Oil flows around sanctions
Russian Oil & Gas Outlook Survey Results 2017
Russia 2017
Introduction

Dear Colleagues,

We are delighted to present our 11th annual Russian Oil & Gas Outlook Survey, based on the interviews with executives from state-owned and private oil and gas companies.

As always, the survey looks at the results and the performance of oil and gas companies, as well as their short- and long-term plans for development.

As predicted by most oil and gas executives in 2015, the year 2016 was marked by a growth in oil prices, with the price of a barrel going up from USD 34 to USD 56. This year, the survey has found that only half of the respondents remain optimistic about a potential boost in prices in 2017.

Many of the respondents surveyed have replied that Russia and other countries will see oil demand continue at the same level while gas will enjoy a growth. This may have an impact on hydrocarbon prices because retaining and growing production levels usually come from obtaining a higher recoverability from traditional deposits and exploring new ones, including those with complex barrels that require large-scale investments, as noted by more than 80 percent of the respondents.

With high capital intensity and complicated access to funding, almost half of the surveyed respondents believe Russian oil and gas projects will see more participation from foreign companies in 2017.

At the same time, 80 percent of the experts expect more stringent government regulation in the Russian oil and gas industry within the next five years while particularly stressing a potential growth in mineral extraction tax (MET) for gas condensate and oil. The Russian Government has submitted a draft of Tax Code amendments to the State Duma, requesting a higher MET for the oil and gas industry as well as an increase in excise rates that would allow the oil industry and the public budget to adapt to a slump in global oil prices.

Please read on to see more detailed perspectives on the situation in the oil and gas industry and company plans for 2017.

We would like to thank all the respondents for participating in the survey and sharing their perspectives on the present and future state of the oil and gas industry. We hope that you will find the report useful and interesting.

Best regards,

Gennady Kamysnshnikov
CIS Energy and Resources Leader
Our respondents

We surveyed executives from various corporate levels (seniors, function leaders, department heads and directors) as well as experts and professionals from upstream and downstream sectors and service companies. The survey covers large local and international, vertically integrated companies and independent small and medium-sized businesses. Most of the companies surveyed (81 percent) are not state-owned.
Survey findings

Change in demand for oil and gas on the domestic and global market over the next five years.

Domestic demand for oil will

- Increase: 25%
- Remain the same: 69%
- Decrease: 6%

Domestic demand for gas will

- Increase: 38%
- Remain the same: 62%
- Decrease: 0%

Global demand for oil will

- Increase: 19%
- Remain the same: 50%
- Decrease: 25%
- Don't know: 6%

Global demand for gas will

- Increase: 19%
- Remain the same: 6%
- Decrease: 62%
- Don't know: 19%

Similarly to the last year, most respondents believe that demand for oil in Russia and other countries will remain the same. Twenty-five percent replied with “increase”, compared to the last year when this figure was 15 percent for Russia and 39 percent for other countries. Analysts with the International Energy Agency (IEA) have also confirmed this trend, forecasting an annual growth in oil demand at a rate of 1-2 percent over the next five years, with the two leading emerging economies China and India expected to account for a larger portion of this growth. Six percent of the respondents in Russia and 19 percent in other countries expect a lower demand.

Experts have similar views on changes in demand for gas in Russia and other countries, with 62 percent expecting a higher demand, compared with 38 percent in Russia and 54 percent in other countries in 2016. Some respondents (38 percent in Russia and 19 percent in other countries) believe that demand for gas will remain the same. Another 19 percent replied with a lower demand for gas.
Half of the respondents expressed optimistic views, replying with higher oil prices. As for the experts surveyed, 38 percent believe that oil prices will remain the same while only 6 percent expect oil prices to increase.

Last year, 61 percent of the executives surveyed replied with higher oil prices while 23 percent believed these would remain the same and only 8 percent expected lower prices. The oil price expectations expressed by most experts have been confirmed, with Brent oil prices growing by more than USD 20 over 2016 to reach USD 56 per barrel at the year end.

With the existing trend for a growing presence of state-owned companies in the oil and gas industry, 64 percent agree that the participation from state-owned companies will increase, compared with 46 percent last year.
The views expressed this year are almost identical to the expectations from the last year; most of the companies (79 percent) predict a further growth in government regulation in the industry.

Of the executives surveyed, 81 percent replied with a higher demand for capital. Oil and gas companies are busy implementing high-potential projects and ramping up activities in the deposits. For instance, Rosneft is building facilities in the Russkoye deposit while Gazprom neft is launching the Arctic Gates, a new terminal in the Novoportovsk deposit.

In the context of the existing sanctions, 36 percent believe that the inflow of capital into the Russian oil and gas industry will remain unchanged from last year while 29 percent replied with “decrease”. However, 21 percent expect an increase in capital inflow.
Forty-four percent expect that the share of foreign capital in oil and gas projects will increase. This trend can be seen from the interest foreign companies have for shares in Russian oil and gas majors. Last year, Rosneftegaz signed an agreement, selling a 19.5 percent stake in Rosneft to a consortium of international investors — Qatar Investment Authority, one of the world largest sovereign funds, and Glencore, a Swiss trader. Meanwhile, foreign companies continue to invest funds in Russian projects. Specifically, Shell is currently engaged in prospecting and appraisal efforts in Severo-Vorkutinsk 1, Severo-Vorkutinsk 2 and Syryaga blocks, including subsequent exploration and development activities in the hydrocarbon deposits.

However, 38 percent expect to see a decline in the interest from foreign companies in Russian oil and gas projects, which is partially due to the sanctions.

This year, 55 percent would rely on loans and borrowings as a primary source of capital, compared with 46 percent in 2016. Companies are increasingly naming share capital as a “go-to” source, with 31 percent and 27 percent selecting this reply in 2017 and 2016, respectively. The number of companies expecting to rely on internal funds is down by 13 percent from the last year.

In 2017, the share of foreign capital in oil and gas projects will

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Over the next five years, the primary source of capital for the Russian oil and gas industry will be

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<th>Percentage</th>
<th>Loans and Borrowings</th>
<th>Share Capital (IPO, Strategic/Financial Investors)</th>
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<tr>
<td>55%</td>
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Of the respondents surveyed, 32 percent replied with a “higher tax burden” for the oil and gas industry, which is due to the expectations for higher MET rates on gas condensate and oil. The Russian Government is reported to have submitted Tax Code amendments to the State Duma that provide for higher MET rates for the oil industry and Gazprom, as well as higher excise duty rates.

With lower oil prices encouraging consolidation in the market, 25 percent expect consolidation in both the oil market and the oil service market. According to the respondents, foreign oil and oil servicing companies are less likely to leave the market in the near future.

Given the current context of higher refining returns in Russia, 37 percent see the refining business as a lucrative sector to invest in. Twenty-three percent named oil and gas production as an attractive sector while another 23 percent turned down the idea to invest in oil and gas.

Most respondents see deficiencies in industry legislation and restricted access to capital as a major issue (24 percent for each of these two replies), with restricted access to capital as a result of the existing sanctions.
How did your production assets portfolio change in 2016?

All the respondents replied with “increased”. Oil and gas companies are expanding assets both in Russia and abroad. Acting as part of the international investors consortium, Rosneft has signed a sale and purchase agreement to acquire 49 percent in Essar Oil y Essar Energy Holdings Limited. As a result, Rosneft will obtain a stake in an advanced oil refinery with a complex infrastructure in Vadinar (India) in the Asia-Pacific region. Essar Oil also owns a network of Essar-branded gas-filling stations in India. The cost of the acquisition of 100% of EOL's business by Rosneft and the consortium is USD 12.9 billion.

Rosneft is also intent on gaining access to the international market for gas, which can be seen from its LNG exports and participation in the project Sohr in Egypt. The company has also arrangements with Eni (Italy) to buy up to 35 percent of a concession agreement for the development of the Sohr gasfield, as well as to acquire 15 percent in Petroshorouk, a 50/50 joint venture between Eni and EGAS (Egypt).
How did your headcount change in 2016?

Most respondents (69 percent) replied that the headcount of management and professional staff at headquarters did not change, compared with 50 percent selecting this reply in 2016. Similarly to the last year, 31 percent of the respondents noted increased management and professional staff levels, compared with 30 percent in 2016.

Of the respondents surveyed, 69 percent replied that their production units had their management, professional and administrative headcount at the same level, unlike last year when only 40 percent indicated it. At the same time, 31 percent indicated an increase in headcount, compared with 40 percent in 2016.

As for the blue collar staff, all the respondents noted an increase, compared with the last year when only 30 percent indicated this.
How did your company’s spending in the following areas change in 2016?

Of the executives surveyed, 44 percent replied that their capital and operating expenditure had increased, compared with the last year when 55 percent and 37 percent indicated an increase in capital expenditure and operating expenditure, respectively. The replies from the survey are further confirmed by a growth in capital expenditure from oil and gas companies. The year 2016 saw Gazpromneft increase its capital expenditure by 10.1 percent from the previous year to RUB 384,817 million. The company has plans to continue investing at the same level this year.

Of the respondents surveyed, 25 percent indicated decreased expenditure, up 7 percent from the previous year.

All of the executives surveyed replied with “don’t know” when asked about changes in R&D expenditure in either upstream, midstream or downstream.

### Capital expenditure

- **Increased**: 44%
- **Decreased**: 31%
- **Don’t know**: 25%

### Operating expenditure

- **Increased**: 37%
- **Decreased**: 44%
- **Don’t know**: 25%
Most respondents were not sure about specific changes in expenses on social programs, the environment, staff, occupational health and safety. Only 9 percent replied with “don’t know” to this question last year.

Of the respondents surveyed, 25 percent believe that expenses on environment, health and occupational safety have increased. By Presidential Order, the year 2017 has been declared the Year of Environmental Protection in Russia. In addition to the existing plan for monitoring the environmental impact from production, RN-Severnaya Neft, a subsidiary of Rosneft, is implementing an action plan as part of the Year of Environmental Protection. They have developed initiatives aimed at a stricter control over compliance by their own staff and contractors with environmental and industrial safety rules and regulations. Varyeganneft, a RussNeft subsidiary in Western Siberia, has also focused particularly on priority initiatives to contain and minimise negative environmental impact, as well as increase waste processing levels and ensure compliance with environmental impact ratios.
Compared with 2016, which of the following operational areas are you planning to expand or cut back on in 2017?

This year, most respondents replied with “don’t know” when asked about plans for downstream expenditure. This year only 25 percent of professionals surveyed expect an increase in expenditure on drilling.

The previous year exhibited a similar level of uncertainty for this expenditure. It may be due to Russia implementing the Russia/OPEC agreement to cut production, with production levels being decreased at the expense of exploratory drilling.

**Upstream**

*Drilling—the level of expenditure on drilling operations in your company will*

- Increased: 25%
- Don’t know: 75%

**Exploration**

*Exploratory drilling—the level of expenditure on exploratory drilling in your company will*

- Increased: 25%
- Don’t know: 75%
Compared with 2016, which of the operational areas specified below are planned for expansion or cutbacks in capital investments in 2017?

**Your company’s expenditures on new assets, including acquisitions to expand reserves, will**

- Remained the same: 25%
- Don’t know: 75%

**The level of field development activity in your company will**

- Remained the same: 25%
- Don’t know: 75%

**The level of expenditure on extracting activities by your company will**

- Remained the same: 25%
- Don’t know: 75%

**Expenditures on expanding sales will**

- Increased: 25%
- Don’t know: 75%

Of the executives surveyed, 25 percent replied that their companies had no plans to expand hydrocarbon reserves by purchasing new assets. Seventy-five percent replied with “don’t know”.

Twenty-five percent expect that field development will continue unchanged from the previous year. Seventy-five percent replied with “don’t know”.

All the respondents expressed uncertainty about plans for production expenditure for this year while the last year saw only half of the respondents provide this reply.

Of the companies surveyed, 75 percent have plans to expand sales, up 55 percent from the previous year.
Of the respondents surveyed, 69 percent selected diversification as a priority approach for managing assets while 31 percent replied with “sell non-core assets”.

Of the initiatives listed, 32 percent selected efficient asset management, 22 percent indicated the introduction of performance management programs and 18 percent specified the implementation of advanced and innovative technology. None of the respondents named public-private partnership as their priority initiative.

Professional staff and energy costs are the priority cost optimisation areas, as indicated by 21 percent for each of these categories.

What plans does your company have for asset management in 2017?

- Diversify activities: 69%
- Sell non-core assets: 31%
- Purchase additional core assets: 0%
- Sell low-profit assets: 0%

In your view, which of the strategic initiatives listed below are the most important for your company to stay competitive?

- Ensure efficient asset portfolio management: 32%
- Introduce performance management programs: 22%
- Implement advanced and innovative technology: 18%
- Engage with new partners: 14%
- Retain the existing assets: 14%
- Public-private partnership: 0%

Which of the areas for improving operational cost efficiency will be the most important for your company in 2017?

- Energy: 21%
- Professional staff: 21%
- Administrative staff: 18%
- Service contracts: 15%
- Procurement and supply: 12%
- Environment and occupational safety: 6%
- Transportation and logistics: 6%
- Repair and maintenance: 3%
- Operational cost efficiency is not part of our priorities for 2017: 0%
- Well servicing: 0%
Similarly to the last year, most companies (69 percent) have plans for R&D and innovation investments. Thirty-one percent will keep investments at the same level. For instance, General Electric and Rosneft have signed several agreements to develop and implement innovative technologies to bring greater efficiency to the oil and gas industry. The two companies will work together to design and localise solutions for the optimised functioning of equipment and processes across the entire value chain, including systems for standardised design, as well as to develop vessel technologies for transporting LNG.

Most respondents (69 percent) replied that their companies do not invest in alternative sources, which is almost in line with the replies from the previous year (75 percent).

Unlike in the previous year, the number of the respondents indicating that their companies invest in alternative sources and will continue with current levels of investment has more than doubled, up from 13 to 31 percent. This is also due to the fact that as companies look for a stronger competitive edge their executives are increasingly facing the task of transforming their companies into versatile energy businesses. As part of a project to develop alternative energy sources, RN-Krasnodarneftegaz, a Rosneft subsidiary, has installed a third wind power generator with solar cells on board in the Vostochno-Chumakovskoe deposit. The generator will provide deposit facilities with clean energy over a long period while reducing the environmental impact and energy costs. The alternative sources at other facilities have also demonstrated their efficiency. This enables a platform for building a system of hybrid-type power plants. Another notable experience with hybrid-type power plants comes from RN-Purneftegaz with a hybrid plant in Yamal. This plant works to convert solar energy and can also run on liquid fuel during periods with shorter daylight hours. Other Russian oil and gas companies have similar projects in their pipelines.

This year, the number of companies engaged in import substitution projects has increased by almost 20 percent to 69 percent. For instance, Sibur Holding, Gazprom and Lukoil have supply contracts with HMS Neftemash (Tyumen) for heat-exchange equipment.

The number of companies that are not engaged in import substitution projects has increased to 31 percent from 25 percent last year.
The risks of supplier contractual performance and macroeconomic risks are equally important for respondents, with each of these risks indicated by 27 percent of the respondents. In 2016, these two risks were also named as important by 42 percent and 50 percent of the respondents, respectively.

In 2017, 80 percent of respondents have cited the need for a significant improvement of the quality of products and services so as to enable higher participation from domestic contractors in oil and gas projects. In 2016, 50 percent of respondents shared this opinion. We found that 20 percent of the respondents (25 percent in 2016) note that state support for contractors is important for increasing the participation of domestic contractors in oil and gas projects.
Of the executives surveyed, 44 percent noted the variance of interests, with companies looking for a higher quality at the lowest price and servicing companies offering lower quality services at an excessive price. Another 25 percent see contractors as partners and part of their team with whom they share common goals.

What kind of relationships do you have with servicing companies?

- We look to obtain the highest quality at the lowest price possible while servicing companies would want it the other way around
- Servicing companies are our partners and they are part of our team. We have common goals
- Other

44% 31% 25%

Of the respondents surveyed, 56 percent are convinced that there is a need for closer cooperation with servicing companies while another 44 percent are content with the existing level of cooperation.

Do you think there may be a need for closer cooperation with servicing companies?

- Yes, we do
- No, we don't

44% 56%

Most respondents (69 percent) indicated the need for a unified database of oil and gas contractors (62 percent in 2016).

Is there a need to create a unified public database of oil and gas contractors?

- Yes, there is
- Don't know

44% 56%
Contacts

Artem Fedorov  
Head of the Oil and Gas market research center  
+7 (495) 787 06 00  
afedorov@deloitte.ru

Gennady Kamysynkov  
CIS Energy & Resources Leader  
+7 (495) 787 06 00  
gkamyshnikov@deloitte.ru

Andrei Shvetsov  
Audit  
+7 (495) 787 06 00  
ashtvetsov@deloitte.ru

Igor Tokarev  
Audit  
+7 (495) 787 06 00  
itokarev@deloitte.ru

Anastasia Osipova  
Consulting  
+7 (495) 787 06 00  
aosipova@deloitte.ru

Andrey Panin  
Tax and legal  
+7 (495) 787 06 00  
apanin@deloitte.ru

Alexei Voronkin  
Corporate finance and valuation  
+7 (495) 580 97 12  
avoronkin@deloitte.ru

Energy & Resources regional leaders

Almaty  
Anthony Nicolas Mahon  
+7 (701) 740 01 99  
anmahon@deloitte.kz

Kiev  
Artur Ohadzhanyan  
+38 (044) 490 90 00  
aohadzhanyan@deloitte.ua

Baku  
Nuran Kerimov  
+994 (12) 598 29 70  
nkerimov@deloitte.az

Global Energy & Resources Leader  
Rajeev Chopra  
+44 7775 785350  
rchopra@deloitte.co.uk

Kamilla Zhalilova  
Business Development Manager  
Energy and Resources  
+7 (495) 787 06 00  
kzhalilova@deloitte.ru
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