

## Expansion at the state's expense: Novatek as a driving engine of the Russian LNG sector

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A deal for France's Total to acquire a 10% stake in the Arctic LNG 2 project for US\$2.55 billion was struck on 24 May during the International Economic Forum in Saint Petersburg. This project envisages the construction of a natural gas liquefaction plant on the Gydan Peninsula and is being implemented by Novatek, Russia's largest private natural gas producer. In December 2017, the company launched the first production line of an LNG terminal on the Yamal Peninsula – the Yamal LNG project. In addition to this, Gazprom and Rosneft have confirmed their intention to implement their own LNG projects.

The balance of the actions taken so far suggests that at present Novatek is the only Russian company to successfully implement new LNG projects in Russia. Apart from the LNG terminal operating since 2009 on Sakhalin Island (Sakhalin 2), other projects announced by Gazprom and Rosneft have not made it past the planning stage so far, and there is nothing to suggest that this might change in the coming years.

The positive results of Novatek's operation in the LNG sector are above all a consequence of the financial, administrative and political support it has received from the Russian government. It cannot be ruled out that the Arctic LNG 2 project will also be given similar preferential treatment. The state has offered numerous privileges to Novatek because the company's owners, especially Gennady Timchenko, have close social and business contacts with Vladimir Putin.

Even though the Russian government has not adopted a separate strategy on the LNG sector, many facts indicate that political support for Novatek's projects is motivated not only by the desire to increase Russia's share in the global LNG market, but is also a means to maintain balance between the competing groups of interest in the Russian energy sector. The recognition of Novatek's dominant position in the Russian liquefied natural gas sector could be used by the government as an argument to maintain Gazprom's privileged position in gas exports via the pipeline system, while both Novatek and Rosneft have been lobbying for Gazprom's export monopoly to be curbed. In turn, Rosneft might receive the government's approval for further expansion in the oil sector.

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### Novatek as the leader of the Russian LNG sector

Actions taken by Novatek prove that the company is becoming the real leader of the Russian LNG sector. In December 2017, the company launched the first production line (5.5 million tonnes) of the natural gas liquefaction plant as

part of the Yamal LNG project (the project's implementation cost has reached US\$27 billion). The next two are expected to be put into operation already in 2018, which will make it possible to reach a total production capacity of 16.5 million tonnes. The company is also planning to build its fourth line with a capacity of 1 million tonnes by 2019.

In turn, the Arctic LNG 2 project, the estimated cost of which will reach US\$25.5 billion, provides for building a natural gas liquefaction plant with a total capacity of 19.8 million tonnes (the first line is planned to be put into operation in 2023, and the third in 2026)<sup>1</sup>. Novatek is also engaged in a terminal construction project in Vysotsk, Leningrad Oblast (with a production capacity of 660,000 tonnes) and is planning to build an LNG reloading terminal in Kamchatka<sup>2</sup>.

**No other Russian energy companies, apart from Novatek, have made progress in the implementation of large LNG projects.**

Furthermore, there are many facts indicating that the company is preparing for the implementation of its next large LNG projects; the deputy head of the company's management board announced during a gas conference held in May 2018 in Amsterdam that Novatek was planning to produce 70 million tonnes of liquefied natural gas annually by 2035.

The large LNG projects announced by other Russian energy companies (see Appendix 1) – some of which were announced already in the first decade of this century – have not yet moved beyond the planning stage. Although Gazprom have been conducting talks with foreign partners concerning the implementation of joint projects over the past few years, the only effect is initial arrangements. A memorandum on the implementation of the Baltic LNG project was signed with Shell in 2017; the agreements concerning the construction of the third production line as part of the Sakhalin 2 project (last signed in 2015) are also non-binding. Even

though a so-called 'final investment decision' on the construction of the Vladivostok LNG terminal was passed in February 2013, this project has in fact been frozen<sup>3</sup>. Gazprom is, in turn, implementing small projects in the liquefied natural gas sector, mainly in Russia. Kriogaz, a company controlled by Gazprombank, has built small LNG terminals in Pskov (an annual production capacity of 23,000 tonnes) and Kingisepp (10,000 tonnes annually). Terminals in Petrozavodsk (100,000 tonnes annually), Kaliningrad (150,000 tonnes annually) and in Vysotsk port<sup>4</sup> in Leningrad Oblast (660,000 tonnes annually) are under construction. Small-scale terminals are built mainly for the purpose of ship bunkering. In addition to this, Gazprom is building an export terminal in Leningrad Oblast that will be used to export gas to Kaliningrad, and a regasification terminal in Kaliningrad Oblast<sup>5</sup>. In turn, in December 2017, it signed an agreement concerning the construction of a small regasification terminal in Republika Srpska (Bosnia and Herzegovina).

Rosneft's plans also remain unfulfilled. Russia's largest oil company which has intensely lobbied to be granted the right to export gas in liquefied form<sup>6</sup>, has not even made investment

<sup>3</sup> The main reason has been Russia's unsuccessful attempts to attract foreign investors (China and Japan). In turn, Gazprom would find it difficult to implement this expensive project by itself (its estimated budget is around US\$10 billion), taking into account both the sanctions (Gazprombank, on which sanctions have been imposed, was planned to be one of the main sources of funding) and other investment priorities. Apart from this, the project was also frozen due to the fall of gas prices on the Asian market, visible especially from the middle of 2014 to the first half of 2017. Although Gazprom announced in July 2017 that the project would be implemented as a small-scale terminal, no details of the investment have been presented so far.

<sup>4</sup> In July 2017, a 51% stake in the project was taken over by Novatek.

<sup>5</sup> The investment finalisation deadline has been shifted from December 2017 to December 2018.

<sup>6</sup> Its lobbying efforts ended in success in November 2013, when the act liberalising the rules of gas export in the section concerning LNG was adopted, de facto granting the export right to two entities, apart from Gazprom: Rosneft and Novatek. For more details, see: S. Kardaś, *A feigned liberalisation: Russia is restricting Gazprom's monopoly on exports*, 'OSW Commentary', 28 November 2013; <https://www.osw.waw.pl/en/publikacje/osw-commentary/2013-11-28/a-feigned-liberalisation-russia-restricting-gazproms-monopoly>

<sup>1</sup> «НОВАТЭК» и «Тоталь» становятся партнерами по проекту «Арктик СПГ 2», 24 May 2018, [http://www.novatek.ru/ru/press/releases/index.php?id\\_4=2443](http://www.novatek.ru/ru/press/releases/index.php?id_4=2443)

<sup>2</sup> An agreement with the government of Kamchatka Krai was signed in October 2017. The estimated cost of the terminal's construction is US\$1–1.5 billion, and its reloading capacity is expected to reach 20 million tonnes annually. The investment is planned to be finalised in 2023.

decisions as regards its plans to build an export terminal in the Far East (the so-called Far East LNG) or concerning the implementation of the Pechora LNG project.

Given Gazprom's investment plans in which the projects of building the Nord Stream 2, Turkish Stream and Power of Siberia gas pipelines are given top priority, the implementation of any large LNG project seems rather unrealistic. Sanctions, especially those imposed by the USA, are an additional problem because they impede the implementation of the plan to build the third production line of the natural gas liquefaction plant as part of the Sakhalin 2 project announced several years ago (US sanctions have been imposed on the Yuzhno-Kirinskoye field which was to serve as the project's raw material base).

The situation with Rosneft is similar, as it has not been implementing its LNG project in the Far East not only due to other investment priorities (asset acquisitions on the internal market, projects in India, Indonesia and Venezuela) but also as a result of the restrictions resulting from sanctions. The Far East LNG project was to be implemented as a joint venture with the US company ExxonMobil which, however, suspended its co-operation with the Russian company after the introduction of the sanctions regime. Another problem in the case of Rosneft is the lack of access to transport infrastructure in the Far East, which has been the subject of long-lasting disputes with Gazprom.

### **The privileged position of Novatek and the company's costly successes in the LNG sector**

The close social and business links between the company's owners and the Kremlin are the main reason why Novatek has a privileged position in the Russian energy sector. This concerns above all Gennady Timchenko, one of the key owners

of the company<sup>7</sup>, who is a close friend of the Russian president<sup>8</sup>. During Vladimir Putin's rule he has become one of the most influential people in the Russian energy sector; until March 2014, he co-owned the trader firm Gunvor, which in the first decade of this century accounted for the sale of around 40% of Russian oil on foreign markets. Stroytransgaz, a company controlled by Timchenko, is implementing lucrative infrastructural investments in the energy sector (including the Baltic Pipeline System – 2 oil pipeline or Power of Siberia gas pipeline). Proof of the businessman's high position in the Russian business elite may be found in the fact that he has been placed on the US sanction list created in connection with the Russian aggression on Ukraine.

### **Novatek's privileged position is a consequence of the close links existing between the company's owners and the Kremlin.**

At the same time, Novatek's expansion in the LNG sector is a very high expense for the state budget. One example of this is above all the Yamal LNG project, the implementation of which – with a slight delay (the first line was launched one year later than planned) – has been possible due to the preferential conditions it was offered. Firstly, for twelve years since the terminal launch, the consortium will be exempted from extraction tax (NDPI) and export duties. The consortium will also pay a preferential income tax (13.5%) by the time its

<sup>7</sup> Timchenko exercises his rights as the owner via the Volga Group holding which holds a 23.49% stake in Novatek. The largest stake in the company is held by Leonid Mikhelson (24.76%); the remaining shares are owned by Total (18.9%), Gazprom (9.99%) and small shareholders.

<sup>8</sup> Gennady Timchenko denies Putin links made him one of Russia's top oligarchs; 'The Guardian', <https://www.theguardian.com/world/2014/mar/21/oligarch-timchenko-denies-putin-links-us-blacklist-sanctions>

total output has reached 250 billion m<sup>3</sup> of gas, for a maximum of twelve years. The project will also be exempted from import duty and VAT on equipment, an unprecedented solution in the Russian Federation. Apart from this, Novatek has been exempted from paying taxes for twelve years to the budget of the Yamalo-Nenets Autonomous Okrug (exemption from tax on real estate and movable assets located in the territory of the okrug which are used in the process of gas extraction or liquefaction). Secondly, the project was one of the few to have received support from the National Welfare Fund since the imposition of the sanctions; it was allocated for the redemption of 15-year bonds issued by Yamal LNG (worth 150 billion roubles, i.e. around US\$2.36 billion according to the exchange rate applicable in 2015). The bonds were redeemed in two instalments: at 75 billion roubles each in February and No-

**Regardless of the recent increase in Novatek's activity in the LNG sector, it will be difficult to achieve the ambitious strategic goals set by the state in this area.**

vember 2015. Thirdly, the consortium received the fields that will be used to expand the project's raw material base from the government already in 2011. The total resources of the four production centres received: Severo-Obstkoye and Vostochno-Tambeyskoye (both offshore fields) and Utrenneye and Geofizicheskoye (both on the Gydan Peninsula) reach 978.6 billion m<sup>3</sup> of gas (confirmed resources); according to estimates, the total resources of these fields are almost twice as large, reaching around 1.76 trillion m<sup>3</sup> of gas and 640 million tonnes of oil and condensate. Natural gas from the Utrenneye and Geofizicheskoye fields will be supplied to Gazprom's system, while Yamal LNG will receive gas from the Tambey group

owned by Gazprom: the Severo-Tambeyskoye, Zapadno-Tambeyskoye and Tasiyskoye fields. Even though representatives of the company's management have announced that they will not apply for state support for the Arctic LNG project, partly due to the risk of being included into the US sanctions, it cannot be ruled out that the project will receive some privileges. The Russian media dealing with this sector suggested already in spring 2017 that tax and customs allowances similar to those offered to Yamal LNG might also be applied in the case of this project.

Besides, state support may turn out to be the necessary condition to expand the circle of foreign investors. Interest in participation in this project has been expressed by Japanese, Korean and Chinese firms<sup>9</sup>. However, there is a lot to suggest that, given the continuing US and European sanctions imposed on Russia, they expect guarantees that will minimise the risk of capital engagement. Chinese banks decided to offer financial support to the Yamal LNG project after many months of negotiations and political arrangements between the governments of Russia and China as late as April 2016 (Novatek assumed that it would be able to close the issues concerning the project financing model by June 2014). In turn, Japanese companies have not decided – despite Russian proposals – to take part in the Yamal LNG project, and the Japanese bank JBIC granted the consortium a loan of 200 million euros only in December 2016 after it had been given guarantees by Italian and French credit agencies (SACE and COFACE, respectively).

<sup>9</sup> So far Novatek has concluded a few unbinding arrangements providing for Asian companies engagement in Arctic LNG 2 project: in December 2016 with the Japanese companies Mitsui, Mitsubishi and Marubeni; on 1 November 2017 with the Chinese company CNPC; on 22 June 2018 with Korean company Kogas.

## Novatek's activity versus state strategy in exports...

There is much to suggest that the state supports Novatek's projects in the hope that this will help it to at least in part make up for the backwardness as regards the implementation of the goals of the external gas strategy in the LNG sector. It was indicated already in the General Scheme of Gas Industry Development until 2030 adopted in 2008 that it would be possible to produce between 15 and 20 million tonnes of LNG in 2015, 50–60 million tonnes in 2020, and 60–82 million tonnes after 2025<sup>10</sup>.

**The state also seems to be favouring Novatek as a means of balancing the interests of the various groups in the Russian energy sector.**

However, in practice, Novatek's state-supported activity may turn out to be insufficient to achieve the key goal, namely increasing Russia's share in global LNG trade to a level of 100–120 million tonnes in 2035<sup>11</sup>. Currently Russia's share in the global LNG market is around 4%. In addition to exports effected as part of the Sakhalin 2 project (for detailed data, see Appendix II) and supplies launched as part of the Yamal LNG project, Russian firms are present on the global market mainly through short- and Sakhalin 2 project (for detailed data, see Appendix II) and supplies launched as part of the Yamal LNG project, Russian firms are present on the global market mainly through short- and medium-

term contracts covering small volumes<sup>12</sup>. While Novatek managed to sign long-term contracts under which gas originating from the Yamal LNG project will be exported (see Appendix 3), no contracts have been signed in the case of the Arctic LNG project as yet. The company will likely launch negotiations to this effect not earlier than after 2020, but this may mean tough talks with potential contractors, given the intensifying competition among exporters. Therefore, it is unclear to which markets the gas produced as part of the project would be supplied.

The growing competition from other liquefied natural gas producers is a serious challenge to Russia. Taking into account the timely launch of the three production lines as part of the Yamal LNG project, the total Russian production capacity in 2020 will reach around 27.5–30 million tonnes. For comparison, Qatar, currently the

<sup>10</sup> *Генеральная схема развития газовой отрасли на период до 2030 года*; <http://www.energyland.info/files/library/112008/7579b56758481da282dd7e0a4d-e05fd1.pdf>

<sup>11</sup> *Россия строит планы по захвату мирового рынка СПГ*; 30 May 2018, <https://ru.reuters.com/article/business-News/idRUKCN1IW0S3-ORUBS>

<sup>12</sup> Gazprom became active in LNG trade in 2005. In the first four years, the total sales volume reached 1.2 million tonnes (around 1.7 bcm). A separate company, Gazprom Global LNG Limited, was established in August 2008. In the following years, though, this share was growing mainly owing to the launch of the natural gas liquefaction plant as part of the Sakhalin 2 project. In the ensuing years the total LNG sales volume in the case of Gazprom was low: 1–2.3 million tonnes annually (1.82 million tonnes in 2010, where as much as 1.6 million tonnes was gas originating from the Sakhalin 2 project; 2.3 million tonnes in 2011, including 0.96 million tonnes from the Sakhalin 2 project; around 2 million tonnes in 2014, around half of which originated from the Sakhalin 2 project and half was bought from the gas market via Gazprom Marketing & Trading Limited (GM&T), which is a subsidiary of Gazprom.

Gazprom has signed new LNG supply contracts over the past few years. In 2012, GM&T signed a 20-year contract with the Indian firm Gail India under which 2.5 million tonnes of LNG will be supplied annually starting from 2018–2019. Furthermore, on 27 October 2015, Gazprom Marketing & Trading Singapore (a subsidiary of GM&T) signed a 10-year contract with Pavilion Gas (a subsidiary of Singapore's Pavilion Energy) envisaging the sale of LNG to Asian markets. This deal does not state precisely when the supplies will start or what their volumes will be in individual years.

Rosneft's position on the LNG market is also marginal. In May 2016, the company carried out its first LNG supply ever; gas was supplied to Egypt on the basis of a contract signed by Rosneft and the Egyptian company EGAS on 27 August 2015. In turn, on 25 May 2018 in Saint Petersburg, Rosneft signed a 12-year contract with the Ghana National Petroleum Corporation (GNPC) covering annual supplies of 1.7 million tonnes.

world's largest liquefied natural gas producer, will be able to produce around 100 million tonnes of LNG annually, the USA around 77 million tonnes, and Australia around 83 million tonnes.

### **... and on the domestic market**

There is much to indicate that state support for Novatek in developing the LNG project is also aimed at balancing the influence of various interest groups in the Russian energy sector. One of the key points of dispute is the reform of the Russian gas sector, including the demand to liquidate or limit Gazprom's monopoly on pipeline gas exports expressed by so-called 'independent gas producers' (Novatek, Rosneft). Although President Putin ordered the government to develop proposals for resolving this issue during a meeting of the Presidential Commission for Strategic Development of the Fuel and Energy Sector and Environmental Security in June 2014, no variants have been presented so far.

The recognition of Novatek's dominant role in the LNG sector (one expression of which is the political, economic and administrative support for the projects implemented by the company) may be used by the government as an argument for maintaining Gazprom's privileged position in pipeline gas exports. Gazprom has already raised the issue of the risk linked to potential competition on foreign markets between liquefied natural gas and natural gas supplied via pipelines. In a special letter sent to the ministry for energy in spring this year, Gazprom also insisted that the state should take such administrative measures that would exclude competition between Russian entities on external gas markets. In the case of Rosneft, which is also demanding curbs on Gazprom's monopoly but which has not received state support for its own LNG projects, one benefit could be the government's 'green light' for a further consolidation of influence in the oil sector.



## APPENDIX 1

### Russian LNG projects in 2005–2017

	Project leader (stake)	Name	Foreign partners and their stakes	Production capacity	Launch date	Comments
In operation	Gazprom (50% plus 1 share)	Sakhalin 2	Mitsui – 12.5% (Japan) Mitsubishi – 10% (Japan) Shell – 27.5% minus 1 share (United Kingdom/Netherlands)	10.9 million tonnes	February 2009	The third production line of the natural gas liquefaction plant as part of the Sakhalin 2 project is expected to be put into operation in 2022 (full capacity 5 million tonnes annually in 2023), even though the final investment decision concerning this matter has not been made yet (implementation estimated cost: US\$5-7.4 billion).
	Novatek (50,1%)	Yamal LNG	Total – 20% (France) CNPC – 20% (China) Silk Road Fund – 9.9% (China)	16.5 million tonnes	2017 Full capacity 2018/2019	Novatek is planning to build the fourth production line with a capacity of 1 million tonnes by 2019
In progress	Novatek	Arctic LNG 2	Total (France)	Target 19.8 million tonnes	2023 Full capacity 2026	Talks on attracting new partners and the financing model are underway
Planned	Gazprom	Vladivostok LNG	-	2018/2019	2018 Full capacity 2020	Frozen; the estimated initial project implementation cost was US\$12 billion
		Baltic LNG	potentially Shell (Netherlands)	Target 10-15 million tonnes	2021	Framework agreements with Shell have been signed,; the terminal is to be located in Ust-Luga, its estimated construction cost is US\$10 billion
	Rosneft'	Far East LNG	potentially ExxonMobil (USA)	6,2 mln ton	2025	In planning stage; The project implementation cost was estimated at US\$ 15.3 billion
		Pechora LNG	-	Target 4-8 million tonnes	-	Frozen

## APPENDIX 2

### LNG production and exports from Russia in 2009–2016 (in million tonnes)

Year	Total exports	Exports according to directions								
		Japan	South Korea	Taiwan	China	Thailand	Kuwait	India	Netherlands	UK
2009	5,00	2,84	1,02	0,12	0,19	-	0,31	0,51	-	-
2010	10,44	6,29	3,39	0,51	0,38	-	0,07	-	-	-
2011	10,49	7,18	2,82	0,18	0,24	0,06	-	-	-	-
2012	10,92	8,31	2,17	0,06	0,38	-	-	-	-	-
2013	10,76	8,73	1,96	0,06	-	-	-	-	-	-
2014	10,57	8,32	2,00	0,06	0,13	0,06	-	-	-	-
2015	10,92	7,78	2,69	0,26	0,19	-	-	-	-	-
2016	10,84	7,38	1,92	1,29	0,26	-	-	-	-	-
2017	11,14	6,96	1,93	1,65	0,46	-	-	-	0,07	0,07

Author's own calculations on the basis of data published by the World LNG Report in 2010–2017

## APPENDIX 3

### LNG export contracts using supplies from the Yamal LNG project

- a 25-year contract covering supplies of 2.5 million tonnes of natural gas originating from the Yamal LNG project to Spain (the contractor is the Spanish company Gas Natural Fenosa; current name Naturgy);
- a 24-year contract covering supplies of 4 million tonnes of natural gas originating from the project to the French market (the contractor is the French company Total);
- a 23-year contract with Novatek Gas & Power (Novatek's subsidiary) covering supplies of 2.7 million tonnes (of this, 1 million tonnes annually will be supplied to the French firm Engie);
- a 20-year contract with the Chinese firm PetroChina (a subsidiary of CNPC) covering supplies of 3 million tonnes of gas to China annually;
- a 20-year contract with Gazprom Marketing & Trading Singapore covering supplies of 3 million tonnes of gas annually (Gazprom will use the gas for the needs of implementing the contract for LNG supplies to India).

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