

Increasing the Efficiency of Oil Production: Responding to the Challenges

KEY CONCLUSIONS

Windfall profit tax optimizes taxation in the oil industry

“Taxation is a powerful incentive for oil companies that helps to specifically develop fields and regions that are most efficient. This year an important decision has been made – the law on WPT (windfall profit tax from the extraction of hydrocarbons). This law will take into account specific aspects of geology and the complexity of mining to the greatest degree, which can subsequently be taken into account in the implementation of relevant projects. But this is just the first step, and based on the tax breaks that we come up with, we will be able to transfer the cost centre and production centre to the respective regions”, Head of the Department of Oil and Gas Production and Transportation at the Russian Ministry of Energy Alexander Gladkov said.

“The law on WPT will make it possible to test new approaches to the taxation system – and the influence of taxation on the financial result above all else – in pilot mode. We regard this stage as an important element in the tax system. This bill primarily aims to give a boost to the fields of Western Siberia. Based on the project results, a decision will be made to further extend it to other regions of oil production. In addition, we are offering a number of incentive measures to attract additional investment for oil production. These include the uplift mechanism, which involves the use of a higher depreciation rate on investments in Western Siberia, incentives for geological exploration, greenfields – an adjustment to the reference point for calculating regional mineral extraction tax breaks from the time 99% oil reserve depletion in the subsoil area is reached, and incentives for the development of oil rims”, Deputy Director of the Department of Oil and Gas Production and Transportation at the Russian Ministry of Energy Andrey Tereshok said.

“The Ministry of Finance presented a counter-initiative – let’s replace all types of existing oil production support measures with the WPT. Perhaps this is also a solution for the future that could work. The WPT could become

a common umbrella that includes all tax regimes”, LUKOIL Vice President for Economics and Planning Gennady Fedotov said.

“We have been working for a long time to introduce the WPT. I fully agree that this is by no means the end of the road. We are only halfway there to harmonizing and improving the efficiency of our tax legislation in the mining sector, since the WPT is being introduced on a very limited pilot basis”, Director of Tax Policy for Work with Oil and Gas Sector Companies at KPMG in Russia and the CIS Viktoria Turgeneva said.

Geological exploration needs to be incentivized

“The resource prospects for traditional production areas are still quite high. They account for roughly 45 billion tonnes of D0–D2 category resources, almost 26 billion tonnes of which are in Western Siberia. These reserves are mostly small objects in marginal zones and in deposits with difficult development conditions – Bazhenov and Domanik formations, overlooked deposits, and sub-gas deposits. There are still prospects for major discoveries, but mostly in areas far from infrastructure. Of course, these reserves should also be explored and incorporated into development, which requires adopting measures in two key areas: the first is incentivizing geological exploration in order to discover new fields in remote and marginal areas of traditional oil production regions and the other is incentivizing development of hard-to-recover reserves”, Russian First Deputy Minister of Natural Resources and Environment Denis Khramov said.

“If we don’t incentivize geological exploration now, we will not be able to create a reserve for the stable reproduction of the mineral resource base and a stable level of production in the country”, Head of Crude Oil Upstream and Technologies Direction at VYGON Consulting Daria Kozlova said.

PROBLEMS

Reduced production at conventional fields and depletion of the resource base

“Oil production in Western Siberia accounts for about half of total Russian production. Over the past 8–10 years, the decline in production in the region has averaged 2–3% per year. If these rates of decline are not

reduced, production in Western Siberia will decrease by 50 million tonnes in 10 years. It is impossible to quickly build up [oil production] using greenfields, offshore fields, and the shelf”, Gennady Fedotov said.

“It is clear that we can’t expect an increase or improvement in the resource base. If we want to comply with the promises made by our country’s leaders and companies to support production and growth, then we must do something with a resource base in the next 7–10 years”, Gazpromneft NTC Executive Director for New Technologies Alexey Govzich said.

Shortcomings in the manufacturer support system

“I get the impression that obtaining benefits is becoming a strategic goal. We proceed based on a very simple scenario – to produce as much as possible and then come what may. Let’s continue to distribute benefits – great, that’s a good idea. We will reach some sort of peak production, then we will start to rapidly fall back from it. We have 15 billion tonnes of reserves that are already being granted tax benefits”, Director of the Tax and Customs Policy Department at the Russian Ministry of Finance Alexey Sazanov said.

“When there are a lot of benefits, this means that the [tax] regime is initially wrong”, Head of Tax and Legal Partner at KPMG Russia Mikhail Orlov said.

Shortcomings in tax regulation

“If you look at the current economics of the projects, the prime costs for Western Siberia are about RUB 6,000 per tonne, while taxes amount to more than RUB 20,000. Consequently – no miracles there – the geological mining conditions are deteriorating, so the share of the pie where we can afford to levy such high taxes on existing projects will gradually decrease. The state should be ready for this”, Director of the EY Moscow Oil and Gas Center Denis Borisov said.

Outdated depleted well regulation system

“There is still a rather extensive and complicated system of regulation for wells that have been working for a long time, have become depleted, and are profitable at a particular oil price and unprofitable at another. Companies see which wells need to be shut down and which ones need to be turned on at a certain time. But our regulation system is such that we

cannot shut down a well for more than 6 months. After 6 months we have to mothball it. Mothballing itself costs money. In fact, there is an increasing number of such wells, and something needs to be done with this regulation system”, The Boston Consulting Group Senior Advisor Alexey Kondrashov said.

Difficulty of forecasting the industry’s development as technology rapidly evolves

“I was embarrassed to ask the question of why we needed 550 million tonnes of production given that we had planned much less. The only answer I can come up with is that maybe oil will not be needed at all in 5–6 years. It’s pointless now to conserve and reduce oil production while expecting to produce it for another 70 years, given that alternative sources of energy will put an end to oil as the main energy industry in the next 10 years”, Mikhail Orlov said.

SOLUTIONS

Improve extraction technology

“Our technological breakthrough is the technology for chemical-based advanced recovery methods (which are used for the additional extraction of oil from highly depleted, flooded oil-bearing strata with dispersed and irregular oil saturation). Several years ago, Gazpromneft NTC, along with specialists from Shell, successfully tested chemical-based advanced recovery methods. The water cut decreased from 98% to 88%. The oil recovery factor delta increased by 17%. Using this method, we could produce an additional 40 million tonnes of oil by 2030, and in the long-term, such growth may reach 70–100 million tonnes. Restrictive factors for technology include: the cost of chemicals (but here we are cooperating with Russian manufacturers, in particular with Sibur) and the second factor is economic. It requires additional preferential taxation. The initiative is supported by the Russian government, and there are hopes that in 2019 we will pay much more careful attention to this technology”, Govzich said.

Optimize regulation

“We need to pay more attention to small fields and study the experience of the Republic of Tatarstan. After all, they had the same situation in 1997 – oil production had been declining for 17 years until 67 fields were



transferred to small companies and the government created a targeted tax system”, Association of Independent Oil and Gas Producing Organizations (AssoNeft) General Director Elena Korzun said.

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