethe retail fuel market is mostly competitive, the wholesale fuel market is highly monopolized, leaving independent filling station owners in a weak position. The difficulty in establishing healthy business relationships between independent operators and fuel suppliers is also affected by the fiscal system.

Due to the fragile position of independent operators, who suffered from price hikes and fuel scarcity, in the late 2000s the Russian Fuel Union, with support from the Federal Anti-Monopoly Service, initiated the setting up of the independent fuel exchange for trading oil products in the Russian market.

Major oil companies, although sceptical about the program at first, decided to take the leadership in the exchange of oil products and eventually became its major founders. While the oil companies regulated all the main processes on the new exchange, independent filling stations became mere consumers, rather than autonomous managers.

Some experts branded the system “perverse” for it handed oil companies too much power. They would often create stressful conditions for steep rises in wholesale prices deliberately through artificial fuel deficiency in their sales departments, forcing independent filling stations to depend on the fuel exchange, where the volume of fuel was limited. Manoeuvres such as raising prices claiming an increase in demand demonstrated that the price setting process on the fuel exchange market was flawed. Naturally, an increase in wholesale fuel prices would always lead to more expensive fuel at the pump.

As part of the Russia Special, PetrolPlaza has published an* ***interview with the Director of Tatsuno Rus, Victor Gordov**, a Russian equipment supplier which is celebreting its 19th anniversary this year. Tatsuno Rus specializes in fuel dispenser equipment and measuring and control systems for service stations.*

Written by Taya Shetle | Edited by Oscar Smith Diamante

Part 2 and 3 of the Special on Russia´s fuel market will follow