

TEXT

Rosneft President, Igor Sechin presentation at the International Petroleum (IP) Week in London on 10-11 February 2015

Greetings ladies and gentlemen

We are, no doubt, are in a fairly acute crisis in the oil markets.

Over the past 50 years we have seen several crises related to the oil market, which had both economic and political causes.

In the second half of 2014 there was a **drop in oil prices**, which was **faster** than anything that has been seen before. When comparing this drop with that of the mid-80s, one should not only adjust for inflation, but also take into account that at that time the dollar was much stronger to a basket of currencies than it is today. With these taken into account, the oil price level before the falls, and the magnitude of the price falls, are similar.

At the same time in 2014, there were no sharp changes in global stock markets. Stock markets and other assets were stable. This crisis is positioned as a "fundamental oil crisis", which has distinctive feature that the balance of **supply and demand** for oil remains fairly close, within the past decade's fluctuations.

Please, note that in the eighties a significant drop in prices was accompanied by **huge OPEC spare capacity**, which accounted for **24% of world consumption**, as well as by major discoveries of traditional fields outside OPEC, such as the North Sea. Today, spare capacity is only 5% of consumption, which is only 2 percent, or 2 million barrels a day above the ten-year minimum. Let alone the fact that almost **half** of today's spare capacity is **not available** simply because of wars, revolutions and sanctions. **Where are the fundamental drivers for the oil price crash?**

So, fundamentally, the crisis in oil prices in 2014 – **is just a ripple on the water compared to the oversupply tsunami of 1985**. The proportion of spare capacity is **one fifth**. Operating costs are **twice as high**. Investment costs are **two - three times higher**. Instead of a deep drop in demand – demand is growing. The rate of decline in Marginal production – is **ten times higher**.

There is a **clear discrepancy** between the observed price dynamics and the fundamental drivers, which in our view has been caused by a complex of medium-term and situational factors, including the translation of North American market parameters into the rest of the world, production growth in Libya and Iraq, as well as unilateral sanctions. **What could it lead to?**

In response to the **extreme decline in prices**, oil companies around the world significantly reduce their **investment programs**. There have already been announced reductions of **67 billion** US dollars or on average **20-30%** compared to the last year. Wood Mackenzie estimated that in 2015 investments are expected to reduce in the amount of more than \$ **100 billion** US dollars.

Oil service companies have announced **significant** staff reductions, about **20 thousand employees**, indicating the decrease in the volume of services provided.

The number of **rigs in the United States**, which held because of the long-term contracts, has already begun to decline quite sharply. According to Baker Hughes, in January 2015, the decline was **276 units or more than 18%**, and **it is just the beginning**. For the time being this has not yet reflected on the physical delivery markets due to the growth of fracking density, and price hedging by independent producers.

Decline in investment will inevitably lead to the **restoration of the balance of supply and demand** in the oil market, but **excessive reduction** of investment in production now could lead to a **shortage of oil already in the fourth quarter of the current year**.

With regard to the fiscal budgets of producing nations, it is widely known that in recent years they have grown strongly, mainly in order to address social problems. In the current environment, a number of these countries, most of which do not have substantial financial reserves have significantly reduced social obligations. What effect might have similar actions in such intense but important oil regions as Nigeria, Libya, Iran, Iraq and Angola?

The position of consumer countries when oil prices fall at first glance seems positive. But despite supporting economic growth, this reduction leads to a decrease of **centralized fiscal revenues** to such countries because of reduced profits of major oil companies registered there. And social obligations in some of these countries on the contrary grow due to rising unemployment in their own high-cost oil production sector.

We have already talked about reducing the investment budgets of major oil companies and here are examples of some of them such as those by Shell, Total, Chevron and BP. Reduced investments are in the billions of US dollars.

Small and medium-sized oil companies will suffer more than others, because they do not have a diversified resource base and the level of financial stability. Share prices of independent companies are declining, indicating that soon many of them may experience severe financial hardship and are likely to become subject to takeovers.

Related industries also have significant losses, reducing headcount by tens of thousands. This will create an additional burden on the budgets of some countries.

In general, the very basis of investment activity in the oil industry is being undermined, which, given its long-term investment cycle, may have long-lasting negative consequences.

Base production in traditional fields declines by 5-6% annually. At the same time, the decline rate of shale fields amounts to 30-50% per year. As a result the weighted-average base production decline rate in the United States, according to IHS data, is around 28% per year.

Clearly, with annual base production decline of 5-6 million barrels per day given an initial surplus of 2 million barrels a day, a sharp drop in investment coupled with a constant growth in demand will lead to a balance on the **physical market** in less than a year. Of course, assuming that there are no artificial methods of extending the current crisis!

Even amid an unstable global economic recovery, oil demand is steadily growing. As you remember, there was a significant drop in demand during the 80s crisis: in the early 80s demand declined by 7% and only by 1987 did the demand for oil reach the 1979 level. Today, such a sharp decline is nowhere to be seen. The growing world population consumes more energy. Despite the increase in energy efficiency and competition from other fuels, oil remains the main source of energy for transport and feed for the growing petrochemical industry.

According to world's leading analytical centers, oil consumption will grow by 10 percent from the current level by 2020, and a further 10% by 2030-2035.

The growing demand for oil, with increasing rates of base production decline will require more and more investment in the development of new high-tech oil fields, and, consequently, higher prices in order to attract such investments. Concurrent

investments in related industries will contribute to the growth of the world economy, including its high-tech sector.

The main reason, discussed by experts and analysts for current oil overproduction, is the growth of production in the United States connected with the shale revolution. But usually revolutions do not last long, and after a while the hard reality returns. With regard to oil production in the US, this reality consists in a low availability of resources – given the current production level, proven reserves would only last **12 years**. If we consider all resources, there will be enough for 55 years, but in this case we are talking about resources in a broad sense, including potential and yet unproven volumes.

According to current estimates, largest oil reserves are concentrated in the Middle East. But we know that for non-public companies from the region, oil reserves have not been independently audited.

Excluding the Middle East, large oil reserves are in Russia, Canada and Venezuela. But **the potential growth** will inevitably rely upon what we call the "high-tech oil" - including oil sands, extra heavy bitumen oil, the Arctic shelf, shale, etc. They require most advanced technology and large investments for development. But it is necessary from the perspective of energy security, which, of course, includes ensuring necessary diversification of supply sources.

While overcoming the current crisis, the oil price will rise to the level of "investment" balance, in other words, to the price that provides an acceptable rate of return on full cycle development costs of new fields, including exploration, drilling and infrastructure.

Even before the crisis, during the high oil price period, major oil companies were increasing their investments, whilst only managing to maintain a stable level of oil production. This proves one thing – new oil is more difficult to produce and requires both innovations and large investments, which will justify higher prices.

So we witness a profound mismatch between fundamental factors and market reaction to them in the current crisis.

What leads to such distortions?

What problems exist in the pricing mechanisms on the oil market?

First of all, I want to draw your attention to the increased role of financial instruments and financial players in oil pricing. Over the past 20 years, the volume of open positions in futures Brent and WTI rose by five to ten times, while oil

consumption increased only by 32%. It has already been noted that such growth of "paper contracts" largely led to price volatility in 2008. Due to the fact that the oil market has become a kind of a financial market, speculative factors, including the movement of capital, liquidity, the popularity of alternative investment assets, began to exert more pressure on it rather than real economic factors.

The problem of financial markets is their tendency to "bubble", let us remember the dot-com crisis of 2000 and the mortgage loans crisis of 2008.

Another aspect of the financial markets is that they are susceptible to **outright manipulation**. Let's just remember the exposed collusion on **Libor rate** fixing, gold fixing, and **bogus triple-A ratings** on infamous mortgage-backed securities.

Unlike the shares of internet companies, regular oil supplies are **vital** to the daily functioning of society. Exposing oil market to the risk of **market bubbles** and **distortive manipulations** is **shortsighted** and may lead to most **dramatic consequences**.

The dynamics of share prices of the independent US E&P companies makes us wonder: **are we witnessing another 'bubble'?**

Unlike European companies, whose stocks are 40% lower than January 2014, stock prices of independent US E&P companies today are back to the level of January 2014.

Why is this happening? Have these companies boosted their **efficiency** *so much* as to **fully compensate** the declining oil price effect? Have they resolved their multibillion debt issues? Or maybe the market is simply **not assessing them properly?** Aren't the **'fashionable'** shale investments the today's analogue of dot-coms and mortgage-backed securities?

What will happen to the US **financial sector** when this bubble bursts?

Here's another example.

On the one hand we have Lukoil company. This company is accountable for **2.1% of the world's crude production**. It has assets in exploration, production, refining, and retail across the globe.

On the other hand – EOG company, leader in tight oil development in the US. Its reserves are only 25%, and its production is about 1/7th of Lukoil. No refining and retail businesses are available. Despite this, EOG's market capitalization exceeds that of Lukoil **by 34%!**

In our opinion, this is another evidence of the fact that US shale oil companies are **overvalued**.

Clearly, the development of market infrastructure is an issue. It has to be addressed by establishing **proper regulation** that would ensure **transparency** both in the **crude futures markets** and in the **securities markets**, including stocks and bonds of oil companies.

State regulation is present within the oil market; however it is often heavily **protectionist** and does **not contribute** to the effective development of the global oil market.

For example, state regulation in the United States, which has been banning oil exports for over 40 years, combined with the shale oil development, results in US refiners having **non-competitive advantages** versus European refiners. Also, it is strange to observe selective exceptions with respect to condensate exports, which was granted to only two market players.

Excessive regulation in Mexico and Nigeria inhibits growth in crude production.

Tax and excise duty policy in the EU countries interferes with the pricing for oil products.

Sanctions against Russian Federation are aimed at **undermining** long-term crude supplies to Europe and may lead to further growth in Brent/WTI differential to the detriment of European refiners.

All of this leads to the regionalization of the global oil market and misbalances of the markets for oil and oil products.

Over the past five years **Brent/WTI differential** has expanded significantly, failing to reflect the intrinsic **consumer value** of these two crude streams; as a result a **regional market of its own** has formed in the United States, fueled by a lower crude price, **translating distortions** into the markets of other regions.

Thus, American refining is **displacing** European refining. Because the US market is long in **light crude** due to the export ban, a distorted light/heavy differential is formed. It is hard to imagine what the consequences could be if such regulation was introduced with respect to the exports from Russian Federation. But we did not go along this way!

As a result of differentiated taxation in Europe and USA, differently structured oil products markets have formed in these regions, which are not only different from each other, but also do not match the refining yield structures of these regions.

Overall, we are observing that **competition for the premium markets is heating up**, as does the struggle for extracting rents from oil. Governments of oil-consuming countries are imposing **taxes** on oil and gas, that are **higher** than those imposed by the producing countries. In case of the **European** countries, taxes and duties on oil products are higher than the **oil price itself**.

This kind of regulation distorts the markets **so much**, that one cannot help but wonder: **is there a market?** In fact the most real foundation of the global oil market is the activities and cooperation between large world-scale corporations, including their strategic agreements, long-term contracts, exchange of assets and technological know-hows, and other modern forms of long-term cooperation.

OPEC's share in the global oil market in recent years is quite stable at around **39% this year**. Of course, it is still a noticeable organization in the market. But the organization has lost the unity of interests of its members. A group of the Middle East countries has been formed seeking to dominate within OPEC and refuse to consider the interests of those members, for which the stability of the oil market is vital as a result of socio-economic factors. We must also take into account that a number of OPEC countries have significant problems in the areas of **security** and stability.

In fact, only this select group of the Middle East countries has (or believes that it has) the sufficient financial resources and considerable resources of available capacity; to execute a **coordinated oil policy**. In the recent years their policy has led to the destabilization of the market and simply a lack of understanding on the part of many of its participants of the real objectives of such a policy.

In a broader sense, the infrastructure for the discovery of oil prices **is not reliable** and **requires improvements**.

First, the **fundamental data** on the oil market is not completely reliable. We have already mentioned the issue on **the audit of reserve volumes** of oil producing countries where production is carried out by non-public companies. At the same time, **our company**, like many other public companies, discloses **detailed information** about its reserves. **The rules of the game** should be the **same for all**.

Analytical units of large investment companies produce public reports that, apparently, can be influenced by conflicts of interest between their unbiased beliefs

and the need to support the investment positions of their parent companies. As a result we are seeing "zig-zagging"; sudden changes in the conclusions and recommendations that contribute to the destabilization of the market.

Quotations from other market participants also often contribute to market distortions. Thus, a number of **articles** published last autumn by leading news agencies pushed prices to a radical drop.

Unfortunately, we can assume that, given the possession of inside information, those statements were aimed at the furthering their own interests, which again is typical for non-public companies which operate in a different regulatory regime.

Fundamentally similar events are often interpreted arbitrarily and oppositely. For instance, the recent increase in oil storage in tankers by large investment market players - regarded as a **positive signal of inflationary expectations (in accordance with the contango in the forward curve)**, and the growth of commercial stocks in the US - as a negative signal of weak demand leading to a price decrease.

Finally, the question can be raised about the price discovery in the **oil market**, as well as the accuracy of price reporting. As you know, in 2008 this issue was considered by the US Securities Commission, and in 2013 an investigation was initiated by the European Commission in relation to **price reporting agencies** in connection with suspected **manipulation**.

At the same time, business and real oil market participants may oppose risks caused by regionalization, volatility and financial speculation by engaging in closer integration along the value chain and by building **long-term relationships**.

For example, consumers are financing the construction of infrastructure to ensure a stable supply.

Long-term contracts for the supply of oil allow to minimize the risks of consumers and to ensure replenishment of the resource base of oil producers.

Consumers and traders could increasing their presence in exploration and production.

Same things are happening in the oil service sector and high-technology equipment manufacturing.

Producers and traders are investing in refining, as well as entering the retail markets in consumer countries.

These processes **are already taking place** and many companies, including Rosneft and others listed on the slide are parties to them.

The infrastructure of the oil market requires major improvements. In our view, such improvements should primarily affect the following areas.

With respect to **market participants** and **trading platforms**, they should:

- Control the influence of **financial players** in the pricing of oil and increase the role of the **real** producers and consumers.
- Increase the share of **physical volumes** in oil pricing up to 10-15% of total trade flows.
- Develop regional **oil trading platforms**, taking into account the specificities of their respective markets and dominant grades of oil traded there.

The following could be a useful improvement to the **market information infrastructure**:

- Reorganize the exchange infrastructure of the oil market via strengthening of the role of producers and consumers, accompanying this with increase of transparency of the exchanges to reduce the possibility of price manipulation (similar to activities carried out in respect of bank interest rates and pricing agencies).
- Improve the efficiency and quality of **market information** (production and consumption volumes, reserves, price information, terms of strategic contracts for oil, the registration of OTC transactions, etc.).