

Vostok Oil: Russia's Newest Arctic Energy Hope

Rosneft's Arctic energy project is the latest attempt to exploit the region's vast resources.

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Vostok Oil has demanded huge tax breaks from the Russian government before it launches Arctic oil production. **Pixabay**

There is a new kid on Russia's oil producing block: Vostok Oil, a joint venture set up to explore and exploit the oil resources of the Arctic. Already the Kremlin has started to throw significant resources at the company as Russia's existing oil fields reach peak production.

Russian oil and gas producers have to develop increasingly remote and challenging fields to keep their output stable as some of the biggest oil fields reach maturity or are already in decline.

A recent survey by the country's licensing agency Rosnedra found that a [third](#) of Russia's

2,700 large oil fields are unprofitable to develop and a separate study forecast Russia's oil production will go into decline in the coming decades if new resources such as those in the Arctic are not opened up and developed.

Peak production

The need to develop Russia's Arctic oil is becoming pressing as Energy Minister Alexander Novak warned in September Russia is only three years away from peak oil production.

“We expect about 553 million tonnes of oil production in 2018. We will reach a peak of 570 million tonnes in 2021,” Novak said in September, Interfax reported.

Almost half of current capacity could be lost in less than two decades as existing fields pass maturity, Novak said, with levels expected to drop to 310 million tonnes by 2035. Current reserves stood at 29.7 billion tonnes of oil as of early 2017, he estimated.

The decline in oil production would cost the budget some 3.3 trillion rubles a year (\$46.2 billion) in taxes and another 1.3 trillion rubles in foregone investment — or approximately 20% of its revenue, as well as hurting the already weak investment case.

That is where Vostok Oil [comes](#) in as the vehicle to bring what are believed to be massive Arctic oil resources online.

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Estimates of the reserves under the Arctic ice and snow are necessarily vague, but thought to be in the order of 90 billion barrels of oil, or 12.3 million tonnes, as well as 47 trillion cubic metres of gas in 19 geological basins.

That means the Arctic could increase Russia's reserves of known oil deposits by another half from the 29.7 billion tonnes of oil it has now. Other estimates say that the Arctic deposits could double Russia's oil reserves. No one is really sure as only half of the Arctic basins have been explored, but given the geology of the region, experts are confident they contain very large deposits indeed.

Vostok Oil is a joint [venture](#) between state-owned oil major Rosneft and Russian owned private oil producer Neftegazholding (NGH), which is run by a former Rosneft executive, Eduard Khudainatov.

There are several major oil and gas projects already up and running within the Russian Arctic Circle, but the plan is to start adding to the inventory.

Vostok Oil's principal asset will be the undeveloped Paiyakhskoye field, controlled by NGH and estimated to contain up to 8.8 billion barrels of recoverable oil. It will also include the huge Vankor field group, which belongs to Rosneft. Vankor, where Rosneft is partnered with a group of Indian investors, has been in operation for a decade. Other Rosneft assets in the area may also be brought into the group, including those operated by its Yermak-Neftegaz joint venture with BP.

Tax breaks

The key to getting the Vostok Oil project off the ground is winning tax concessions from the state to help cover the massive infrastructure costs that comes with working in such an inhospitable environment.

Back in April, Rosneft's powerful head Igor Sechin unveiled [plans](#) to President Vladimir Putin to establish a new Arctic production hub capable of producing 2 million barrels per day of oil — equal to almost 9% of Russia's total output last year. But Sechin warned this would only be possible with large tax breaks. Sechin called for 2.6 trillion rubles in cuts to mineral extraction tax (MET), income tax and other levies.

Tax breaks are necessary, Rosneft claims, because of the high cost of developing infrastructure to ship oil from these fields to market, as the fields are far away from Russia's existing pipeline infrastructure.

This argument does not hold up for Vankor, which is already linked to Russia's main pipeline system, and the finance ministry's tax director, Alexei Sazanov, insisted that Vankor would not receive the same support as the other projects in Vostok Oil's portfolio.

Rosneft may fail to secure anywhere near as much relief as it had originally hoped for.

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In the last month Sechin seems to have got some of what he wanted, but not everything. Initially Sechin was asking for a 30-year tax holiday, including zero MET for the new projects and a lower MET at Vankor, as well as zero property and land taxes, an income tax cut from 20% to 7%, and a 7.6% necessary insurance contribution versus the standard rate of 30%.

The government has agreed in principle to a benefits package for Rosneft's Arctic investments, Russian daily Vedomosti [reported](#). The government is offering to switch the projects to a new excess profit tax (EPT) regime, provide them with zero MET for only 12 years, or until 1% of reserves have been developed, and a 1% MET rate for the next five years, with a gradual increase to the standard rate.

“As far as onshore oil fields are concerned, the Arctic tax breaks that have so far been agreed are somewhat more modest than what Rosneft originally requested for the yet-to-be-formed Vostok Oil joint venture in July,” Sberbank CIB said in a research note. This said, a final decision has not been made and Sechin has a record of getting what he wants.

Rosneft also argues that the tax breaks are needed to attract foreign investors that can bring expertise and financing to the project. It reportedly plans to sell a 15–20% stake in Vostok Oil to a group of Indian investors that are waiting in the wings.

The government is caught on the horns of a dilemma as it is just getting into 25.7 trillion rubles of investments through the National Projects [program](#) that is a badly-needed attempt to remake Russia's economic model.

The Russian budget still relies heavily on the MET for its income and the National Projects call for some 2 trillion rubles a year of extra spending, on top of the circa 16 trillion rubles the government already spends — in other words exactly the value of the tax breaks that Sechin is asking for.

The tax relief Vostok Oil is demanding to make these projects feasible will put more strain on the budget. The government is running a 3% surplus at the moment, but that is before the National Project spending really gets underway.

What next for Vostok Oil?

Despite the budgetary juggling that will be needed, the Vostok Oil project is already a reality and will almost certainly go ahead.

While Rosneft may be leveraging its influence to try to get more tax relief than is necessary, government officials agree that state support is vital for Arctic oil and gas projects to be successful under current market conditions and the project is vital if Russia's oil production is not to go into decline in the coming decades.

Global warming has made the Arctic project increasingly viable as it has opened up the so-called [northern route](#) that allows nuclear icebreakers to travel along Russia's far northern coast between Europe and Asia, cutting weeks off the trip and significantly lowering transport [costs](#).

But at the same time lower oil prices have cut the amount the project can earn and reduced its economic viability.

Those projects that have made progress in the downturn have done so largely thanks to government backing.

The \$27 billion Yamal LNG gas liquefaction project on Russia's northwest coast, launched by private gas producer Novatek in late 2017, for example, will not pay any export tax, MET or property tax, and is subject to a reduced profit tax during its first 12 years of operation. Similar concessions are anticipated to be granted to Novatek's upcoming Arctic LNG 2 project, which is now making rapid progress.

Gazprom is also hoping for tax breaks to develop its own LNG project on the western side of the country, and struck a deal with Germany's Linde in October on setting up a joint venture to design facilities for the processing and liquefaction of natural gas.

Arctic setbacks

But attempts to develop Russia's Arctic oil and gas fields have been stymied by a series of external shocks so far, including the 2014 oil price crash. The development of offshore fields in the region came to a complete standstill that year, not only because of low oil prices but also the introduction of U.S. and EU [sanctions](#) preventing Western companies from taking part in projects. U.S. oil major ExxonMobil promptly withdrew from its joint venture with Rosneft at the Pobeda oil discovery in the Kara Sea, where the pair found an estimated nine billion barrels of crude.

So far the only offshore Arctic project to get off the ground is run by state-owned Gazprom Neft at the Prirazlomnoye field in the region, and no new offshore fields are expected to go into production until after 2030.

Fossil fuels still account for around 54% of Russia's export revenues. The concern is that as the industry becomes ever more reliant on the Arctic and other remote areas for growth, the government will increasingly struggle to afford the tax relief needed to spur development.

Moscow may have to look for cash in other areas, potentially adding to the tax burden of its citizens, or bring in large international oil companies as partners, which means making more concessions to the West to ease the sanctions regime.

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