

## Natural resources on the Russian continental shelf: Foreign investors sought... on Russian terms

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In recent weeks, Rosneft, a Russian state-owned oil company, has signed co-operation agreements with three Western corporations: America's ExxonMobil, Italy's Eni, and Norway's Statoil. In exchange for access to Russian oil fields on the continental shelf as minority shareholders, these Western investors will finance and carry out exploration there. They will also offer to Rosneft technology transfer, staff exchange and the purchase of shares in their assets outside Russia (for example in the North Sea or in South America).

Rosneft's deals with Western energy companies prove that the Russian government is resuming the policy of a controlled opening-up of the Russian energy sectors to foreign investors which it initiated in 2006. So far, investors have been given access to the Russian electric energy sector and some onshore gas fields. The agreements which have been signed so far also allow them to work on the Russian continental shelf. This process is being closely supervised by the Russian government, which has enabled the Kremlin to maintain full control of this sector. The primary goal of this policy is to attract modern technologies and capital to Russia and to gain access to foreign assets since this will help Russian corporations to reinforce their positions in international markets.

The signing of the above agreements does not guarantee that production will commence. These are a high-risk projects. It remains uncertain whether crude can be extracted from those fields and whether its development will be cost-effective. According to estimates, the Russian Arctic shelf holds approximately 113 billion tonnes of hydrocarbons. The development of these fields, including building any necessary infrastructure, may consume over US\$500 billion within 30 years. Furthermore, the legal regulations currently in force in Russia do not guarantee that foreign investors will have a share in the output from these fields. Without foreign support, Russian companies are unlikely to cope with such technologically complicated and extremely expensive investments. In the most optimistic scenario, the oil production in the Russian Arctic may commence in fifteen to twenty years at the earliest.

## The terms of Rosneft's deals with the Western companies

On 16 April, Rosneft and ExxonMobil signed an agreement concerning the exploration of the offshore fields on the Kara Sea and the Black Sea. Rosneft entered into a similar agreement with Eni on 25 April (concerning the fields on the Barents Sea and the Black Sea), and with Statoil on 5 May (concerning the fields on the Barents Sea and the Sea of Okhotsk; see map). All three agreements are based on a similar pattern. Rosneft will form joint ventures for each of the fields with foreign investors, who will hold a minority stake (33.3%) in such joint ventures. Licences for the development of these fields will still be owned by Rosneft. The primary aim of the joint ventures will be to explore and prepare the field for production. This work will be financed by the foreign investors (it is estimated that they will spend between US\$2 and 3 billion each; for more information, see Appendix). Furthermore, Rosneft has also gained

**ExxonMobil, Eni and Statoil will explore natural resources in the Russian Arctic, in exchange for which Rosneft will gain access to foreign assets.**

access to minority stakes in projects being carried out by its Western partners in other countries (for example, in South America, Africa or in the North Sea), and thus the opportunity to become familiar with their technologies and to train staff.

However it is still unknown, whether production will be possible in these fields. The experience of Chevron, who withdrew from investment in the exploration of the field near Tuapse (Shatsky Ridge) in the Black Sea in 2011, having found it to be unprofitable, shows that the prospects of the fields remain uncertain. Chevron was replaced by Italy's Eni in April this year. Furthermore, the development of these fields will require vast financial outlays. According to current estimates, the projects to be implemented with Statoil on the Barents Sea may consume between US\$35 and 40 billion, and on the Sea of Okhotsk between US\$30 and 60 billion (see Appendix). The partners will have to negotiate the conditions of the next stage of investment. Some doubts have also arisen over Rosneft's capability and readiness to finance the investment in proportion to its shares. Since the crisis in 2008, capital has started to flow out of Russia (US\$84 billion in 2011 as compared to US\$34 billion in 2010). This suggests that the conditions of doing business and investment safety in Russia are also not accepted by local entrepreneurs, who prefer to invest in foreign markets instead. One manifestation of this is the increasing activity of Russian energy corporations abroad which has been observed in the last two years.

## Foreign investors in the Russian energy sector

The fact that Rosneft has signed the agreements with ExxonMobil, Eni and Statoil means the Russian government is continuing its policy of a controlled opening up of the Russian energy sector to foreign investors.

**The fact that the agreements have been signed means that the policy of a controlled opening up of the Russian energy sector to foreign investors will continue.**

In 2006–2007 (during Vladimir Putin's second term as president), the Russian government decided to privatise Rosneft's minority stakes and to selectively grant some foreign companies access to the production sector (for example, shares in the Yuzhno-Russkoye gas field were purchased by Germany's BASF) and to privatise a significant part of the power generation sector.

However, the increasing presence of foreign investors in the energy sector was halted in 2008 due to the financial crisis and the limited investment activity of global corporations.

High oil and gas prices over the past year have triggered a greater interest in investment in this sector. For this reason the Russian government resumed its policy of a partial opening up to foreign investors. In 2011, France's Total was given consent to acquire a minority stake in Novatek, Russia's largest private gas company. In August 2011, Rosneft signed a strategic partnership agreement with ExxonMobil, envisaging the development of Russian Arctic fields (the agreement signed on 16 April this year is a practical implementation of these declarations). Rosneft's entering into the three agreements concerning fields on the continental shelf in the past few weeks is another stage of this process.

Key Russian politicians – including Vladimir Putin, who was present on the occasion of all the major agreements being signed – have been directly engaged in establishing contact between Russian companies and their Western partners.

## The Russian government's approach to the development of the oil sector

The Russian government has been making efforts to make the Russian energy sector more attractive and to restrict the investment risk. For example, in April this year, Prime Minister Vladimir Putin signed an ordinance which envisages the introduction of special fiscal preferences for state-owned companies engaged in projects on the continental shelf. The preferences will include lifting export duty for the offshore fields and reducing the rate of the tax on natural resources to 5–15% (depending on the difficulty level of production). However, it is still unknown when these changes will become effective. The government has also decided to introduce a zero VAT rate and other allowances for imported equipment (which has no Russian equivalent) used on these fields.

**The present legislation pertaining to the energy sector prevents the Russian Arctic from being developed.**

The Russian government has still not announced any legal changes which would enable private investors to have real access crude. The legislation concerning natural resources currently in force restricts the possibilities for private companies to

acquire shares in licences for the development of offshore fields (as of 2008, the state-owned companies, Rosneft and Gazprom, are the only companies to have access to fields on the Russian continental shelf, with the exception of the Caspian Sea and the Sea of Azov). Despite the government's declarations, the conditions of doing business in Russia, including those related to the protection of private property and claiming one's rights in court, have not improved, and the corruption level has not been reduced.

## The goals of the controlled opening up in the energy sector

This policy of the Russian government means that Russia intends to capitalise on the high demand for hydrocarbons. In the opinion of specialists this will continue for the next few decades. High oil and gas prices (the current price of one barrel of oil is approximately US\$110) are contributing to increasing global investments in this sector (IHS CERA estimates that a total of US\$1.23 trillion will be invested in the energy sector across the world in 2012, and the investments will grow by more than 30% within the next four years). Furthermore, an increase in demand for hydrocarbons by approximately 25% by 2030 has been forecast for example by the International Energy Agency (IEA).

Russia, being one of the key oil and gas producers, does not wish to find itself outside the main trends. According to forecasts (for example by the IEA), oil production in Russia will begin to fall after 2015. The development of new fields, which is in most cases technologically complicated and very expensive, requires changes in the rules of operation in this sector.

The new resources are located in regions of Russia that are increasingly more difficult to access, including the Arctic shelf, where Russian companies have very limited experience (for example, Rosneft only holds a minority stake in the Sakhalin-1 project, where the main investor is ExxonMobil).

Additionally, through offering access for foreign partners to Russian resources on terms of the exchange of assets, Russian energy companies are gaining access to shares in projects outside Russia. This gives them the opportunity to become familiar with new technologies and to train their staff. They are also making their business international and reinforcing their position on global markets.

**Maintaining the Kremlin's control of the energy sector remains the overriding objective in the Russian policy of opening up to foreign investors.**

Furthermore, the Russian government expects that the development of the conti-

nenal shelf will help boost Russian industry, for example that part of the contracts for new platforms or ships will be awarded to Russian shipyards.

However, maintaining the Kremlin's control of the energy sector remains the overriding objective in the Russian policy of opening up to foreign investors. This sector is the foundation of the Russian economy. It generates the majority of budget and export revenues and thus determines to a great extent Russia's international position. At the same time it enables the redistribution of funds and allows people linked to the ruling class to amass private fortunes.

## Conclusions

1. Rosneft's deals with ExxonMobil, Eni and Statoil mark an important step towards the development of the Russian continental shelf but this does not mean it is a foregone conclusion that this venture will be successful. First it is necessary to explore these fields and to analyse the possibilities and the efficiency of production there. Then specific terms of co-operation must be agreed in the next phase of the project (development and production) that will be acceptable to all the parties and which will allow these investments worth billions of dollars to be financed. According to estimates, the first supplies of oil from the Arctic fields will be made in fifteen to twenty years' time at the earliest.

2. It is still unknown to what extent Rosneft will use the option of acquiring shares in the foreign assets of its partners. The details of these deals (including the price) are still to be agreed. It is also uncertain whether Rosneft will be ready for large investments in a situation where it is planning to develop its own fields. Nevertheless, it is doubtless that it will use some of these projects to gain experience, to train staff and above all to receive access to new technological solutions.

3. From the point of view of foreign investors, the agreements with Rosneft offer a chance for further co-operation, also in development of the fields, which would offer them access to Russian deposits and thus boost their economic indicators and improve their position on the stock exchange. The Russian part of the Arctic shelf is the largest area in the world which has not been explored in terms of the presence of deposits. Foreign companies are aware of the fact that Russian firms do not have the experience or technologies necessary for oil and gas production in the offshore fields by themselves. Access to new fields, given the high prices of raw materials and the increasing demand, is of key significance for these foreign companies. It is also worth noting that the conditions of investing in the energy sector in Russia as compared to other oil producers (for example in the Persian Gulf or in North Africa) may turn out to be competitive. Therefore, more deals concerning the exploration of the Russian Arctic by foreign investors may be expected in the immediate future.

4. For investment projects to be successful deep changes in the operation of the Russian energy sector are necessary (not only in the taxes imposed on this sector but also in the rules of access to the fields, etc.). However, it is unlikely that the Russian government will be able to overcome its fears of Russia being dominated by foreign investors (which Vladimir Putin wrote about in his article on the economy in April this year). He will thus decide to create such conditions for them to invest billions of dollars in Russia so that the money allocated to the oil sector will also contribute to the development of other industries, for example shipbuilding. At present, the law does not guarantee foreign companies clear rules of operation in Russia. The direct agreements which receive strong political support (including from Vladimir Putin) also turn out to be an insufficient guarantee for successful co-operation (this was proven by the break-up of co-operation between Rosneft and BP in 2011).

5. Rosneft's deals with foreign investors and the fact that they are promoted personally by Vladimir Putin also show that the energy sector is and will remain the key sector of the Russian economy for the present ruling class. The diversification of the foundations of the Russian economic development will remain at the level of declarations. While oil prices remain high, which guarantees that the budget goals are fulfilled and the welfare state functions (which a significant part of Russian public expect from their government), the government will not decide to carry out any radical economic reforms that could not only limit its control of the capital flow in the energy sector but could also give rise to real economic and political competition in Russia.

## MAP

### Rosneft's Western partners on the Russian continental shelf



## APPENDIX

### Rosneft's agreements with Western companies

| Western partners of Rosneft | Fields on the Russian continental shelf  | Estimated costs   | Assets offered outside Russia   | Additional comments   |
|-----------------------------|--|---|---|---|
| <b>ExxonMobil</b>           | Tuapse (the Black Sea); East-Prinovozemelsky (the Kara Sea)  | Exploration: US\$3.2 billion, Development: US\$200–300 billion  | 30% in the La Escalera Ranch project in West Texas (USA); 30% in 20 blocks in the western part of the Gulf of Mexico; 30% of the shares in a company which develops unconventional oil deposits in Alberta (Canada) | The co-operation envisages a technology and staff exchange. The creation of a technology centre in Saint Petersburg<br><br>The companies also signed an agreement on developing technologies for oil extraction from unconventional deposits in Western Siberia |
| <b>Eni</b>                  | Fedinsky and Tsentralno-Barentsevsky (the Barents Sea); West Black Sea (the Shatsky Ridge) (the Black Sea) | Exploration: US\$2 billion, Development: US\$100–125 billion  | North Africa, and in the future also America and part of Eni's European projects  | The US company Chevron withdrew from the project on the Black Sea in mid 2011   |
| <b>Statoil</b>              | Perseevsky (the Barents Sea) Kashevarovsky, Lisyansky, Magadan-1 (the Sea of Okhotsk)                      | Exploration: US\$2.5 billion Development: US\$35–40 billion, and in the Sea of Okhotsk: US\$30–60 billion | Several deposits in the North Sea and in the Norwegian part of the Barents Sea  | The partners will also jointly explore two Russian onshore fields: Severo-Komsomolsky in Western Siberia and unconventional oil deposits near Stavropol   |



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