

## **Speaking notes of Rosneft Chairman of the Management Board at the 4th Eurasian Forum in Verona (Italy)**

I welcome you to this important forum, which has not only become a popular platform for exchange of views on the development of the world economy, but also a place to discuss business relations between Russia and Italy, the countries of Central Asia and Europe. I am sure that the **respectable list of the participants and the list of major issues to be discussed will make a significant contribution to the development of mutually beneficial and long-term cooperation in Eurasia.**

I would like to thank Mr. Romano Prodi, former President of the European Commission and President of the Foundation for International Cooperation, Ms. Maria Elena Boschi, Minister of Constitutional Reforms, Mr. Flavio Tosi, Mayor of Verona, the management of Banca Intesa and personally Mr. Antonio Fallico for the kind invitation to the forum.

I would like to draw the attention of the esteemed colleagues that our presentation contains some discussions and preliminary judgments.

### **FORUM HISTORY AND FORMAT**

Major Western analysts do not argue that "**Greater Eurasia**" is the core of "**the global firmament**", its **Heartland**. But if you admit it, you have to agree that the ongoing developments in this area are largely determined by the global processes - as political and trade-economic, so investment and cultural.

In fact, the space of Eurasia is the natural axis of the global cooperation and development which is based on objective geo-economic and political matters.

Most recently, this area evidenced, in fact, the **boom of the integration process** including conceptual approaches, such as the **New Silk Road initiative**. We believe that these are very promising directions of development

which are able to give a lot for the development of Europe and for the EU-Russia cooperation.

## MACROECONOMICS

To begin with, contrary to the pessimistic expectations, **the global economy is showing some resilience and vitality.**

In general, the GDP of the USA, UK, Germany and Italy in Q2 is not slowing down the growth momentum. China, whose slowdown is being speculated, in fact demonstrates extremely high growth rate by today's standards - up to 7% in 2015.

The Russia's economy, as recently announced by Russian President Vladimir Putin, "**has adapted in general to the new conditions.**" Moreover, according to the Federal State Statistics Service, the industrial production recorded an increase of 0.6% in September vs. August of this year.

The crisis in the world markets could not but affect the volume of trade between Russia and its European partners. In 2014, the trade turnover between Russia and the EU in dollar terms decreased by 10% to 377 billion US dollars; in January-August this decline fell to 39%. But still a crucial role in this decline was played by the fall in energy prices which, of course, distorts the real dynamics.

## ROBUSTNESS OF THE RUSSIAN FUEL AND ENERGY COMPLEX, ROSNEFT PERFORMANCE

It is important to emphasize that **in the energy sector of the Russian economy, including the fuel export, a sufficiently high level of sustainability is maintained.** The production of energy resources remains stable or even increases and the exports grow. In particular, in January-July 2015, oil exports from Russia to the EU increased by 5.6% year-on-year, export of petroleum products increased by 6%. In 2014, oil exports from

Russia to Europe amounted to 129 mmt which covers 20% of the total oil consumption in the European Union being about 636 mmt.

Here are some Rosneft deliverables. As shown on the slide, the dynamics of the main operating results in the first half of the year are positive.

Despite the unfavorable pricing environment, the financial performance is also strong. **The Company is consistently reducing the size of the debt burden:** the obligations on syndicated loans fell more than twice, from \$56.7 bln at the end of 2013 to \$27.2 bln at the end of September 2015.

In general, the Company remains one of the leaders in terms of the reserves, production and operating efficiency.

**I would like to stress that the sustainability of the energy sector of the Russian Federation has a long-term and fundamental nature.** It is based, on the one hand, on high efficiency of the oil and gas industry, and on the other, it is supported by a flexible mechanism for the formation of the exchange rate of the Russian currency.

In Russia, de facto, the priority is given to the budget stability. The result is the highly stability of ruble revenues of the oil industry.

Given that most of the oil and gas industry investment costs are denominated in rubles, the stability of the ruble earnings, though with some inflation, provides a fairly considerable level of investment.

This means that, despite the crisis in the development of the Russian economy, the prospects for expanding our cooperation, at least in the sphere of oil and gas and investment, look quite positive.

## OIL MARKET ENVIRONMENT

It should be noted that the **world oil market has changed dramatically over the past year and a half.** These changes are primarily associated with the phenomenon of shale oil production and the fact that the balancing that used to be carried out by the OPEC countries, has actually passed to the regional US market, which has become the most important regulator on a global scale.

This happened not only because the shale oil production capabilities have become much higher, but also because the **USA have a whole set of leverages that shape the development of the competitive oil market.** These are financial sources, financial derivatives, stock exchanges, the developed system of oil and gas pipelines and a large number of contractors who multiply the effect of the industry on the entire economy.

In this context, **in the short- and medium-term, the trends in the global oil market will be also largely determined by the US market.** Another factor in the coming months and years – is how the shale oil production hedging contracts are delivered. **The total debt of only twenty-five companies involved in production of shale oil is about \$150 bln.**

According to Wood Mackenzie, only the direct financial gains of "shale oilers" **due to the hedging mechanisms in 2015** is estimated at **\$9.1 bln.** However **in 2016**, as estimated by Wood Mackenzie, this hedge profit will not exceed **\$2.2 bln.** Only a few companies in the sector will be sufficiently protected in the price environment. In the future, the opportunities of hedging will reduce even more.

**One of the conditions underlying the "survivability" of shale companies is that they get loans from banks per a specific field** (RBL – Reserve Based Lending). These renewable, extended credits under the security of proved reserves are linked to the assets of the energy companies which are already at the stage of production or near-production. Namely these loans against field development are the only chance for small and medium-size companies to raise necessary funds to resume the business. With low prices, **this mechanism will operate at least until 2017.**

The shale oil companies are actively restructuring their financial balances: divest non-core or non-operating assets, sequester the investment programs and dividend payment programs, optimize their costs. In general, the shale oil industry (1,600 companies) has reduced the costs in the first three quarters of 2015 vs. 2014 by 37% as estimated by Wood Mackenzie.

All this means that the revaluation of the investment priorities and the production cutback will inevitably happen, but the scale of these processes is likely to be less significant and straightforward as expected.

In the long term, **the main factor determining the future of the oil market is the condition of the resource base.** The currently available estimates indicate that the expected growth in oil consumption in the world can only be achieved by production, including the fields with high lifting cost.

Analysis of the lifting cost of about 75% of new production till 2030 (about 33 mmbpd) shows that **the last 3 mmbpd will be expensive oil at a cost of \$85-98/bbl** in 2015 prices. The lifting cost of about 28 mmbpd of the new production will not exceed \$75/bbl in the prices of 2015.

At the same time, about 30 mmbpd of today's oil production facilities will be put out of operation by 2030. Even today, we are witnessing a decrease in production in the Netherlands and in the North Sea.

The situation in the oil market naturally affects the situation in the refining business. **Presently, the European refining margin has grown due to feedstock cost decrease. But, generally, the European refining has long been facing hard times.** Despite a number of refineries that have an advantageous position in the market, in general, the European refining sector in the recent years has experienced difficulties, which was reflected for many refineries in the negative margins and low throughput.

This is first of all associated with the tough tax regime, biological and technological requirements and external competition.

**Since 2010, approximately 100 mmtpa of refining capacities shut down in Europe,** another 20 mmt capacities are planned for shut-down or divestment. The European refining industry still faces serious constraints that limit its profitability in the long term – sluggish demand and increased competition from foreign suppliers. **Significant deterioration of the financial standing of the oil refineries in Europe can be already expected in 2017.**

In the long term (until 2040), the European market of petroleum products will be characterized by oversupply which would require the rationalization of 100 mmt of European oil refining capacities.

The resulting financial and economic performance of oil refining is quite sensitive to changes in the composition of crude oil. As such, the **refineries that have stable supplies of crude** of the quality that best fits their refining capacities **will get competitive advantages**.

In other words, with long-term contracts for supply of crude of certain quality, refineries will be able to define their strategies for demand-based modernization in a more accurate and efficient way.

### LONG TERM TRENDS

Reflecting on our cooperation and collaboration in the Eurasian space, you will inevitably come to the need for a broad and long-term consideration of the problems. This concerns not only the current environment but also its possible changes; not only Western Europe and Russia, but most of Eurasia including China, India, and the Middle East.

We should take into account the different levels of economic development of different regions in this vast space, their different progress, changing nature of the interactions.

What are the key global trends in Eurasia? Here I first of all mean the energy domain.

**The main thing is the substantial redistribution of power consumption in favor of the Asian part of the continent.** The share of Europe (including Russia) in global primary energy consumption declines from 34% in 1990 to 19% in 2015 and 16% by 2030. At that **the share of Asia increases from 31% to 50% and 54% accordingly**. It is obvious that the trend will continue which means certain consequences, including those for the investment flows and logistical resources.

So that a certain shift in the focus of the Russian power sector eastwards is absolutely in line with the global trend, and is nothing else than the natural response of supply to demand assumptions.

## CHANGE OF OIL MARKET STRUCTURE

The world oil trade demonstrates a continuous redistribution of flows: now oil supplies in the United States are getting shrunk; the supplies to the Asia Pacific is increasing; in Europe, the total imports almost do not grow after the crisis, while the import supplies are being significantly diversified. When OPEC refused from the balancing role, the competition for the markets has significantly increased; the most important regulator of global scale is the regional US market.

The current market developments raise the question of the **efficiency of some of the recently announced major deals**, such as **Shell's aspiration to buy BG**.

Eurasia still remains the world's largest producer and consumer of oil. **59% of the world's oil reserves (142 bln t) and 60% of world's refining capacities** are located here. World's two largest oil producers - Russia and Saudi Arabia – are also situated in the Eurasian continent. Even though, production in the region does not cover its demand which accounts for 67% of the world's oil consumption. The shortage is about 100 mmt of oil per year. This gap is going to grow,

Thus, **oil producers of Eurasia have certain competitive advantage in terms of their geographic positions in respect to the most receptive oil markets**. This includes Russia which is currently the largest supplier of oil and gas to Europe, providing about 20% of European oil imports, and in the future it may actually claim to increase its role in the Asia-Pacific markets.

Global oil consumption will grow till the end of this decade at relatively high rates – up to 1.5%, due to the boom in car ownership in many developing countries. In the next decade, the global growth in the consumption of oil and oil products will start to slow down, however it will be about 1.0%.

Meanwhile, **we witness a frontal decline in the investment activity of the oil industry**. According to Wood Mackenzie that reviewed a number of the largest companies in 2015, the **decline in global Upstream Capex of \$220 bln**

vs. the previous year has been confirmed. This is rather an optimistic estimate, the decline is likely to achieve \$300 bln.

There may not be a very tough but stable relationship between the investment and the volume of oil produced: the decline in investment in two or three years would lead to a reduction in drilling and a serious threat to production. **The production growth observed during the past half of a year is obviously related to the investments of the previous years and the use of new technologies.**

Little-by-little, the effect of the earlier investments weakens and, according to some estimates, **in 2016 we can expect an absolute decline in oil production which may contribute to the market balancing.**

As always, the most pressing question remains - what exactly can we do today to ensure sustainable development in the future?

Saudi Arabia, as we see, continues to implement its strategy of increasing market share by increasing the production at low prices.

In this regard, it should be noted that US oil imports from the Middle East over the last decade have significantly declined: from 125 mmt in 2005 to 82 mmt by the end of 2015. At the same time, despite all the current problems of the region, production in the Middle East during the same period increased by 114 mmt. Thus, we can see how the **Middle East starts to seek for new markets.**

For example, the Hungarian Duna refinery in Százhalombatta has recently started to import alternative oil from Kurdistan. A similar example can be traced in Poland. After the visit of the Polish Prime Minister to Saudi Arabia in April 2015 **an agreement was reached to supply the Arab oil to the Polish port of Gdansk** for further processing at refineries Plock and Gdansk.

At the same time, a question arises - how long and reliable can these supplies be, knowing that the Middle Eastern oil transported to Europe does not have a logistical advantage over its supply to the Asia Pacific region?

It should be also noted that **the strategy chosen by Saudi Arabia does not bring it significant benefits, if anything.** The low prices induce it to



spend tens of billions from the sovereign wealth funds are resort to foreign borrowings.

Recently, there was a need for fiscal austerity. Thus, the **Ministry of Finance of Saudi Arabia encouraged other ministries** of the country to restrict spending. In particular, the ministries were recommended **not to buy new cars** or furniture, not to rent new premises and freeze the employment by the end of the year.

In such a way, OPEC has completely ceased playing the role of the regulator. At the recent OPEC meeting no decisions were made.

### ROSNEFT INVESTMENT OPPORTUNITIES

In my report, I would like to note that, **despite the crisis and sanctions, Rosneft is one of the world's most investing oil companies.** In 2015, the total scope of materials, works and services purchased by the Company will be **at least 21.9 billion euros.** The approved business plan till 2017 and the plan for 2018 suggest an increase in total purchases up to 23-24 bln euros per year.

The scale of Rosneft investment program envisages one of the world's largest anchor orders for engineering industry and chemical industry products, in the first place – about 4.6 bln euro annually.

**The total demand of Rosneft for materials** in 2016-2018 will be **€15.9 bln** in accordance with the business plan. In particular, the Company will require resources in the following key product groups:

- **Over 2.5 mmt of casing and tubing** at more than **2 bln euros**;
- **Over 800,000 t of chemicals**, additives and other chemical products at more than **375 mln euros**;
- **Over 47,000 km of downhole cable** at **250 mln euros**;
- **Over 17,000 downhole pumps** for production at more than **220 mln euros**;
- **Over 2,800 transformer substations** at more than **180 bln euros.**

I would like to stress that European companies started to lose their historical advantage in respect of import deliveries for the needs of Rosneft. In

particular, **following the 2015 procurement procedures, the volume of European contracts is 9 times less** than the volume of deliveries over the same period under the past contracts. The replacement of suppliers is fast enough, the beneficiaries are usually the companies from Asia-Pacific countries and the United States. I believe that the European suppliers can and should regain their positions.

Another area of our bilateral trade expansion is the import substitution processes on which Russia is focused and which have significant government support.

Efforts of the European companies to localize their production in Russia would help to effectively compete with the supplies from ATP and win a considerable market share in Russia.

For Rosneft, the key investment objective in this regard is the **construction of the Far East shipyard Zvezda** to meet the future needs for the development of the Arctic shelf. Its **investment capacity is about 2 bln euros** and the planned sales volume when the project runs at full capacity is more than **5 bln euros per year**.

It will require high-quality machinery, fittings, electronics, control systems, etc. I think that the Italian engineering corporations would be interested to participate in this project.

The JV of Finmeccanica, Rosneft and Helicopters of Russia (Rostec Group) involved in the production of shipboard helicopters is certainly a good example, considering that in the framework of this project the anchor order of only Rosneft will be **up to 180-200 helicopters**. I wish there were more such examples.

## RUSSIA AND EUROPE: NATURAL SYNERGY

The issues of cooperation development in the Eurasian space are extremely topical. And it is based on the Russian-European cooperation as the most historically close and comprehensive, having a natural synergy.

I have no doubt that the Europe's energy security will not be based on spot supplies from the Middle East, but rather on the expansion of the volume of long-term contracts for the oil supply from Russia. **In 2014, oil supplies from Russia to Europe amounted to about 127 mmt of which 41 mmt** were provided under long-term contracts with Rosneft.

#### RUSSIA AND EUROPE: LOCAL PARTNERSHIP OPPORTUNITIES

At the same time I am confident that our partnership in the energy sector should not be limited to the supplies within Europe. Temporary volatile downturn opens up new opportunities for effective cooperation throughout Eurasia. They are connected with the objectives of risk management, energy security, reciprocal linking of the interests of suppliers and consumers. The most important areas here are the **development and transfer of technology**, education and training of qualified personnel.

In light of the key macro trends and the development of the world energy market, the role of Eurasia becomes defining. There is a need to support the transformation of the structure of supply and demand which would lead to a shift in the geography of global energy supplies towards Eurasia and within Eurasia – towards the Asia-Pacific countries.

In practice, this opens up a wide variety of opportunities for the European business in the course of cooperation with Russian partners. These include **supplies of equipment, participation in joint production and logistics projects**, portfolio investment and bank financing. According to our estimates, only **Rosneft can offer projects worth about \$100 bln to European partners** in the course of relations development along the energy bridge "Russia - Europe" and "Russia - Asia-Pacific countries."

In this way, together we shall make efforts to increase the transparency of the borders in Eurasia, make the return on equity efficient, build up the investment income, pace and scale of the projects.

The most impressive recent example is the deal with Pirelli which not only successfully restructured its financial debt with our help, but also received a valuable asset in the form of a strategic investor from China and quite new development prospects.

Pirelli demonstrated a model approach to risk minimization and the use of synergy potential of Eurasian cooperation. What happened is actually a large-scale launch of European tire technologies at the largest APR markets with the use of resource potential of Russia and financial capability of China.

## CONCLUSION

Energy as well as food production, due to their strategic importance for any economy, and for the quality of life of mankind, basically should not be subject to made-up interference, political pressure or manipulations of any kind. We all should seek to ensure that flows of energy resources and respective flows of capital and technologies do not become political bargaining chips.

There is no alternative to the international specialization of labor, constructive and mutually beneficial cooperation and interaction.

I take this opportunity to thank our Italian partners for their hospitality and good cooperation; these are companies ENI, Saras, Pirelli, Finmeccanica, Autogrill, Pietro Barbaro, Intesa Sanpaolo, Unicredit and many others.

I wish you every success! Thank you for your attention!