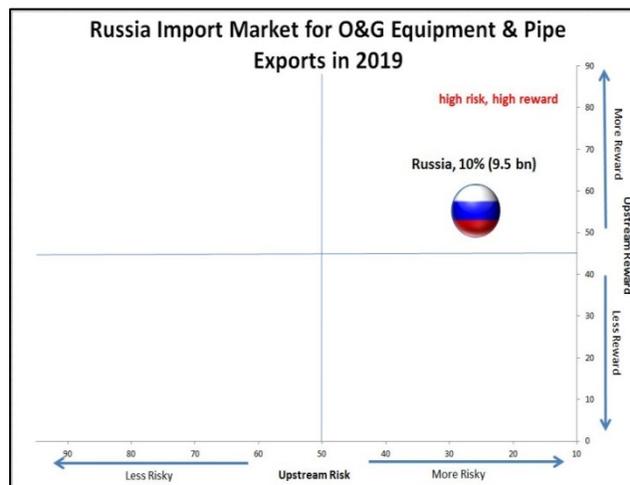


2016 Top Markets Report Upstream Oil and Gas Equipment Country Case Study

Russia

Overall Rank: 20

As long as existing economic sanctions remain in place, U.S. companies will have difficulty finding profitable investments in high-cost, long-term projects in Russia. U.S. companies will be impacted by U.S. Government sanctions on deepwater, Arctic offshore and shale projects in Russia. In light of ongoing Russian actions in eastern Ukraine, operating in Russia's O&G sector remains risky, as there are concerns over the weakness and instability of the Russian economy. This has resulted in some western companies abandoning the market with others slowing their operations. U.S. exporters should consult with both the U.S. Treasury Department's Office of Foreign Asset Controls (OFAC) and the U.S. Department of Commerce's Bureau of Industry Security (BIS) for the most current listings and descriptions of applicable sanctions.



Background

Russia holds the world's eighth largest proved reserves of crude oil and the largest proved reserves of natural gas. Given its vast hydrocarbon resources, Russia is the world's largest producer of crude oil and the second largest producer of natural gas (after the United States). O&G exports are central to the Russian economy, with hydrocarbon sales accounting for more than half of the government's total budget revenues. Russia currently exports an overwhelming majority of its crude oil and natural

gas to Europe but is attempting to increase its exports to East Asia, as Europe is working to diversify its natural gas sources. The Russian and Chinese governments have agreed to long-term natural gas sales and construction of a transmission pipeline. Details of the agreement, however, need to be negotiated, and the pipeline has not yet been constructed. Russia currently has one LNG export facility at Sakhalin Island, which transports LNG to Japan and South Korea. Exploration and development of additional hydrocarbon resources in the Arctic, the Caspian Sea and other regions could

change the dynamics of Russia's O&G industry, but given current strains on the Russian economy and low international price of oil, Russia is expected to delay investments in these high-cost and risky areas.

The Russian government strives to maintain a tight control on the O&G industry, viewing it to be of strategic significance for its national security. The state has closely controlled the sector by promoting the creation of domestic vertically integrated oil companies (VIOCs) (which account for about 90 percent of the overall oil production and refining), taking political control over re-distribution of ownership within VIOCs, heavily taxing the industry and limiting direct access of foreign companies to exploration and development of oilfields. There are currently only three production sharing agreements (PSAs) in place in Russia: Sakhalin 1 (ExxonMobil, Rosneft, SODECO, ONGC); Sakhalin 2 (Shell, Gazprom, Mitsui and Mitsubishi) and Kharyaga (Total, Statoil, Zarubezhneft and Nenets Oil Company). No PSAs have been added to date due to the restrictive nature of the PSA law, and the share of all the three projects in Russia's overall oil output remains low.

Market Analysis

Russia represents a large global import market for O&G field equipment and is the sixth largest equipment importer globally. In 2015, U.S. exports of O&G equipment dropped to \$409 million (from \$674 million in 2014) and represented less than 2 percent of global U.S. exports. Due to ongoing sanctions, U.S. market share is expected to decrease further in 2016.

In 2014, the United States was the fourth largest source for Russian imports of O&G equipment, holding an 8 percent market share. Russia's largest sources for O&G equipment were China, Germany and Italy with 17, 16 and 11 percent market shares, respectively. Machinery and mechanical appliances, filter/purify machines for gases and tankers for the transport of goods represented more than half of Russia's O&G equipment imports. In 2015, the largest U.S. exports to Russia were parts for boring or sinking machinery (20 percent) and machinery and mechanical appliances (44 percent).

Policy Context: Opportunities and Challenges

In response to Russia's occupation and attempted annexation of Crimea in 2014 and its continued violation of Ukraine's sovereignty, the United States, the European Union and other international partners have imposed a number of sanctions on individuals and entities, as well as a trade embargo on the territory of Crimea. Those targeted by the sanctions include certain O&G companies. For more detailed information, U.S. companies should contact the U.S. Department of Commerce's Bureau of Industry (BIS) and Security and the U.S. Treasury Department's Office of Foreign Assets Control (OFAC).

Western companies, including U.S. firms, have traditionally enjoyed a good reputation for quality, modern O&G equipment and skillful O&G project management in Russia. Many western companies that ventured into Russia at earlier stages and successfully managed the market's uncertainty and instability have seen their products and services accepted by the local industry. Due to Russia's actions in Crimea and Ukraine and the imposition of economic sanctions, however, many joint projects have been put on hold. Low crude oil prices have further stressed Russia's O&G sector, and U.S. companies may find it more difficult than before to sell to the Russian market.

Declining oil prices, coupled with a lack of economic reforms and economic sanctions, have slowed economic growth, thereby putting pressure on Russia's currency and banking sector and reducing access to foreign financing and new technologies. As a result, Russian NOCs have revised their investment plans and are less likely to support the development of technically challenging and uneconomic deposits (i.e. deepwater, Arctic offshore and shale resources). To meet production targets, Russian O&G companies have redoubled efforts to maximize conventional deposits, including stimulation and drilling in existing brownfields, and some greenfield development. Until Russia can fulfill the commitments outlined in the Minsk Protocol, including respect for Ukraine's borders and sovereignty, sanctions will not be lifted. In this policy context, in addition to the current stagnation of the Russian economy, U.S. company participation in Russia's O&G sector will be limited.

The current economic sanctions are likely to cause U.S. companies to encounter more competition in Russia's O&G industry, as the Russian government is encouraging greater import substitution. Since sanctions were put in place, there has been growing sentiment in Russia for more domestically sourced technology and services, not only in the sub-sectors which were specifically sanctioned (deepwater,

Arctic offshore and shale) but also with regard to other types of equipment and technology used in conventional O&G exploration and production. The key technologies for import substitution in 2016 include horizontal drilling, well completion and stimulation, and technology to facilitate the lowering of equipment into the wellbore.