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**OIL MARKET – ON THE PATH TO BALANCE  
AND SUSTAINABLE DEVELOPMENT**

Dear colleagues!

Welcome to St. Petersburg and I'm glad to see you at today's session. I hope that, as always, our discussion will be interesting and productive. By the way, according to media reports the US Congress is closely watching our work and has started to discuss another round of sanctions just when we have our Forum so I hope we won't disappoint anybody.

Now seriously. For the last years our sector has suffered foremost disturbances that resulted in tectonic shifts.

## **I. LATEST EVENTS AND THE CONDITION OF THE MARKET**

As you know, last autumn the President of the Russian Federation Vladimir Putin made an important contribution to the success of the international agreement among a group of oil producers. This affected the improvement of the market situation and the result in the rise of oil prices to \$50 per barrel and higher is beneficial for Russian budget and enterprises but this situation on the market is not stable.

The so-called "Agreement between OPEC and non-OPEC countries", mainly invested in by Saudi Arabia and Russia, is giving the market a timeout, but that can hardly be considered systemic measures, the impact of which can lead to the long-standing stabilization. A number of large-scale oil producers, that do not take part in these agreements, use such conditions to strengthen their market positions, and that leads rather to new imbalance than to the sustainable development. In this way shale oil producers in the US have become the largest exporters with a volume of more than 1.3 mmboe per day. Statistics for May, published yesterday, show that the US output reached the highest level for the last 21 month amounting to more than 9.3 mmboe per day and resulting in the rise of crude oil exports to more than 1.3 mmboe per day.

The OPEC countries that are out of the quotas report an active growth in production - in Nigeria by 100,000 bpd and in Libya by 210,000 bpd. Some experts consider that in May total oil produced by OPEC exceeded the volumes, agreed in November, by 450,000 bpd.

**Given this we can state that the period of low oil prices will last for a long time.** During the last year the prices for Brent stopped at \$45-50 per barrel - sometimes getting higher for short periods of time - but the volatility at the market and uncertainty have drastically increased.

**In such circumstances analysts already consider scenarios with the prices of \$50-40 and even \$30 per barrel.** Balancing the market long enough at the level of \$40 per barrel will lead half of the production to the brink of loss ratio - first of all deep-water projects in Brazil and oil sands in Canada, will create problems for shale producers except for high-effective blocks in the Permian basin. As the screen shows, Russia, Saudi Arabia, a number of highly effective projects in the US, Iran and projects in some other countries will preserve competitive power but this won't help the consumer market.

Unfortunately, uncertainty at the market intensifies the struggle for consumer markets and I have to state that today all market participants prepare to rise production volumes and fight for the share on sales markets. We have to agree with the fact that **if our sector needs sustainable and long-standing balance - all large producers must take part in regulation of the production.** That is why in current state we cannot speak about stabilization or sustainable break through the negative market trends.

## **II. GROWING DEMAND FOR ENERGY, THE ROLE OF HYDROCARBON ENERGY AND ALTERNATIVE SOURCES**

It is important to note that now, for the first time since 2010, we observe simultaneous growth of economic activity in both developed and developing countries. A growing global economy establishes a strong demand for energy in a wide range of forms, which must be met at acceptable and competitive prices in compliance with energy security and ecology requirements. And in my opinion, that's where we face, **in spite of the growing market demand from energy consumers, a situation of obvious**

**dissonance between the regulatory agenda and the challenges of effective satisfaction of this growing demand.**

Firstly, it concerns **the use of revenues from the traditional hydrocarbon energy industry for unjustified subsidization to alternative energy**. Some experts and regulators express clearly overstated expectations regarding the growth of energy efficiency and energy saving. Yes, these processes are actually underway, but it's clear that lately the rate of energy efficiency is not increasing. The overall rate of the energy consumption decline in the global economy was just slightly over 1.0 percent in 2016. Given the role of coal getting reduced for environmental reasons and limiting the role of nuclear energy, there is a significant burden of covering these needs that will fall on gas, liquid hydrocarbons and potentially renewable energy sources (RES). **So, the question for the participants of our discussion is to what extent are the RES capable to assume the mission of the main resource to cover the growing demand? It seems that these possibilities are rather limited.**

In an answer to this question about new sources of energy, a good and important example for the oil industry is the role and development dynamics of the electric vehicle market.

Most likely, in the long term, electric vehicles will take their place in the growing fleet of the means to provide mobility of people and business. This will have a certain effect on the rate of consumption, but will not generally lead to the displacement of petroleum products and to the use of gas in transport. **A more serious change in the role of electric vehicles will require rethinking challenges of energy security, the requirements for the production of the main components of these products and large-scale investments associated with the growth of this sector, which regulators often do not consider.**

According to leading investment banks, in order to reduce world oil consumption by only 2 percent by 2035, it will be necessary to build enterprises for the production of batteries with a production capacity of more than 500 GWh in 2020-2030. And yet, facilities planned for commissioning before 2020 do not exceed 35 GWh, i.e. 15x power increase is already required! **Facilities under construction are already being implemented with delays.** The production of batteries on this scale will require fundamentally other volumes of consumption of nickel, lithium and cobalt. The Democratic Republic of Congo (responsible for more than 50 percent of world production and reserves) will be the main supplier of cobalt, one of the key components of batteries for the electric vehicle market. **So, the next question to be discussed is whether the energy security of developed countries will increase or decrease after the transfer of decision-making to new geography in comparison with today's distributed decision-making model.**

Yes, electric vehicles have already appeared today, although it's too early to talk about full-scale commercial success because sales volumes are small and depend on tax and excise incentives in different countries. Today, the share of electric vehicles does not exceed 1.0 percent in total sales in the US (about 157,000 units in 2016), 1.3 percent in the EU (212,000 units), 1.7 percent in China (351,000 units). The only country where the sales share of electric cars has reached a serious level of 24 percent is Norway. **The simple reason is that in Norway the subsidies amount for one such car is \$18,000 to \$19,000** (for comparison, in the US and other EU countries it's only \$6,000 to \$8,000). Let's not forget about other important details as well:

- electric cars are much more expensive than cars with oil engines;
- electric car charging is a very long-lasting process that isn't very convenient for ever-hurrying car drivers;
- issues concerning effective energy storage, ecological properties of storage batteries manufacture and disposal are of current interest;
- charging infrastructure expansion hit considerable scales only in the USA, EU and Japan; establishing of charging stations network and related infrastructure just begins; for the moment these issues stand open;

– in many regions, specifically in the European Union, taxes and excises on oil products constitute an important part of the budget revenues sent for social purposes among others. But RES producers and electric cars consumers rather got used to the opposite – government subsidies;

– it is not clear how an extra demand for electric power generated by mass development of electric car industry will be satisfied (it will be necessary to increase generation and find solutions for networks development);

- there is no doubt that electric car operation in winter in regions with severe climate will be a problem because the storage batteries are quickly discharged under such conditions.

As a result of recent discussions with a number of the European regulatory authorities there is a confirmation that **electric cars are not in demand in such key economies as Germany and other large EU countries that casts doubt** on the possibility of explosive demand growth expected by some analysts.

In our opinion, under these circumstances the assessment of prospects of electric car producers made by the market is significantly overestimated. So, the assessment of the Tesla Inc. value is based on extremely aggressive plans of sales growth – annual 90 percent increase rate for 4 years to produce 1,000,000 cars per year, the rate of new car models launch and support infrastructure construction, planned by the company, are extremely complex problems. A half of \$1.2 billion recently raised by Tesla were spent in the first quarter of 2017 and there are obvious questions on the economic viability of the business model. That is why J.P. Morgan and a number of other investment banks believe that the current market capitalization of the company (\$56 billion) is significantly - almost two times - higher than its fundamental indicators. I hope that the market will get answers to many of these difficult questions on June 6 after the Tesla shareholder meeting.

Thus, until the electric cars become as convenient and attractive for consumers as combustion engine cars, the prospects of electric cars remain largely uncertain. The same problems relate to other alternative energy sources – **they are characterized by unstable government subsidies and lack of possibility to work in base mode of electric energy consumption.**

**The absolute truth is that the hydrocarbons energy was and will be in demand.**

**Analysts agree that the share of liquid hydrocarbons in global energy consumption will slightly decrease but exceed 25-28 percent in future, the role of gas as an ecologically sustainable source will grow. Therefore we urge to adjust the regulatory and fiscal agenda in accordance with fundamental tasks to provide global consumers with energy.**

### **III. SHORT- AND MEDIUM-TERM RISKS**

From this point, it must be noticed, that during the last crisis, volume of investment in new projects has reduced significantly.

In 2016 operational and capital expenditure in global upstream development totaled about \$860 bln, 33 percent less than in 2014 (\$1.3 trln). First of all, companies reduced budgets, allocated for exploration. **As a result, reserves growth did not compensate production.** For instance, in 2014-2016 investment in prospect drilling decreased 2.7-fold. The industry lost 2-3 years of effective geological exploration, which in 5-7 years may result in an imbalance of global supply and demand.

Evaluations, regarding exceedance of production over demand in past quarters, provided by the leading analytic agencies, vary significantly: on the 4th quarter of 2016 they ranged between 0.6 mmbob per day and 1.1 mmbob per day. This also makes it harder to reach equilibrium on the market.

Strong signals are needed for a coordinated behavior of the market players, but obviously, we lack justified data on condition of the market. For example, until the first shale revolution in 2009-2011, the USA had no urgent need to form detailed information on weekly dynamics of oil production. The market

started orienting to 'surrogates' of data - dynamics of commercial reserves. However, this index was influenced by many factors of completely different nature - from change of oil refining volumes to amount of stored oil and petroleum products. Also the role of commercial oil reserves in the world has changed. Oil reserves management became an independent business, less sensitive to short-term fluctuations of supply and demand.

Speculative trading of future contracts increases volatility on the market. Recently the volume of such trading on two world's largest commodity exchanges in New-York and London (WTI and Brent benchmarks respectively) reached historical maximum, **exceeding volumes of purely financial trade from 10 years ago by more than three (!)-fold.**

The **performance of oil market** itself increasingly develops following its own rules and according to the interests of market speculators. At the same time, it influences physical market greatly. It can be said, that today financial markets - **dynamics of which is more than 70% dictated by North American market places** - act as some sort of regulators. It is also demonstrated by the fact, that different companies of the industry have different opportunities of access to loan and stock capital.

Unfortunately, these and other objective problems created preconditions for increasing variety of market manipulation methods that we were talking about a year ago. These problems have proved the market's sensitivity to manipulations by generating and distributing false signals, distracting participants' attention with minor factors.

Long periods of extremely intense price volatility of the market were observed in 2016. For instance, volatility of derivatives (Oil Volatility Index) amounted to 65-70 percent in Q1 2016. The volatility and price leaps themselves represented a very large multiple of the extent of real changes in the market balance of supply and demand. **In Q1 2017 the volatility in question dropped to 25-30 percent which was a sign of temporary stabilisation.**

The steady growth in oil demand **on the real market** did not lead to rebalancing of the supplies last year, as the temporary decline in US production had been offset by inertial production growth at major projects outside OPEC launched earlier, and, mainly, by production growth of those OPEC members who tried to compensate for the fall in their incomes that way.

For their part, Russian enterprises have been expanding to new markets intensively by establishing effective dialogue with their partners in the Asia-Pacific region. Domestic companies have been increasing investments in import substitution by implementing projects with their foreign peers actively. **As assessed by The Financial Times and The Wall Street Journal, the Russian oil market is being developed successfully and attracts funding despite the external restrictions.** In particular, we cannot but mention forbearance and high quality of work of Russian regulators less focused on the political environment and more on ensuring the industry development.

While speaking more generally, we can observe an «offset» of the nature of the industry's proprietorship - even private companies are forced to participate in political processes owing to the sanctions regulatory mechanisms. The boundaries between the private and public sectors are blurred - this concerns both the selling prices of petroleum products and the selection of certain projects for implementation by direct instructions from regulatory bodies such as the OFAC. This often happens at the expense of their own shareholders, and I would not be surprised, should this issue be raised much more intensely at another stage of the cycle by companies' owners who have to accept the scenario of expectation losses.

**The rise of oil prices to \$50-55 per barrel in Q1 2017 resulted in recovery of cautious investment optimism in the industry, as well as in shrinking of the volatility.** At the same time, uncertainty about the true state of balance and production growth in OPEC countries exempt from the Agreement, as well as active development of shale reserves in the US caused the prices to drop from that range in early May and created risks of destabilisation on the market. Surprisingly, the recently achieved agreement on

extension of the deal for 9 months created a «short-term volatility» effect and even led to a decrease in oil prices that were rebalanced again soon.

Recovery of large-scale long-term projects of majors is the slowest. For instance, the number of big projects launched in 2015-2016 decreased 4-5 times compared to the level of 2008-2012 and dropped to minimum observed only in the late 1990s and early 2000s when the price of oil was as little as \$20-25 per barrel (\$30-35 of today's real prices). This can be explained with a few factors:

- objective quality of their resource base, relatively poor provision of high-quality resources with competitive unit costs of exploration and development in comparison with large national enterprises;
- previously made decisions, including those about financing projects with high breakeven point unprofitable in the current price environment.

Besides, traditional advantages of majors - their up-to-date technologies, quick decision-making, coordination on the market, large-scale volumes of swaps - are being used more and more actively by national companies. Now majors with their technology-based business model compete less with other majors and more with producing countries and their state-owned enterprises expanding to the global market. **Today it's not obvious at all that majors will be the best buyers of traditional resources. National companies are quite competitive and have already gained the experience and expertise required while implementing big and complex projects. Their contribution to the global production is over three times higher than majors'.**

As a result, we can see yet more vividly the strengthening of state-owned oil and gas enterprises such as Saudi Aramco, Qatar Petroleum, Chinese CNPC and Sinopec. Moreover, their operation expands not only in their own countries, but also globally.

In particular, Chinese national oil and gas companies work very hard to expand their international operation by purchasing stakes in projects not only in emerging markets, but in the USA, Canada and refining and petrochemical industry. In fact, a new energy hub is being formed that will have its own indicators and thus will be able to lower the impact of traditional oil-trading centres such as London ICE, New York NYMEX and Chicago CME.

Similar strategies are implemented by Indian companies, the coordinated policy and possible consolidation of which are supported at the highest state level.

Instability of the energy market development makes its participants' lives more challenging but, at the same time, tailors new opportunities for strong companies that have potential for redesign. However, their opportunities are also mostly determined by external factors and regulatory agenda of the countries of operation - fiscal and tax factors, infrastructure costs, technologies and ability to develop them, as well as structure of equipment and services supply markets.

#### **IV. HARMONIZATION OF CONDITIONS OF OPERATION IN OIL MARKET**

So, for example, an important factor for both OPEC at large and Saudi Arabia as the biggest participator of the organization in particular is upcoming Saudi Aramco holding IPO. It is already possible to say that it will become one of the most important events in international energetics.

The active state policy of the Saudi Arabia government aimed at national oil company support should be noted. A pivotal revision of the Saudi Arabia tax system which was made for Saudi Aramco investment attractiveness rising and will ensure radical tax burden cut and dividends growth is the most impressive.

On our part, we can only welcome the upcoming IPO and wish every success in its realization. Our experience shows that the strategic and financial investors entry in capital allows to increase the company business value, gives a strong impulse to search for extra sources of effectiveness. Moreover, this step will allow Saudi Aramco to run a business not only within a frame of transnational agreements but the

corporate links which will provide the necessary flexibility, increase the speed of decision-making and allow creating business partnerships based on market relations.

Favourable conditions are also created in the USA oil sector, I will dwell on them.

The reaction of the USA shale oil production was slow even after the prices fell below the breakeven point and only in 2015 the production capacity fall became evident. The total production of liquid hydrocarbons in the USA declined at about 0.8-1.0 mmboe per day in the conditions of the economic slump. The shale oil production declined at about 600,000-700,000 bpd making a contribution in this fall.

Several factors influenced this development:

– constant technological progress in the field which became even faster in stress conditions of the crisis. I note that all of us face and are to face the technological challenges in the conditions of rising competition in the foreseeable future;

– the flexibility of the American oil sector at large including the service and transport capacities redundancy in the crisis period and the risk of customers' pressure on cost of service provided by service companies, well-developed hedging devices, the possibilities of drilling replanning within the short time, well-developed oil and gas pipeline network.

The situation in the USA shale oil sector is still very diverse. The stagnation and decline last on many fields but growth leaders have emerged – first of all, the Permian basin. I think that simultaneously with the activity restoration in shale oil sector we are on the verge of the significant growth of expenses due to increased demand on services provided by service companies and a requirement of vast investments for its meeting. **I do not rule out that the «new wave» of expenses inflation may influence other countries.**

Our consolidated estimates show that WTI price change leads to changes in number of active oil and gas rigs with the lag of about 4 months. The number of active rigs is the best marker for the number of wells put into production in two months. In this way the oil price change leads to change in the shale oil production in the USA in about 5-6 months.

Overall, we observe the analysts' optimism concerning potential shale oil production growth in the USA in 2017 – at this moment it is at 700,000-1,000,000 bpd. Such dynamics is driven, first of all, by the performance growth in the USA shale oil sector. For example, projects' capital expenses were reduced by 71 percent and the horizontal wells drilling capacity declined by 60-70 percent in 2016 compared with 2014. Despite that, the rig penetration grew by 47 percent and the new oil production increment cost halved.

Even more optimistic are the growth perspectives in 2018 – about 1.5 mmboe per day. So the production cut within the frame of the agreement of the OPEC and non-OPEC countries can be compensated in the great measure by the shale oil output growth in the USA by the middle of 2018.

There are exclusively favourable conditions for shale oil production in the USA:

– according to the Rystad Energy data, current tax payments do not exceed 10-15 percent, taking into account widely applied stimulations;

– new tax initiatives of the USA government, particularly income tax reduction, will create extra preferences;

– well-developed finance markets with the full set of tools – cheap funding, hedging.

Of course we must note that there are several factors which can slow the rebound of shale oil production including infrastructure restrictions, the scale of required investments, restrictions in cost of service provided by service contractors. **A number of these restrictions might be overcome within implementation of the new US energy initiatives.**

Associated gas production in the USA, supply surplus of which will create additional preconditions for US LNG export development to the promising and highly competitive markets of APR countries and Europe, is growing along with oil production. At the same time, competition on the European gas market might be even tougher, taking into account large volumes of pipeline gas supplies not only from Russia but also from the African countries and Norway.

Growth of US «gas liquids» production also became an important factor, which resulted in the fact that the overall liquid hydrocarbons production during the crisis fell only by 200 mmboe per day. The factor of expanding «gas liquids» production will contribute to the growth of US production in middle- and long-term perspective and will give a powerful stimulus for petrochemical industry development.

**In conclusion we would like to emphasize that the capability to determine a globally competitive regulatory regime, including taxes and other factors, is a key to sustainable quality growth for oil producers, and the US example is prominent in this case.**

The Russian oil industry has its own peculiarities in terms of ability to finance its own development, primarily due to internal financial reserves and generated cash flows.

Russian share in the global demand coverage in recent years remained generally stable, so the production growth caused by implementation of companies' business plans (about 2 percent per year) was only slightly higher than demand growth rate (approximately 1.5-1.7 percent per year). **In my opinion, the stability of Russian production was underestimated by the market.**

**Now the reasons of this phenomenon are well explained: it is a quality of Russian resource base, successful development of local technological and service competences, intensive work on reducing costs, effective acquisitions and high corporate responsibility.**

In general, the Russian oil sector investments in rouble equivalent (and most cost items are in roubles) under the crisis conditions were increasing, and so did the production.

In Russia a number of companies including Rosneft made investment decisions, implementation of which causes production growth, several year ago. We adjust them in accordance with understanding of importance of reaching global balance, of course. We believe that as the market demand for new supplies grows, we can contribute to meeting it.

I would like to note that many countries are ready to reduce fiscal burden on business. It seems that other industry regulators including responsible Russian regulators should also monitor such processes to ensure competitiveness of the industry.

## **V. TECHNOLOGICAL PROGRESS AND NEW IMAGE OF OIL AND GAS COMPANIES**

We have repeatedly stressed the importance of technological shifts in energy sector in general and in oil and gas industry in particular. Without technological breakthroughs many things that we are discussing now and which constitute prospective of our business would be impossible.

The world will increasingly become involved in what is now called the «fourth industrial revolution», and our industry will actively participate in these processes.

The ongoing qualitative changes in economy technological basis modify demand structure of not only energy, but also hydrocarbons, which become required in new classes of products and goods.

At the same time, **the development of petrochemical industry** as the basis for the production of new construction materials (fully synthetic and composites) already competing with metals for their performance characteristics, as well as of a wide range of high-tech petrochemical products is an underestimated factor in any discussion about the peak of oil demand.

I would like to point out the processes, taking place in the service market.



The companies shift to integrated model of complex services and equipment suppliers. This contributes not only to the development of technological competences, but also allows to diversify risks and increase financial stability. The processes of merging and creating partnerships for ensuring the synergy of joint usage of competences (technological, market, production, financial competences) of their participants will continue to play an important role. In this regard we may single out the deal on merging of Baker Hughes, one of the «Big Three» oil service companies, with General Electric Oil and Gas. This deal creates assets synergy and strengthens both companies' position in the industry, at the same time showing change in oil service meaning itself.

I should note that over the past years our company has been developing partnership with General Electric, which allows us to work out and introduce advanced technological solutions on the largest oil and gas projects and facilitates progress of the Russian economy due to building of production facilities and localization of equipment and technology production.

**We need to find and more actively use industry development tools, which meet the challenges we face.**

In particular, it is necessary to establish vertically integrated chains involving consumers and manufacturers, asset exchange and use other approaches enabling openness and stability of the industry.

Under the conditions of the ongoing changes, oil companies themselves should change by taking active part in forming demand on new products they are able to produce, by searching for new ways to increase their efficiency and finding a new place in the economic system of the future that is yet taking shape.

It seems necessary for the companies to contribute to demand formation, including that on hydrocarbons as the main source of raw materials for oil and gas chemical industry development.

There is a need for new forms of increasing corporate efficiency that would affect all the factors totally, from cost-cutting to accelerating the introduction of new hydrocarbon reserves and boosting the flexibility of manufacturing schemes.

## **VI. ROSNEFT, A RESPONSIBLE INDUSTRY LEADER**

As for Rosneft, despite market volatility, we were able to set our records: hydrocarbon production amounted to 5.6 mmbob, having increased by 4 percent over a year. **The company outperforms many countries in oil production (210 mmtob per year).** Last year Rosneft continued actively forming regional and global partnerships and developing integration ties with the countries of Europe, Africa and Asia-Pacific region.

Let me list the landmark deals closed last year:

- in December 2016 we acquired a share in the biggest Mediterranean gas field Zohr in Egypt, which allows us to enter promising gas markets in the region (this project is a joint one with our partner Eni, from Italy, and BP Oil Company);
- restructuring our joint venture with BP in Germany in December 2016 resulted in stronger positions in one of the most promising oil product markets in Europe and in us becoming the third biggest oil refiner in the German market;
- in October 2016 we announced the acquisition of a share of one of the biggest Indian refineries, which does not only allow us to enter a new fast-growing market, but also to ensure the stability of operation in the region.

**Partnerships created by Rosneft open new opportunities both for our European and Asian partners.** These include new projects, opportunities for swap oil supplies, equipment supply, joint projects in production and shipping, and joint ventures in production designed to monetize the company's resource base.

The integral privatization deal on acquisition of Public Joint Stock Oil Company Bashneft share and a sale of 19.5 percent share of Rosneft to new strategic investors became a crucial step not only for Rosneft Oil Company but for the whole Russian economy as well. The deal showed that even in a complicated market situation the performed transactions and formed partnerships proved a great potential value of really high-quality assets.

**It is with confidence that I say our most prominent achievements are still ahead.**

We know that the Russian government is about to release new tax initiatives associated with introduction of a tax for additional income, which is supposed to give a new impulse to attracting investment in the industry and become an important step to creating a competitive fiscal system, taking into account the latest initiatives of Saudi Arabia and the USA — we cannot but welcome such initiatives.

Competition within the industry and around it will keep on growing. The role of boosting business administration efficiency and the quality of the corporate decisions is increasing. **On our part, we are going to continue working in the direction of realizing Rosneft resource potential, active cooperation with our partners and pushing the boundaries in the best interests of our shareholders.**

Thank you for your attention, I wish you to succeed in realizing the plans you have made.