International Partnership and the Future of Russian Oil and Gas

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Structure

- Current issues for the Russian oil sector
- Areas of IOC participation
- Challenges for foreign partners in Russia
- Some thoughts on addressing the risks
The oil sector underpins Russia

- The oil sector makes by far the largest contribution to Russian budget revenues, dwarfing the gas sector.
Russia’s oil production outlook

Maintaining Russian oil production above 10mmbpd is becoming more challenging

IODCs will be important contributors of technical experience, management expertise and financing for difficult projects

Partnership is vital to the future of Russia’s oil (and gas) sector

Russia has an oil tax problem

*Tax concessions have underpinned stable oil output*

- Russian oil production would already be in decline if tax concessions had not been made to specific types of projects
- Production must not be allowed to fall below 10mmbpd or the tax revenues problem will be compounded
The Russian gas sector is adapting to a new role

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<tbody>
<tr>
<td>Gazprom production</td>
<td>522</td>
<td>550</td>
<td>487</td>
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<tr>
<td>Non-Gazprom production</td>
<td>73</td>
<td>114</td>
<td>169</td>
<td>181</td>
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<tr>
<td>Central Asian imports</td>
<td>34</td>
<td>68</td>
<td>29</td>
<td>33</td>
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<tr>
<td>TOTAL</td>
<td>629</td>
<td>732</td>
<td>685</td>
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<th>MARKETS:</th>
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<td>Russian gas demand (UGSS)</td>
<td>412</td>
<td>462</td>
<td>465</td>
<td>461</td>
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<tr>
<td>Exports to CIS countries</td>
<td>89</td>
<td>89</td>
<td>63</td>
<td>57</td>
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<tr>
<td>Exports to Europe (physical Russian gas)</td>
<td>129</td>
<td>159</td>
<td>139</td>
<td>162</td>
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<td>LNG Exports to Asia</td>
<td>0</td>
<td>0</td>
<td>14</td>
<td>14</td>
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<tr>
<td>TOTAL</td>
<td>630</td>
<td>710</td>
<td>681</td>
<td>694</td>
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Source: Gazprom

- Gazprom and gas sector have had to balance political and commercial objectives, but this is becoming increasingly difficult
- Gazprom has lost a significant amount of control over the Russian gas matrix
- Russian gas sector will need to generate more budget revenues while adapting to increasingly competitive global market
Is Russia becoming the global gas swing producer?

Russia’s oversupply of gas

![Map of global gas sources and demand](image)

Source: WEO 2013
A short history of IOCs in Russia

- **Soviet Period**
  - Competition for ROC equity – IOCs not wanted
  - Technology and finance needed – JVs and initial PSAs
  - Consolidated ROCs - Limited equity sales to IOCs
  - Consolidation
  - Increased State control

- **Privatisation**
  - Major governance issues and economic crisis – IOCs not interested

- **Corporatisation**

- **Consolidation**

- **Increased State control**

**Graph:**
- mmtpd
- 1985 1987 1989 1991 1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013
IOC activity in Russia in 2014

- Barents Sea Exploration
- South Kara Sea Exploration
- Laptev and Chukchi Sea Exploration
- Yamal LNG
- Tight Oil
- Gas
- Black Sea Exploration
- East Siberia JV
- Sea of Okhotsk
- Sakhalin production and development

Equity stakes:
- bp 19.75%
- TOTAL 16%
- NOVATEK
Brownfield recovery through EOR

- Difficult to recover reserves account for 62% of Russian total
- IEA estimates that EOR could account for 500kbpd of output by 2030
- Enhanced waterflooding techniques and reservoir management already in use
  - Water cut averages 80%
- Tertiary methods gradually being introduced as tax incentives increase
- International techniques brought by IOCs and service companies

*Russia’s oil is getting more difficult*

Source: E&Y
Tight oil developments for medium term

- Expectations for unconventional oil are running high
  - Largest prospective resource base in the world
  - The Bazhenov shale is current focus

- Exxon, Statoil, Total and Shell all have JVs with Russian companies

- Production estimates range up to 1.5mmbpd by 2030

- Many issues need to be resolved
  - Tax, service industry capacity, technology, funding

- Commercial environment not conducive to fast development

Output expectations from shale oil

Drilling set to increase sharply

Source: OIES
Arctic exploration – long-term upside

- Arctic exploration set to begin in August 2014
- Rosneft the leader, with huge acreage position
- JVs signed with ExxonMobil, Statoil and ENI
- South Kara Sea the initial focus, with IOC involvement vital
  - Technology
  - Experience
  - Funding
- Huge commercial and geopolitical significance
- Vital for Russia’s long-term production profile

Russia owns 60% of Arctic resources

1mmbpd of output estimated by 2035

Source: USGS analysis

Source: E&Y
Black Sea is an area of increasing strategic importance, with exploration and pipeline activity.

- Russia’s involvement in Black Sea exploration has become a more sensitive issue.
- The South Stream pipeline will become a major strategic asset partly funded by European companies and causing fierce debate with the EU.
Eastern partnership becoming a greater focus, with export sales and finance the key drivers

- Development of Russia’s eastern regions a domestic priority
- Asia to become a vital source of extra export revenues
- Oil production and exports set to rise based around ESPO pipeline
- Gas export deal with China to catalyse eastern gas programme
- Foreign partnership focused on Chinese and Japanese companies
- IOCs involved in Sakhalin and could have a greater role to play as region developed

Eastern oil production to fill ESPO

Eastern gas programme to cost $80-100bn
LNG developments – technology, marketing and finance all needed from foreign partners

- LNG has become a priority in the gas sector as Russia seeks to confirm its role as a global player
- International partnership is vital to the development of new LNG schemes
- Gazprom is facing a challenge from domestic peers with IOC support
Financing of projects will be a key issue

- Development of Russia’s emerging regions implies huge capital expenditure
- Project financing will be a necessity
- A spread of international lending, IOC equity investment and state support will be needed
- Banks will always be more prepared to lend if partners have credibility and experience
- Political uncertainty clearly a key risk – IOC presence can offset this to an extent

Major ROC debt positions – Rosneft’s burden is heavy

Almost $2 trillion of investment needed to 2035
Russian Business Environment – The “Triangle of Tension”
Russian Business Environment

...... characterised by complexity and ambiguity:

• Factional and fragmented; managed tension between factions; trade offs but not always connected business and interests
• Tenacity – determined and persistent
• Confrontational and aggressive
• Conflict and mistrust are the norm
• Unconventional business model – not linear and not transparent
• ‘Win lose’ is preferred outcome

.....the partnership model in Russia is competitive - specifically competition for knowledge
Theoretical context for FDI in a weak state environment
Key Themes from Case Studies and Interviews

- **Key themes from 1990s included:**
  - Foreign partner brought a combination of technology, management skills and money
  - Domestic partner brought access, assets and local knowledge
  - Transfer of knowledge tends to be a one-way process
  - DP local knowledge is an asset to a JV but also a key risk for the FP
  - In any conflict over JV issues the DP normally wins

- **Interviews from 2000s confirmed that:**
  - The business environment for international partnerships in Russia has not changed dramatically over the past decade
  - Institutions remain weak and dominated by key individuals
  - Business outlook remains relatively short-term as faith in reliability of laws and regulations remains low
  - Status quo unlikely to change soon, as it benefits the domestic elite
  - Local knowledge and influence remain vital commodities
  - International skills and work-force not always welcome, which can undermine foreign partner position
Survey of partnerships provided objective confirmation

- Foreign partners in 33 joint entities surveyed

- Confirmed that domestic partner learning took place and was encouraged

- FPs learning identified through change of control over key responsibilities
  - No significant change identified

- Remained strong in original areas, made no progress on local knowledge issues

- No gain in confidence either
  - Related to internal partnership issues as no change in external environment

- However, there was a range of FP performance around this average
More local knowledge = more success

**Overall Model explains 61% of FP success**

\[ FP \text{ success} = K + (0.46 \times \text{Increase in Local Knowledge}) + (0.32 \times \text{DP Success}) - (0.31 \times \text{State Influence}) \]

For every 25% increase in FP Local Knowledge his chance of success goes up by 12%

**Joint Venture Model explains 58% of FP success in JVs**

\[ FP \text{ success} = K + (0.63 \times \text{Increase in Local Knowledge}) + (0.31 \times \text{DP Success}) \]

For every 25% increase in FP Local Knowledge his chance of success goes up by 16%

**The Corporate Model makes a significant contribution to FP success on its own**

Joint entities using a corporate model are statistically more successful than normal JVs, but no other factor makes a significant contribution
Managing Risk and Protection - Principles

- What you see is not what you get
- What is really happening vs. what you are being led to believe
- Understand interfaces and motivations – the real drivers
- Always triangulate politics, business and vested interests to build an integrated picture (better than 75%)….and develop a response
- Persistence is key to protecting yourself

**Bottom line:**
Difficult to manage and/or negotiate if you don’t understand the drivers and what is really motivating a decision
Foreign Entities in Russia – Common Mistakes

• Over-reliance on intermediaries who promise understanding of, and access to, key decision makers but who cannot deliver
• Overconfident senior leadership who underestimate the level of complexity and ambiguity
• Misunderstanding/ misinterpreting the signals due to poor intelligence – send and receive capability
• Quality of human resources you have on the ground in Russia – do they really have insight into what is happening?
• Lack of persistence in protecting and defending yourself
• Complacency and arrogance once you have established a foothold
Key Moments in the History of TNK-BP

- **1997**: BP buys 10% in Sidanco.
- **2001**: BP increases Sidanco stake to 25%.
- **2003**: TNK-BP formed.
- **2006**: BP participates in Rosneft IPO.
- **2007**: Shareholder dispute resolved and TNK-BP stabilised.
- **2008**: TNK-BP buys BP Intl assets (Vietnam/Vzla).
- **2010**: AAR / TNK-BP minorities litigation.
- **2011**: Strategic Alliance with Rosneft lapsed.
- **2012**: Strategic Alliance with Rosneft announced.
- **2013**: Rosneft purchases 100% of TNK-BP from AAR and BP for $55bn.
- **2006**: SAKHALIN exploration agreements with Rosneft.
- **2003**: Arctic Cooperation Agreement with Rosneft.
- **2008**: Shareholder dispute with AAR at TNK-BP.
- **2007**: Bob Dudley leaves Russia.
- **2013**: BP announces potential sale of its 50% stake in TNK-BP.
The “7 Rs” Engagement Strategy

Protection
- Reality
- Relationships
- Rigour

Proactivity
- Renewal
- Resourcing
- Reciprocity

Everything revolves around Foreign Partner Relevance
Conclusions

• Never underestimate the degree of complexity and ambiguity or be complacent – Russians have a strong sense of when and where a partner is weak – and they will fully exploit it

• Russian partnership model is competitive, specifically competition for knowledge

• In a weak state environment balance can only be maintained if a FP gains local knowledge

• It is vital to understand the business and political environment and your partner’s key drivers as fully as possible

• This requires an integrated engagement strategy – 7Rs Model to ensure continuing relevance and balance in the relationship