Confrontation:
Russia, Short-Sighted Politics or Long-Term Strategy?

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1 CHALLENGES FOR RUSSIA

2 NEW RUSSIAN EXTERNAL ENERGY POLICY

3 POTENTIAL CONFLICTS

Major new challenges for the Russian energy sector

Domestic challenges:

- Stagnation of the Russian economy slows down domestic energy demand. Lower investment availability and frozen energy prices cut investment programmes in the energy sector slowing don its renovation
- Institutional framework in the energy sector has reached unacceptable level of inefficiency (i.e. state-controlled companies – Rosneft and Gazprom)

Global challenges:

- Potential export revenues expectations are declining :
  - Stagnant oil and gas demand, changing rules in the European energy sector (main market for Russia)
  - Main demand growth moves to Asia, where Russian presence is very limited for the next 5-7 years
  - New hydrocarbon suppliers (shale from the U.S., Iran, Iraq, Brazil, Australia, East Africa, etc.)
  - Oil and gas prices declining trend until 2022-2025
- Geopolitical threats: new sanctions or even embargoes

Increasing confrontation and pressure on the Russia`s gas export strategy in 2014

European energy policy

- 3rd Energy Package
- EU diversification policy
- EU "Energy Union"
- EU and US pressure on the South Stream
- Falling EU gas demand
- EU anti-trust investigation

Global dynamics

- US shale gas revolution
- LNG oversupply
- Falling oil-indexed and spot prices

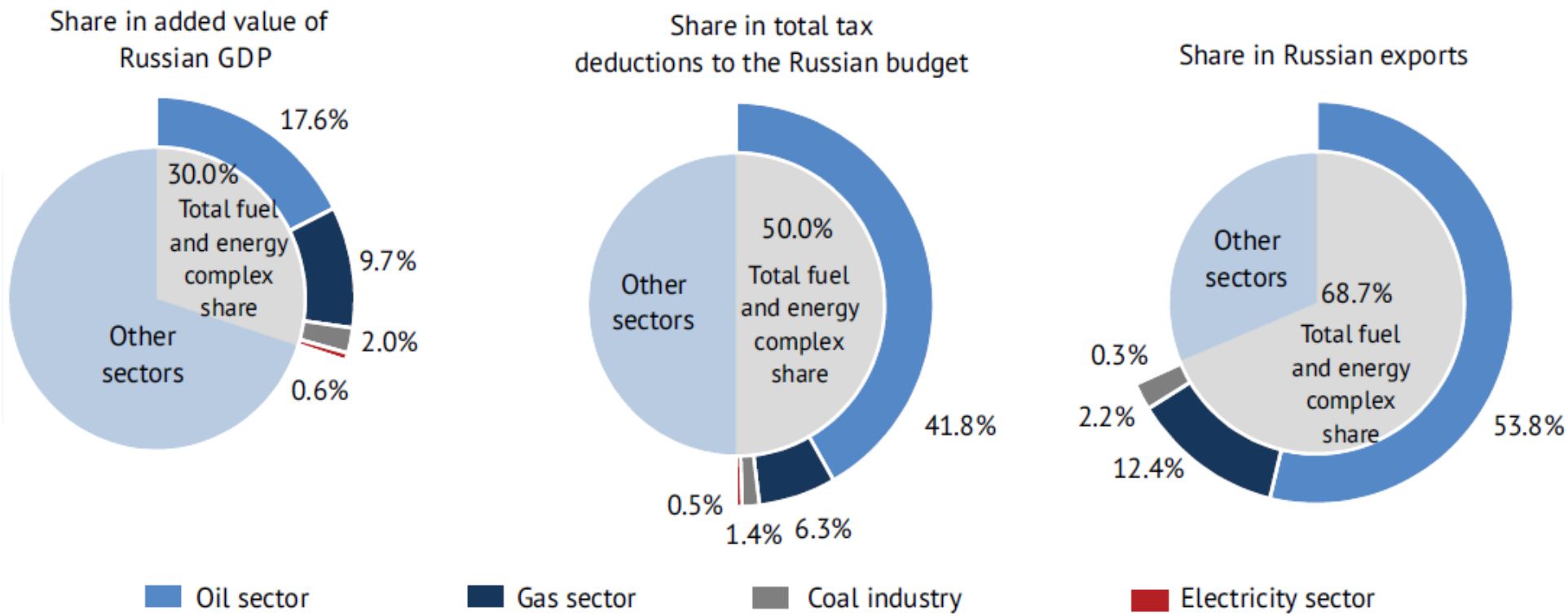
Politics

- Financial sanctions and capital unavailability
- Ukrainian crises and transit risks

→ Russian gas export strategy

The role of the energy sector for the national economy has reached its maximum…

Shares of energy sector in Russian GDP, exports and budget

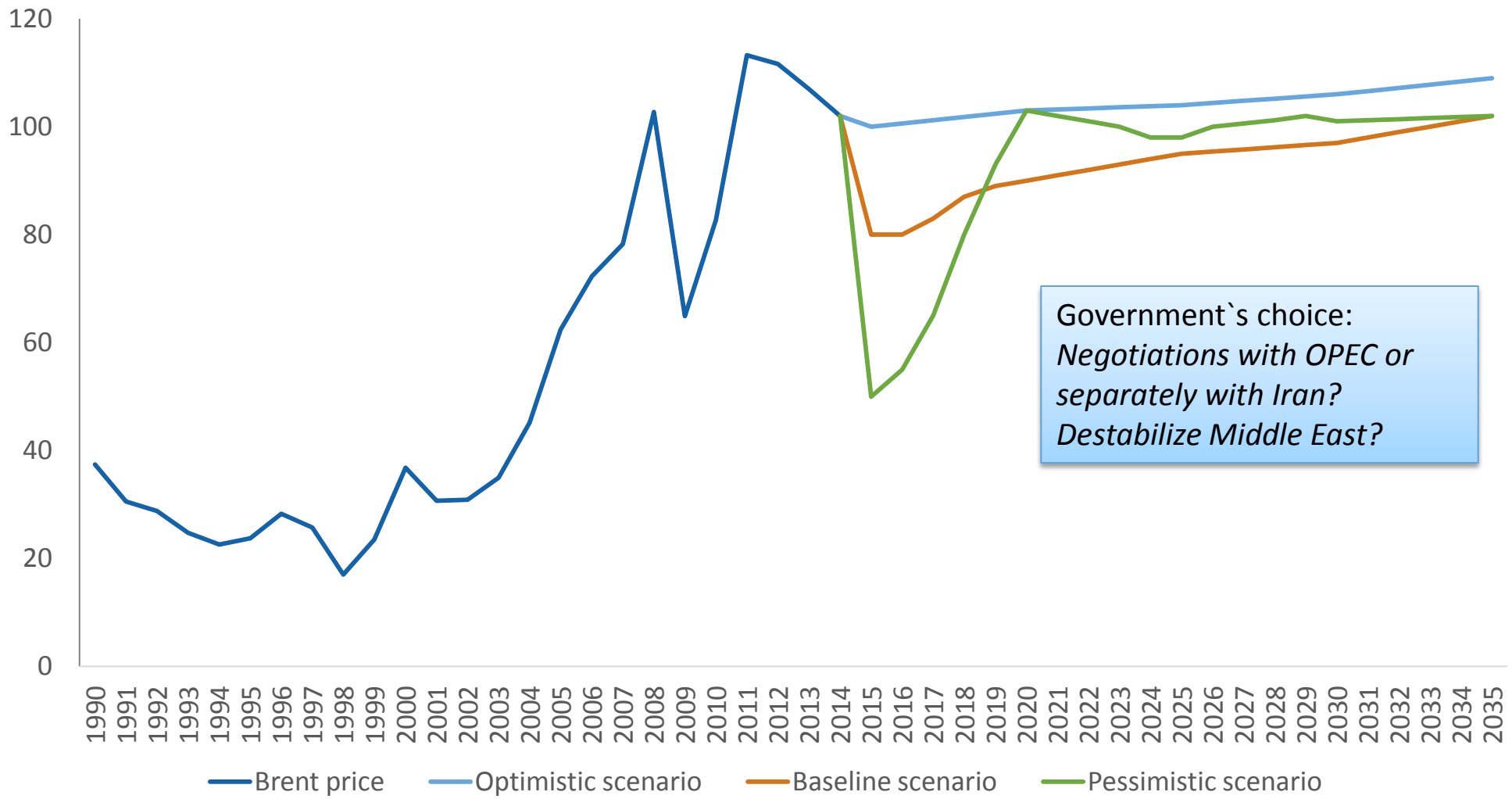


Source: Global and Russian Energy Outlook up to 2040. ERI RAS-AC. 2014.

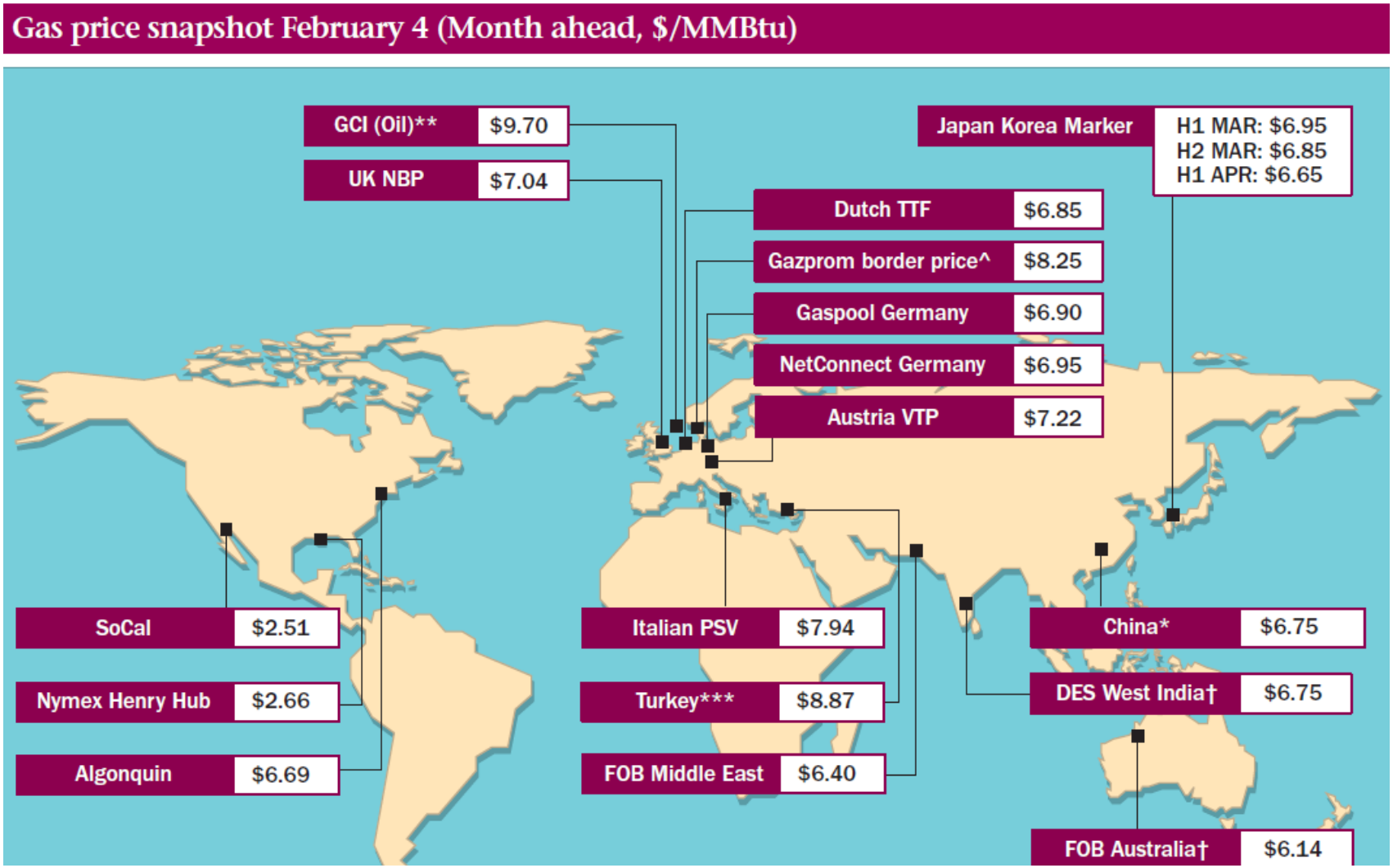
Is there life under sanctions?

- **Financial sanctions.** Russia is now facing unprecedented challenges related to the finance availability and access to the international loans. Chinese seem to become the major source of investments (but demand equity shares in return – see Vankor case).
- **Technological sanctions**. Sanctions create serious problems with access to the modern technologies. So far the sanction lists, adopted by the U.S. and EU, are not limiting significantly current operations, but they are seriously undermining future development (Arctic, shale oil).
- New sanction could be introduced as an answer to further deterioration of the Ukrainian situation.
- Increasing “patriotic mood” promotes and supports total import replacement, but it will take 5-7-10 years.
- Russian companies engagement in the European market is regarded as risky and thus reduced (see Lukoil case).
- Sanctions introduce additional pressure on the industry and population thus reducing their demand and purchasing ability (in addition to recession).

Oil prices are the most critical factor



Global gas price collapse, approaching 7$/Mbtu both in Europe and in Asia



Source: Platts

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Russia started its historical gas shift Eastwards

- Now there is clear urgent need for Russia to diversify its energy export markets:
  - There is no room for increase of Russian exports to Europe
  - Increasing competition (North American shale gas and oil, potential Iran, Iraq, Australia, Brazil entrance to the global markets)
  - For geopolitical reasons Europe is targeting to decrease dependence on Russian energy supplies
  - The sanctions target the finance and energy sectors, restricting some state firms' and banks' ability to raise financing
- North-East Asia seems to be the most attractive new energy market
  - Asian markets are demonstrating the highest growth rates even during the crises, and according to all projections, they will drive future global hydrocarbon demand growth
  - Lack of own energy resources (and problems with nuclear in Japan) make North-East Asian countries ideal, complimentary partners for Russia in the energy trade.
- Asian partners are regarded by Russia not only as a market, but also as a source of financing, technologies, equipment and even labor force. Russia is now promoting switching to roubles and RMB payments, which could mark a new stage in the whole Asian energy trade development.
- Creation of the new energy infrastructure in the Russian Eastern Siberia and the Far East is regarded as a tool to accelerate country`s economic growth, helping to form new industrial clusters based on the development of energy resource production and processing.

China is expanding its participation in the Russian upstream

- In 2005 Rosneft offered Sinopec 25.1% of shares in the **Veninskii block of Sakhalin-3** project.
- In August of 2006, Sinopec purchased from TNK-BP 96.86% of the shares of its subsidiary **Udmurtneft**, which produced 6.4 million tons in 2011, through the company Promleasing.
- In 2006 Rosneft and CNPC signed an agreement about the creation of a joint-venture **"Vostok Energy"** (Rosneft - 51%, CNPC - 49%). In the summer of 2007 “Vostok Energy” won licenses for two small deposits in Irkutsk oblast, located near the ESPO.
- In the course of **Rosneft's IPO**, CNPC acquired 0.6% of the state company's shares for $500 million.
- In October 2013, Rosneft and CNPC agreed to set up a joint venture for upstream developments in East Siberia, with Rosneft holding 51% and CNPC with the rest. The deal gives China access to the **Srednebotuobinsk field**, which has an estimated 2.05 million barrels of oil and equivalents in Siberia.
- Russian companies are also trying to move downstream in Asia, though so far success is very small. At the end of 2007 Rosneft (49%) and CNPC (51%) created the joint venture **"Chinese-Russian Eastern Petrochemical Company"** for the construction of a Chinese refinery with a capacity of 16 million tons in Tianjin, petrochemical complex and a network of 300 filling stations in the north of China. The cost of the refinery is estimated at $4.6 billion, initially it was planned to be commissioned by 2011. However, it took much longer because of disagreements on a number of issues, including the financing of the project, and the agreement was signed only in May 2014. According to the terms of the agreement signed in May 2014, CNPC and Rosneft expect the first production in 2020.
- In September 2014 it was announced that CNPC is to get up to 10% in Russia’s **Vankor oilfields**, Rosneft’s biggest production asset. The deal is very profitable for the Chinese since this is an already developed field, while it could allow Rosneft to raise up to 1$ billion to help manage its accumulated debt.

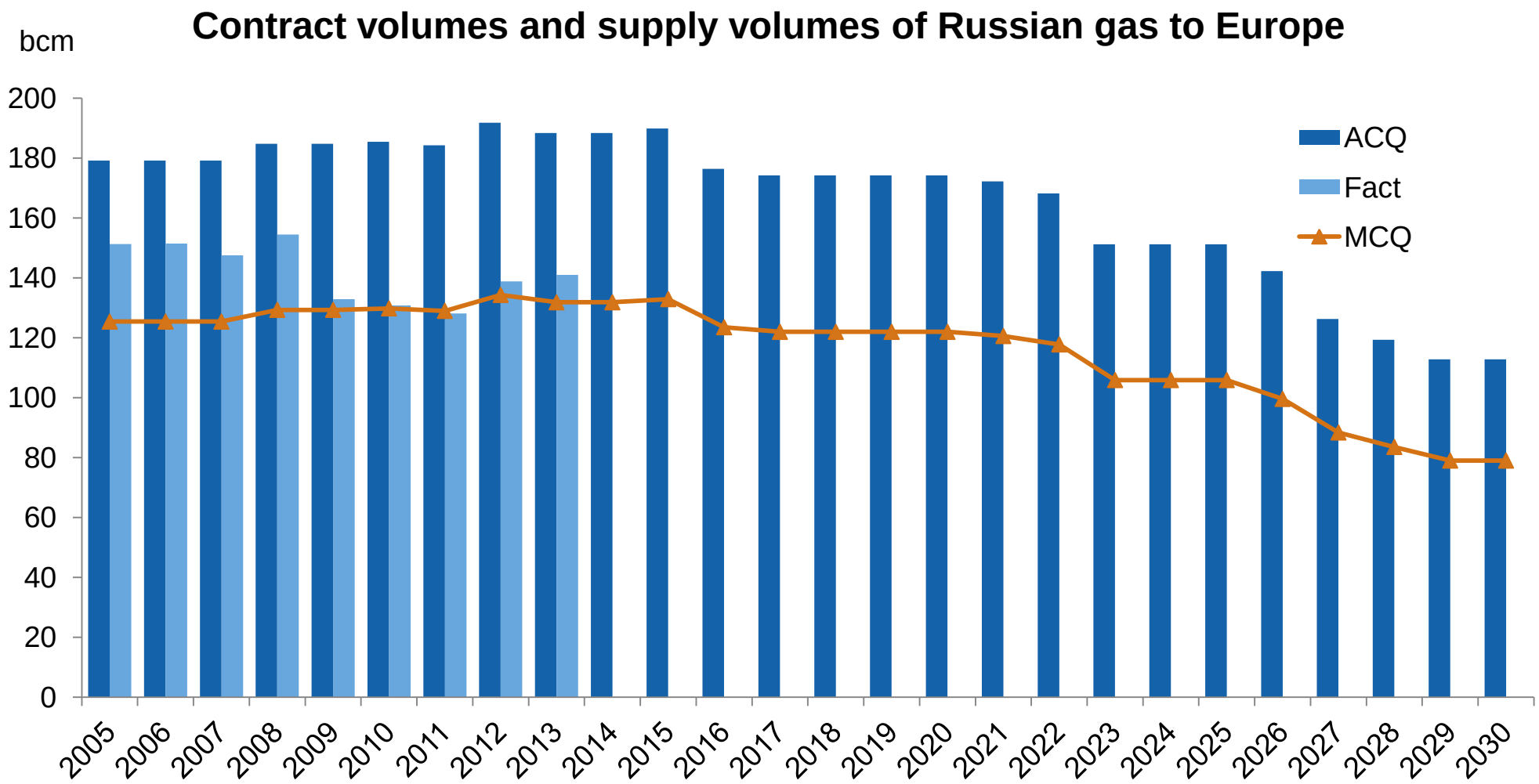
Oil exports to Asia are replacing European supplies

Source: Global and Russian Energy Outlook up to 2040. ERI RAS-AC. 2014.

Changing gas export strategy?

Old strategy	New strategy
❑ Expansion strategy in the “sellers` market” in Europe (based on the expectations of stable gas demand growth in Europe and low competition), cautious market assessment in Asia.	❑ Strategy of market niche protection in the “buyers` market” in Europe (where demand dynamics is disappointing, aggravated by the geopolitical tensions, while competition is supposed to increase) and expansion strategy in Asia.
❑ Gas supply on the basis of oil-linked LTCs with “take-or-pay” clauses.	❑ Increasing share of spot contracts, reduced oil indexation and “take-or-pay” clauses in the LTCs.
❑ Delivery points on the EU border (trying to move them further into EU territory). The strategy of moving downstream and gaining access to end users in the European countries, developing a large number of joint ventures, as well as involving itself in searching for European storage, transport and distribution assets.	❑ Moving delivery points to the Russian border and Turkey. The strategy of moving downstream and developing joint ventures is abandoned, as well as involving itself in searching for European storage, transport and distribution assets.
❑ Irreconcilable conflicts with Ukraine led to the appearance of strategies to bypass the transit countries by building transportation infrastructure in Europe (Nord and South Streams).	❑ Bypassing Ukraine is the political goal, but no more infrastructure investments on the EU territory.
❑ LNG – top priority	❑ Focus on pipeline gas

Existing long-term contracts guarantee stable sales volumes for Russia until at least 2022



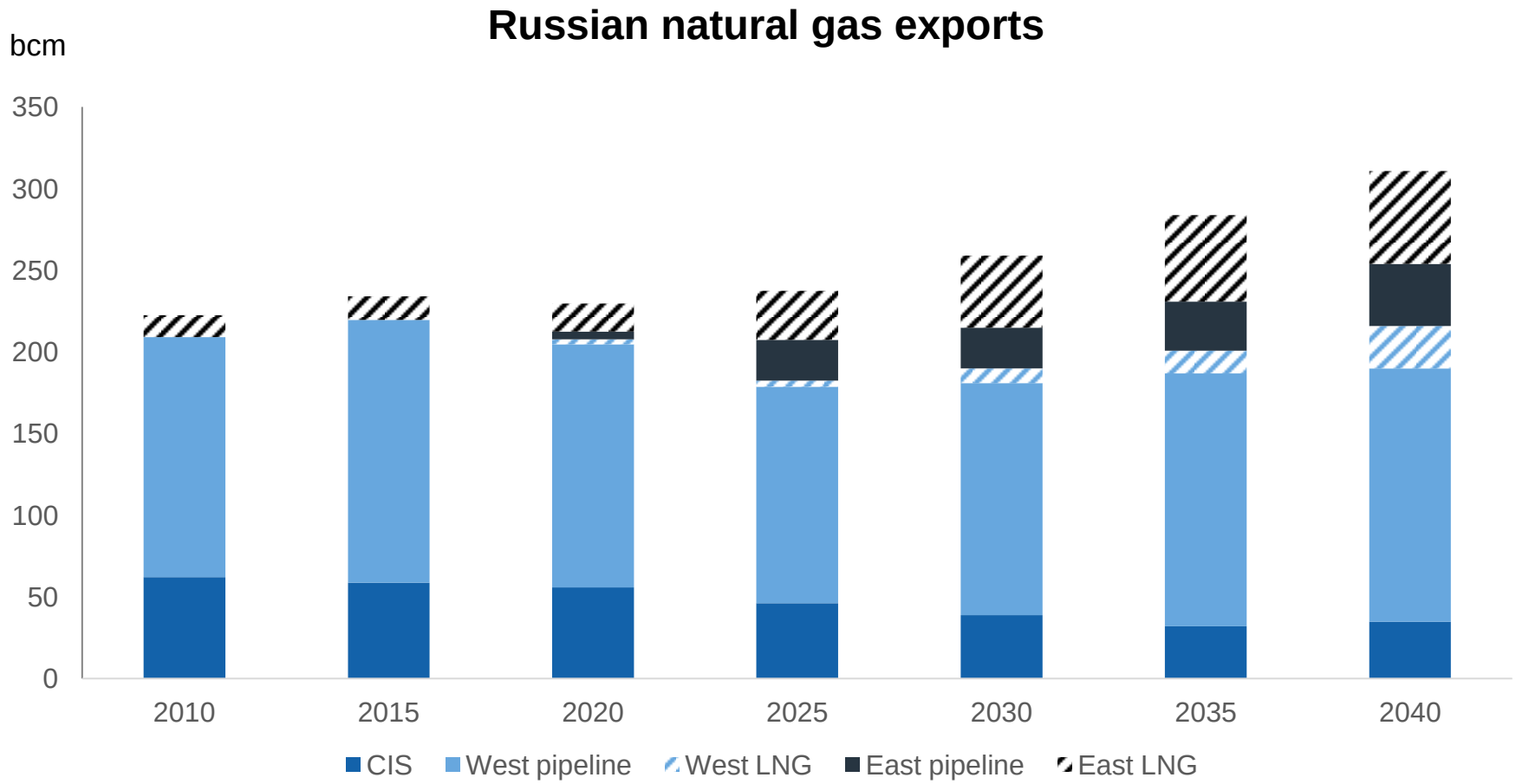
Sources: Cedigaz, NEXANT, Russian Custom Service, ERI RAS.

Chinese mega-deal

- In terms of diversification, Russia is focusing its commercial and diplomatic efforts on China, as shown by two recent landmark gas deals. The first, signed in May 2014, saw Russia agree to supply 38 bcm/y, starting in 2018, from currently undeveloped fields in eastern Siberia to China through “Power of Siberia.”
- The contract is linked to oil prices and has 'take-or-pay' clause.
- Contract price is not officially disclosed (Russian trade representative in China announced, that it it slightly higher than Central Asian gas price for China).
- With total amount of the 30 year long deal of $400 bln., average price was estimated at 370-380 $/mcm under 100 $/bbl oil, but much lower with the lower oil price.
- It seems that there is strong price review clause in the contract.
- $25 bln. were expected as a down payment from the Chinese side, but the deal failed.
- The deal will eventually give Gazprom flexibility in diversifying its customer list, but completion of this pipelines is set for 2019 and it will reach its full capacity only by 2025.

But despite that, the price set by pipeline deal between Russia and China undermines competitiveness of the Australian and US LNG in the Asia Pacific

Russia seems to remain the major European gas supplier at least for the next 10-15 years, while in Asia Russian (and Central Asian) pipeline gas could set a floor price for LNG supplies



The main increase in Russian gas exports (if LNG is allowed) will be to Asia, LNG export volumes are most uncertain. Russian gas export volume estimations are reviewed significantly downward (from 400 bcm to 250 bcm in the longer-term), but still remain the highest in the world.

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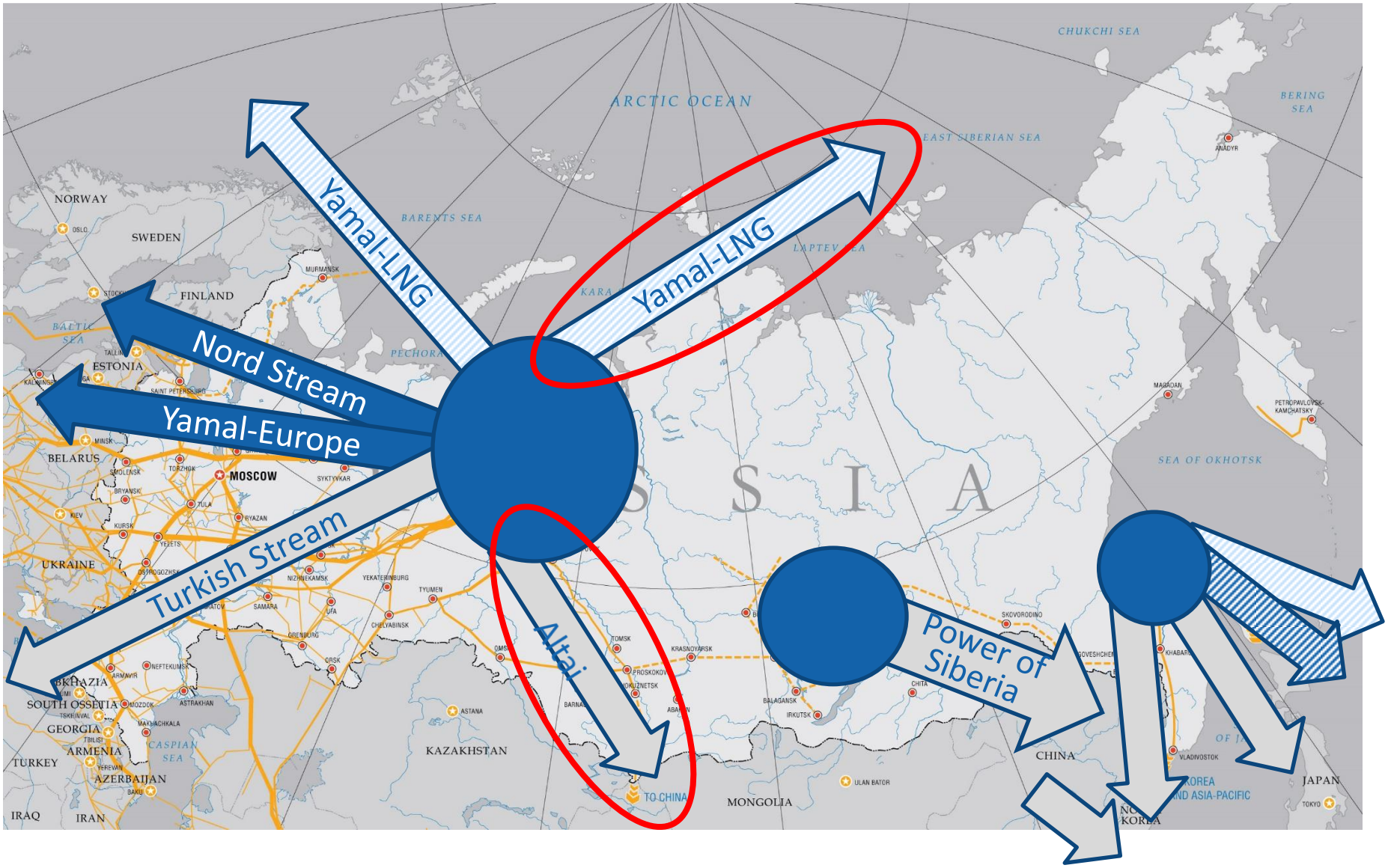
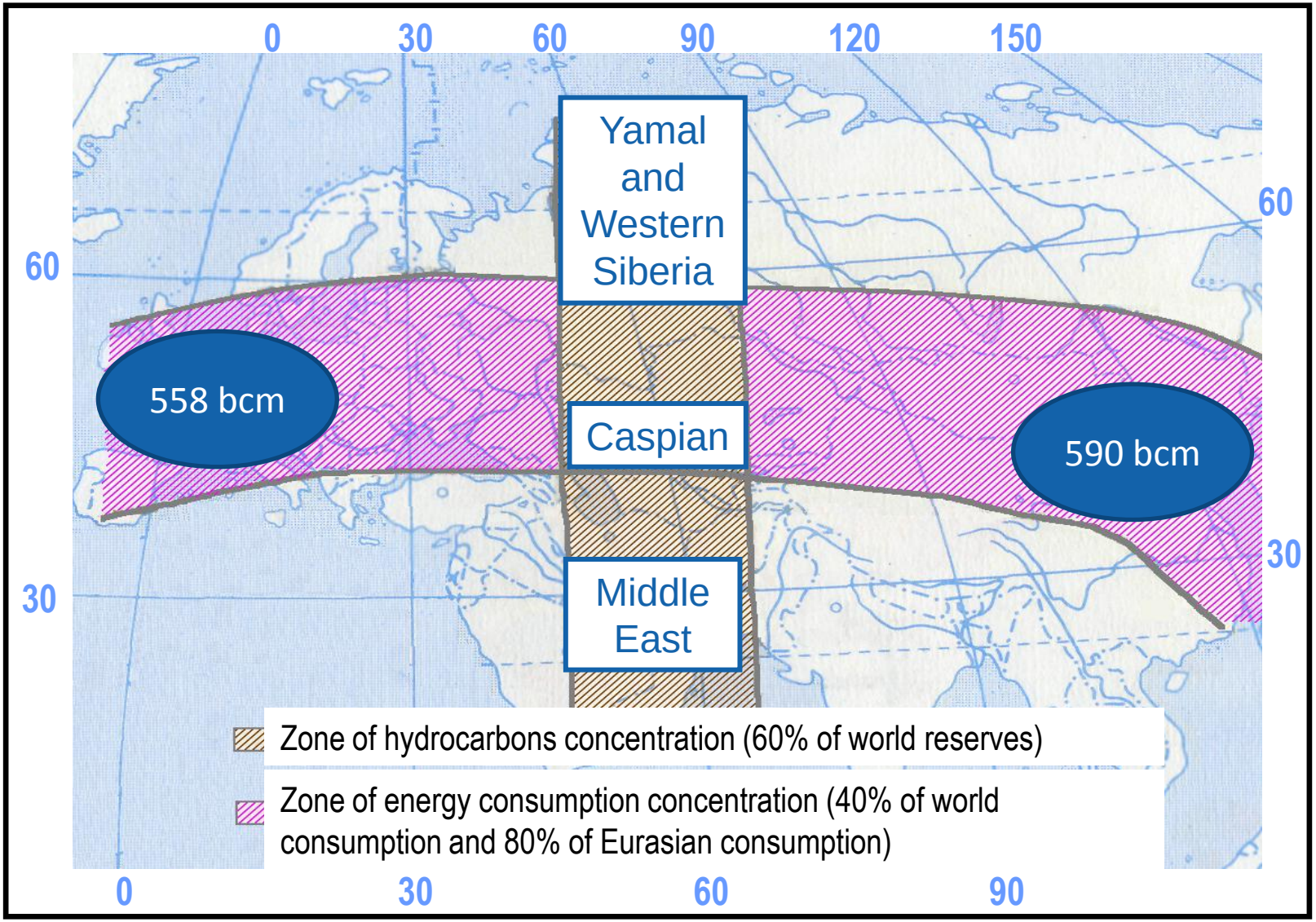
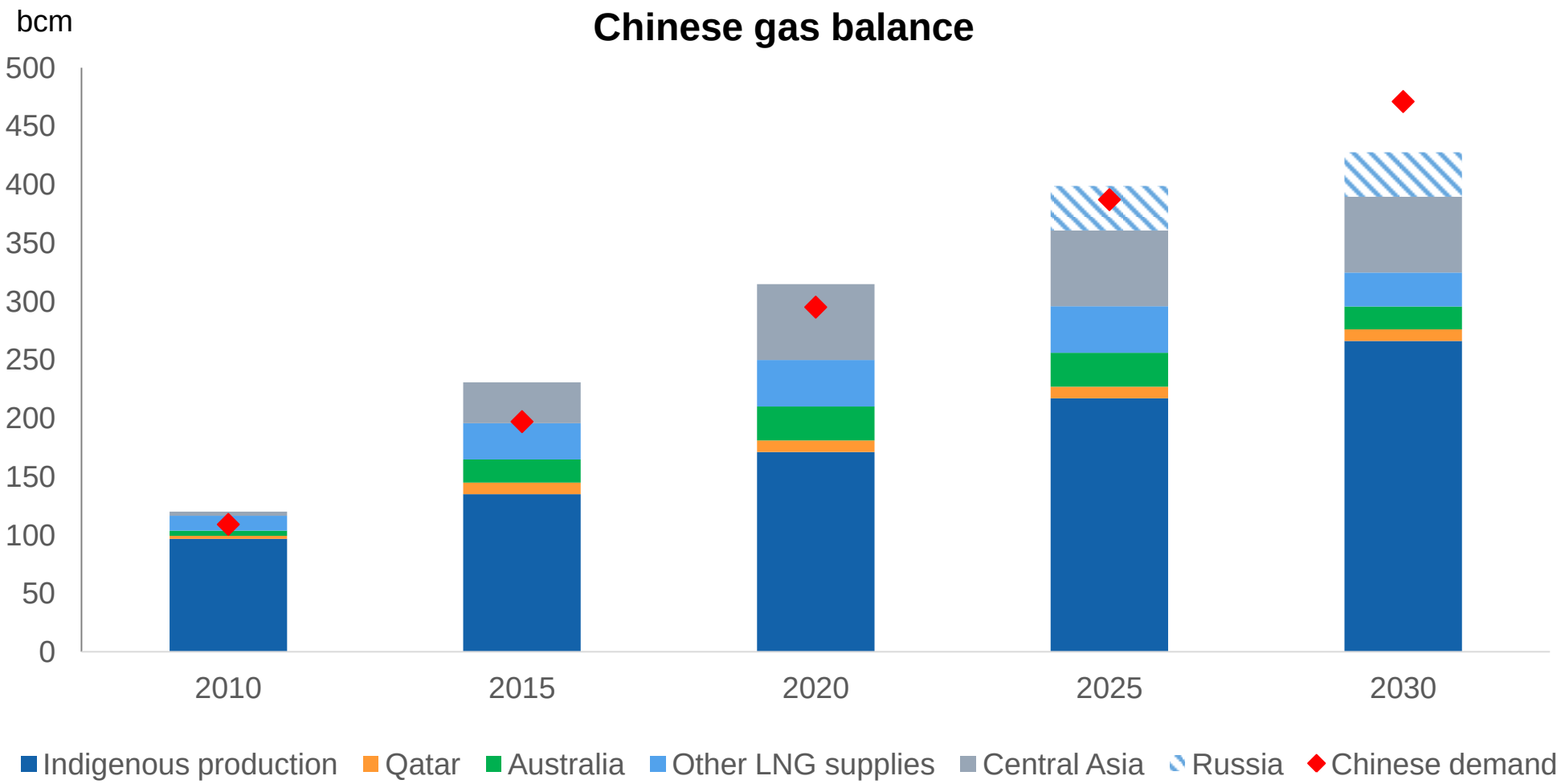
Russia's role as a key market arbitrage point as a supplier to Europe and Asia



“Eurasian Cross” in 2025: three arbitrating suppliers



Russia has absorbed all market niche in China up to 2028

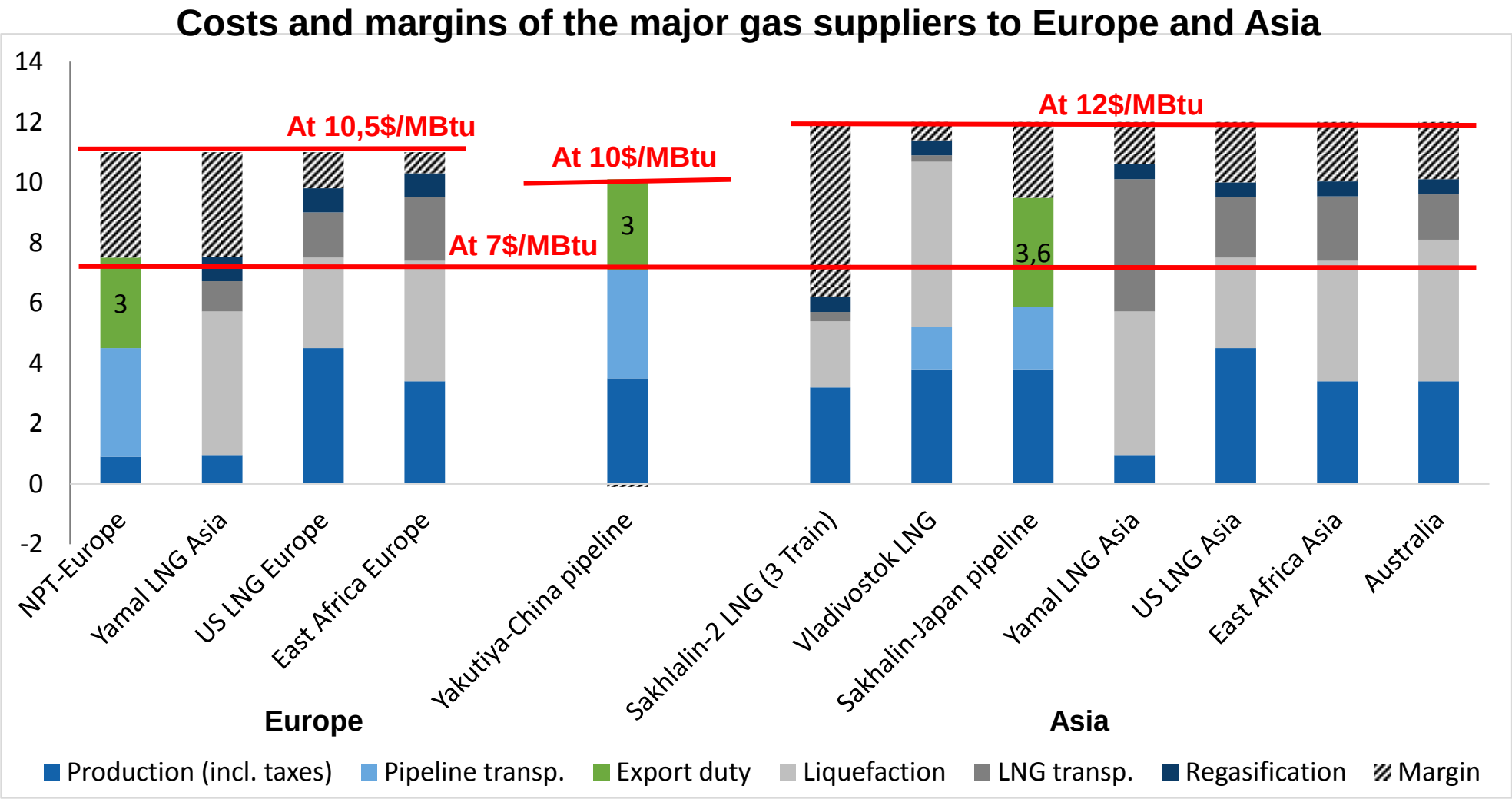


Sources: IEA WEO2014, Cedigaz, ERI RAS

Post-May 2014 negotiations:
Altai, Korean and Japanese pipeline negotiations

- On August 2014 Gazprom started negotiations with CNPC on the “Western route” (6700 km long “Altai pipeline” with 30 bcma capacity from the Western Siberia, diverting supplies targeted to the European market). Gazprom says that the pipeline could be built very fast and its capacity might be expanded up to 100 bcma. In October 2014 Russia signed framework agreement for the Western route. The Memorandum of Understanding lacks agreement on crucial details such as price, but if the details are worked out and both these deals are implemented, the supply of 68 bcm/year to China would make Beijing Russia’s biggest individual gas customer.
- In October 2014 Gazprom for the first time announced that it is ready to refuse from Vladivostok LNG and to send all the feed-gas to China via pipelines. Sakhalin has the option of increased LNG exports or the S-K-V pipeline to Vladivostok and possibly into NE China.
- The Eastern route between Russia and China has also laid a favorable foundation for extending another subsea gas pipeline from China’s Shandon province to South Korea, linking the three countries. If the transnational pipeline network is completed, Japan will not be far from joining the league for energy security particularly.
- Russia-Japanese pipeline project discussion is back, though politically very difficult so far.

Pipeline gas shows the best economics, if it comes to the price war: 30% export duty reduces with the gas lower prices (to 2,1 $/Mbtu with 7$/Mbtu final gas price)



Sources: NEXANT, IEEJ, ERI RAS

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