

Fiscal and cultural barriers to raising recovery in Russia



By Ildar Davletshin

Lead Analyst, Oil and Gas, Renaissance Capital



The Russian oil and gas sector is entering a new era in which the conventional legacy West Siberian fields are being quickly replaced by frontier plays and even traditional fields need new approaches to continue producing profitably as natural depletion accelerates. Continuous decline in flow rates at new wells in West Siberia, coupled with rising water level and escalating lifting costs, are signs of a dangerous trend.

This creates conditions for what looks to be a perfect marriage between international oil companies (IOCs) and Russian oil companies. The IOCs are believed to be able to offer modern technologies, while they get access to new resources which Russian companies can offer them, making such partnerships a win-win situation for both sides.

However, the actual results achieved by various partnerships in the Russian oil and gas sector have been mixed, with barely a single example of a true success story. The typical reasons put forward to explain this relatively unexciting track record relate to overall sector conditions including onerous fiscal terms, limited access to resources and lack of strong institutions. While all this seems correct, the broader context of the Russian oil sector is often left out.

It is worth remembering that the Russian government is the biggest stakeholder in the sector in two ways: as the biggest beneficiary through its fiscal function (over 70 per cent of the oil price goes into state taxes) and as the biggest investor in the sector, controlling about half of the Russian oil output and about 80 per cent of gas production. There is an inherent conflict between these two roles, however consistent they may appear at first glance. Tax policy prioritises short-term returns over the long term, as half of the current government spending is funded by the oil and gas sector. At the same time, as a shareholder, the government aims to maximise the ultimate value of its investment which often means investing more now and getting benefits in the future.

When two goals are pursued simultaneously, the result is that the only projects to get approval are those with immediate pay-off. The same situation occurs when investors apply an extremely high discount rate to evaluate projects, as often happens in high-risk countries. Essentially this means that the cost of capital is indirectly lifted for most operators

in the sector. This pushes operators to select projects with a quick payback period, naturally limiting overall investment in the sector.

An additional problem for international companies is related to poor recognition of earnings stream from Russian assets that are normally discounted by a much bigger factor. It is quite telling that dividends from the Anglo-Russian company TNK-BP accounted for up to 90 per cent of total dividends paid by BP itself in 2011, the last year before agreement was reached between Rosneft and controlling shareholders of TNK-BP over the future acquisition of their interests. Yet, TNK-BP accounted for less than a quarter of the total value of BP, according to the consensus valuation.

If full value is not assigned to the income from Russian operations, this discourages IOCs from investing in future growth in Russia, although at the same time IOCs can continue to rely on their Russian operations as a valuable source of cash to fund their growth projects in other parts of the world (including shale and deep offshore projects in the US).

One conclusion that can be drawn from this is the need to move to profit-based taxation, away from the current revenue-based fiscal regime.

Moreover, numerous tax benefits and exemptions motivate companies to seek access to assets in more remote areas as they will get tax credits, while neglecting mature fields where additional production from enhanced oil recovery (EOR) is bigger than what most green-field operations can deliver. As a result, foreign companies seek to partner with state giants like Rosneft and Gazprom, which have the best access to new assets and enjoy tax benefits. Such a situation creates interesting opportunities in neglected mature assets, because the potential from EOR is utilised very modestly and mature fields are left relatively undervalued. Russian companies have only recently started using horizontal wells with multi-stage fracking, not to mention more advanced techniques with chemicals. Even traditional water flood techniques are often used in quite a simple way, leaving a lot of oil in the ground.

The main constraint on more active use of EOR at mature fields in Russia is not lack of technical knowledge or skilled personnel, but rather the poor state of the service market and a different culture. These two issues need to be well understood by oil companies if they are to extract maximum value from



their brown field operations.

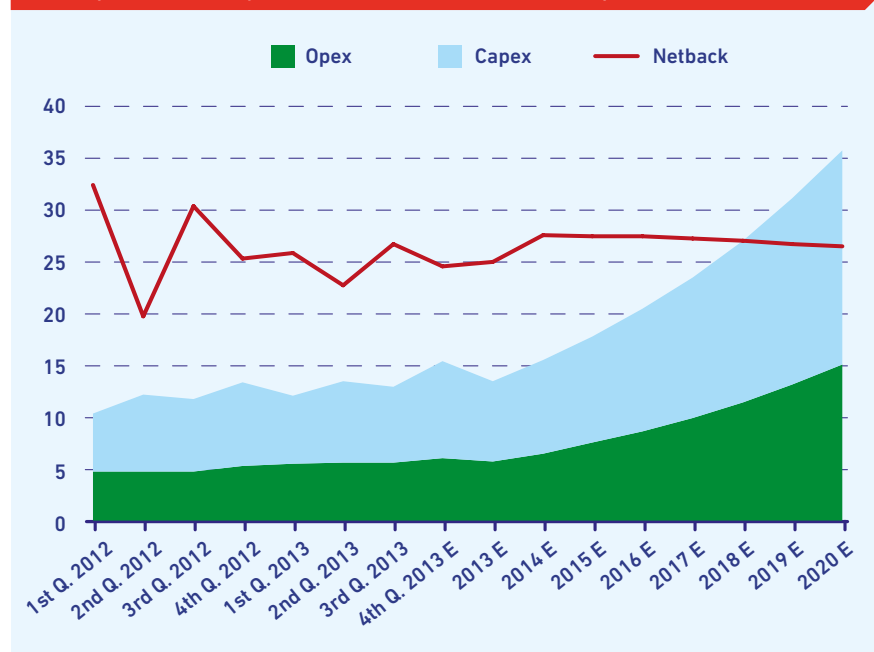
The Russian service market comprises a few international companies focusing on R&D, with Schlumberger the market leader, several domestic providers of basic services and equipment, with Eurasia Drilling and CAT Oil being the leaders in drilling and hydraulic fracturing, and many small providers of other low-quality services. Rosneft and Surgutneftegas keep large in-house service companies. This is in stark contrast to North America, where hundreds of providers compete on costs, quality and technical solutions that they offer to their clients. Unlike their North American peers, Russian companies, have to work within a limited universe of suppliers.

The situation is further complicated by the old age of most assets of the Russian oil services companies with 60 per cent of rigs being more than 20 years in operation and soon to be retired.

One way to overcome this issue is to expand along the value chain to minimise time and costs. For example, Gazprom Neft and Shell are building their own polymer plant in Russia to produce polymers to be injected into reservoirs and to improve efficiency of water flooding. At first sight, this goes against conventional wisdom that advocates lean structures and focusses on core competencies, but in Russia this should help in managing costs and thus expand the reserves base that can be accessed economically. This longer value chain to fight costs can be structured in different ways, with direct equity ownership being just one of the examples. Other options include joint ventures, alliances and various forms of contracts that incentivise suppliers to be more cost-efficient.

This leads to the second issue in developing mature reserves economically – which is culture. While the Soviet Union collapsed more than 20 years ago, its legacy is much stronger than most people think, especially in the oil and gas sector. Most companies

Cost per barrel dynamics for Russian oil companies (\$/bl)



are organised in a very hierarchical manner, where risk taking is highly discouraged and the key incentive is meeting annual targets. A reservoir engineer in a Russian oil company would typically prefer a solution that leads to a pre-agreed production target as distinct from one that could lead to lower costs or quicker production growth with some element of risk and uncertainty. The consequences of not meeting original targets are much higher than the benefits from potential optimisation.

As a result, budgets are normally inflated in terms of required time and costs while production targets are understated. Even if oil operators have adopted a different culture, they will be inevitably dealing with suppliers of an older culture, and they may bear the consequences as a result (delays in project executions, cost over-runs, final quality below original expectations). To avoid these constraints oil operators may consider different contract terms with their suppliers with final compensation linked to future performance or other risk and profit –sharing arrangements. Developing further vertical integration in order to control the supply chain better is also one of the possible solutions. ■