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Changes in Regulations Could Help Break the Offshore Ice

By Alexander Panin

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Gazprom's Prirazlomnaya rig is the only platform pumping oil in the Arctic, having begun production in December.

State-controlled oil giant Rosneft had a very good year.

That is what company chief executive Igor Sechin told Prime Minister Dmitry Medvedev on Friday at a meeting to review Russia's largest oil producer, whose capitalization grew by 18 percent to $73 billion at the end of 2013.

Sechin's optimism was tangible as he painted a rosy picture of the country's No. 1 cash cow for the coming years.

Rosneft contributed 2.7 trillion rubles ($76.7 billion) to Russia's budget last year, counting all taxes, duties and royalty fees. "And we hope to increase that number a little bit in 2014. It should be about 3.1 trillion according to our estimates," Sechin said.

By comparison, Gazprom, Rosneft's closest rival in the amount of paid taxes, was expected to generate more than 1.2 trillion rubles for the budget last year.

But behind the optimism, however, lurks a major challenge: moving from reliance on traditional fields to getting oil out of offshore locations, where Rosneft has done extensive seismic research in the last years.

Exploration of Russia's continental shelf has been booming for the last two years, especially in Arctic waters. Numerous foreign companies, such as ExxonMobil, Statoil and ENI have been entering agreements with Rosneft and Gazprom regarding potential Arctic shelf projects. Drilling for oil or gas there, however, has started only at Gazprom's Prirazlomnaya oil field in the Pechora Sea. That was what sparked the conflict with Greepeace last December.

But it is not environmentalists that are causing delays in shelf exploration. One key reason is existing regulations. Last week Sechin even sent a letter to President Vladimir Putin asking for help with simplifying procedures of working on the continental shelf, Kommersant reported.

And this was not the first time a major state company, which collected 46 licenses for drilling for offshore hydrocarbons, has asked for assistance to combat bureaucracy. In December of last year, it also complained of faulty regulations that make it difficult to effectively explore the seabed.

Putin reportedly supported the claims and passed them to the head of his administration and Medvedev. There has been no reaction yet, but several legislative initiatives passed to the Duma by the government last year suggest that the seeds have fallen onto good soil.

Private role limited

Besides tedious paperwork that industry players complain can delay the start of offshore development for more than a year, there are a myriad of regulations that complicate such efforts. For example, workers on platforms need to get their passports stamped each time they leave Russia's mainland to go to a sea platform. Other hindrances include a ban on foreign operators owning drilling and other equipment and the necessity to ship out nontoxic drilling waste — mostly sand and seabed detritus.

"Another major drawback for private domestic and foreign companies working with state giants on the shelf is the unclear procedure of determining what the returns will finally be as oil or gas starts to be extracted," said Igor Litvinyuk, a senior analyst at the International Institute of Energy Policy and Diplomacy.

The root of the problem is that only companies with more than 50 percent state ownership and more than five years experience in the industry are permitted to drill the continental shelf. As a result, state giants Gazprom and Rosneft hold the majority of oil and gas licenses to explore the shelf and other companies may enter these projects only by entering into joint ventures as minority partners.

"And it is not clear under the current subsoil law how can the partners of the joint venture get the rights to the oil which they do not have the license for ... who it will belong to as it comes

out of the ground," said a senior partner at an international law firm involved in oil and gas deals with Russian state companies. He spoke on a condition of anonymity because he was not authorized to speak to the press.

One more issue that has been choking investment flow into Russia's shelf development is a strict national security regime that limits foreign companies' access to detailed seafloor maps and seismic data.

"And in the oil and gas business, the ability to find resources is considered almost as much a "sixth sense" as science, so it is easier for the investors to commit more quickly when their own people have a very hands-on role in the exploration process," said Kyle Davis, a partner at law firm Goltsblat BLP.

The fact that state companies are the ones advocating easing the rules is only logical as both Gazprom and Rosneft lack the expertise and technology to work on the shelf, oil and gas analysts said.

"Typically part of the reason for partnering with foreigners in shelf operations is to take advantage of their offshore technical expertise," Davis said.

Breaking the Ice

Despite the imperfect regulation, offshore hydrocarbon production is gradually developing. According to the Energy Ministry, out of more than 520 million tons of oil extracted in Russia last year, almost 15 million tons came from the country's continental shelf, less than 1 percent more than in 2012. But Rosneft expects 20 to 30 percent of all oil to come from the shelf by 2050.

One of the more advanced projects on the Arctic shelf is the joint venture of Rosneft and Exxon Mobile. In 2012 they formed joined forces to manage exploration of hydrocarbons in the Kara Sea in the Arctic and in the Black Sea. The initial cost of preliminary exploration was estimated at more than $3.2 billion for both projects. Drilling in the Kara Sea is expected to start in 2014 and Rosneft plans to extract its first oil on the continental shelf in 2018.

Another high potential project in the Arctic in the works is liquefied natural gas production on the Yamal peninsula. Yamal LNG is driven by Russia's Novatek private natural gas company in partnership with France's Total and China's CNPC. The launch is planned for 2017.

As projects progressed and industry players' cries of over-regulation last year intensified, Russian legislators continued to improve the laws that govern offshore hydrocarbon production.

Recent amendments to the Tax Code and the Shelf Law, which came into force starting from January this year, formally recognize the notion of a third-party joint venture company serving as an operator for field exploration and development — a legal status previously absent from Russian law. The change in legislation addresses the issue of the returns on investment, which has been one of the main concerns of private companies entering a joint venture with state license holders in shelf exploration.

The amendments indicate that remuneration payable to the operator is determined on the basis of the amount of hydrocarbons produced, which means its profits depend on the success of operations.

"We anticipate more changes in the legislative regulations governing Russian offshore hydrocarbons production," wrote Jennifer Josefson and Alexandra Rotar of King & Spalding, a global law consultancy, in a newsletter commenting on the modified legislation. "Such amendments are likely to address, among other things, LNG export, equipment import regulations, and, potentially, the simplification of secondment of foreign specialists."

Cold and Expensive

Even with improved legislation, the costs involved in exploration and drilling in the harsh conditions of the Arctic waters outweigh the gains so far, in most cases.

"Drilling for oil on the Arctic shelf is still too expensive and the price of the resource would be uncompetitive on global markets, even if the producers were to be freed from tax levy," said Mikhail Krutikhin, partner and analyst at consulting firm RusEnergy.

To ensure that production of hydrocarbons in the Arctic is viable and covers different kinds of risks, the oil prices need to be higher than current levels but the outlook for the near future remains uncertain, Litvinyuk said.

LUKoil, Russia's largest private oil producer, has repeatedly asked for liberalization of oil and gas exploration rules on the shelf to allow private companies, saying it would be a boost for the industry.

"The existing law is lowering the attractiveness of the Russian economy and is hampering its development," LUKoil chief Vagit Alekperov said in an interview with Vedomosti in September.

Even if the laws were to change, still, only the majors are capable of standing up to the high risks and challenges of Arctic exploration, said Sergei Smirnov, the head of Sozvezdye association of companies that supply equipment for the oil and gas industry.

"Oil and gas exploration is merely taking its natural course," Smirnov said. "Majors are breaking the ice and smaller private companies will eventually make their way to the Arctic."

But before going to explore the shelf, oil producers may have better luck in developing hard-to-recover resources on shore, he said. "There are such 'tight' oil projects in western and northwestern Siberia, as well as shale oil and gas fields," Smirnov added.

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