

“This idea is destructive at its root”

NOVATEK’s Chairman of the Management Board Leonid Mikhelson speaks on guarantees, partners and the Northern Sea Route

In a fortnight, NOVATEK intends to launch the second Yamal LNG train. Interviewed by *Kommersant*, NOVATEK’s co-owner and Chairman of the Management Board Leonid Mikhelson speaks on how the company plans to develop new LNG projects, what problems it faces with fleet purchases, including at the Rosneft-controlled Zvezda shipyard, and why prohibition on foreign-built ships in the Arctic makes no sense.

– Early in June, NOVATEK sold 10% in Arctic LNG 2, a prospective natural gas liquefaction project, to Total (France) for USD 2.5 bln. As far as I understand, Total sought a higher interest. Why did you elect to sell no more than 10%?

– First, Total acquired as much as it wanted. Total also has an option to buy another 5% if we decide to scale down our interest from 60% as it stands for the time being. Our French partners are a global company which is pursuing a comprehensive LNG strategy, including production, shipping and sales. Their interest in Arctic LNG 2 ideally fits into this strategy. It is also important to bear in mind that Total’s effective interest in the project is higher given its share in NOVATEK itself (circa 19% – *Kommersant*). Second, Total’s interest in Arctic LNG 2 is in line with our intention to maintain the amount of external financing for the project as low as possible, which is quite understandable (the USA imposed financial sanctions on NOVATEK in 2014 – *Kommersant*). We assume that external financing should not exceed 30% in the project costs.

– Is the difference between NOVATEK’s 60% interest in Arctic LNG 2 and 50.1% in Yamal LNG a safety cushion, so to speak?

– No, I would not call it a safety cushion. We may possibly keep as much as 80% in our next project. It is a trade-off when we consider NOVATEK’s growth rate and investment opportunities on the one side and NOVATEK’s asset portfolio and share in the global LNG market, on the other side. While contemplating a higher share, we also seek to avoid overinvesting in one single project and halting other investments. That is why we kept this 10% leeway until at least the investment decision is made on Arctic LNG 2, which is slated for mid-2019. There is still time to make the best choice.

– What about the other 30% in Arctic LNG 2 which is held for sale? Are you going to split it equally among three different investors?

– Equal or unequal is not what matters most. Our discussions involve multiple institutional investors, including our partners from China’s CNPC and Japan. You know, we are also negotiating with the Saudis. South Korea’s KOGAS started considering the project, too. Each prospective partner has its own vision about such participation, but ultimately it all depends on what offers will be coming.

– Of late, you have become a frequent visitor to China where you were seen just last week. Does it mean that Chinese companies are likely to participate in Arctic LNG 2 if they so wish?

– Our key partner is CNPC, China’s largest state-owned company. They already hold 20% in Yamal LNG with a good track record of partnership, so we feel comfortable dealing with them. Last year NOVATEK signed a strategic agreement with CNPC that provides for their potential participation in Arctic LNG 2. They are considering the project. Being a state-owned company, it needs a bit more time to make a decision. I hope that we will see their offer any time soon.

– Do you expect to have the entire pool of partners before the investment decision is made on Arctic LNG 2?

– I believe our existing and future partners and we would feel much more comfortable if this happens before the investment decision is made so that we could make it together.

– Based on Total’s deal size, a 40% interest in Arctic LNG 2, if sold, will bring in circa USD 10 bln in proceeds, which covers your financing commitments as a shareholder. In addition, you continue to generate cash flow from NOVATEK which will soon be enhanced by Yamal LNG. How are you going to use proceeds? Are you exploring other LNG projects?

– Of course, we are exploring future projects right now. NOVATEK’s strategy presented last year sets a clear target for LNG production of least 57 mtpa by or before 2030. Though I think, we will be able to revise this plan upwards in 2022 if not earlier. We have boosted exploration expenditure for 2018 and 2019 to enhance our resource base going forward. Assuming the current estimates of the resource base, our projects in Yamal and Gydan only will support LNG production of 70+ mtpa.

As for the cash flow, it is true that we will have our project financing needs essentially covered if partners finally join Arctic LNG 2. Yamal LNG is set to start generating cash flows as early as in 2019. Therefore, it is quite likely that we will be in a position to revise our dividend payout upwards. NOVATEK now pays 30% of its IFRS profit in dividends vs 25% previously. I think we will be able to increase the payout ratio in 2020 if not earlier. This is about to happen within next 18 months.

– To what extent?

– I am not ready to give any specific figures. This is a serious matter that requires the analysis of financing needs for investment plans and macroeconomic forecasts.

– When could you make a decision on another project following Arctic LNG 2, if any? Is there any chance that a new project will kick off even before Arctic LNG 2 is finalized?

– I have been thinking on this – whether we should implement projects one after another or, possibly, at the same time. It depends on a number of factors where the financial one comes third. The first factor is what capacity we will be able to deploy in Murmansk to manufacture GBS platforms (with each such platform housing one liquefaction train – *Kommersant*). We are contracting equipment for the first dock right now. Then we will build the second dock to be able to manufacture two GBS platforms at once. We may also consider erecting a building berth to manufacture three liquefaction trains simultaneously.

The second factor is how much time we need to prepare the resource base, specifically by what time we will be able to prove reserves sufficient for at least two liquefaction trains with a capacity of 12–15 mtpa. By the way, the Utrenniy terminal that will house Arctic LNG 2 platforms (three liquefaction trains – *Kommersant*) will have its berth designed to support more than three GBS platforms.

– What field is the most likely source of natural gas for the next project?

– This month we are starting to drill a well at the North-Obskiy license area. Its appeal is based on simpler logistics as it is located to the north and requires no approach channel in the Gulf of Ob. I told my partners: “We will discover either good or very good reserves there” (he smiles).

– However, you will have to drill offshore wells, won’t you?

– Drilling depth is low there, just about 10–15 m. We leased a drilling platform from Gazflot. Having drilled the exploration well, we will have an idea when we are likely to produce a field development plan. At the same time, we are also working on the Gydan Peninsula to the north and to the east of the Utrenneye field, on the Shtormovoye and Gydanskoye fields, respectively. Thus, any of these areas will be our next focus.

– **Will there be any gas pipeline connecting the Shtormovoye and Gydanskoye fields to the Utrenniy terminal?**

– Yes, certain volumes will be transported to the Utrenniy terminal.

– **You have been talking about prospective gas chemistry projects for a while. What is it all about? How far have you advanced?**

– We lack expertise in gas chemistry, so we are looking for professional partners.

– **But SIBUR is there...**

– We are looking for partners who have access to the respective market in the first place and boast necessary expertise in the second place. We were considering manufacturing locations in Ust Luga (Baltic Sea) some time ago. Based on economic feasibility, we are now leaning toward building production facilities in Sabetta on the Yamal peninsula.

– **What products are you going to manufacture?**

– Methanol. Understandably, added value is great while the cost of our natural gas is three times lower than that of Henry Hub (USA). On top of that, Sabetta offers good logistics: once loaded, ships can go to anywhere in the world.

– **When do you plan to launch the second and third Yamal LNG trains?**

– I hope, the second train will be on stream in the first weeks of August. The third one is expected to become operational no later than in early 2019.

– **This comes earlier than anticipated while the entire fleet of Arc7 ice-class tankers is yet to be built. How do you intend to transport additional LNG volumes during this year?**

– We rely on additional Arc4 tankers while also considering transshipment to conventional LNG carriers in Murmansk. Going forward, we will deploy a permanent transshipment terminal in Kamchatka. No doubt, even if we launch the third Yamal LNG train on 1 January 2019, we will not be handicapped in terms of shipment volumes.

– **How do you intend to procure shipments if you lack Arc7 tankers?**

– We plan to arrange for transshipment to conventional tankers in Murmansk to reduce the voyage distance of Arc7 tankers coming from the Yamal peninsula. Conventional LNG carriers are available in the market. In terms of freight, these are much cheaper than ice-class tankers.

– **Where will transshipment occur, in Russia or Norway?**

– We view Norway as a temporary short-term solution only. We have already requested a permission from the Russian Government to establish a transshipment terminal somewhere in the Murmansk Region. Necessary approvals are now pending from the Ministry of Defence and the local authorities. I believe that we will obtain them any time soon.

– Is the Murmansk Region intended for transshipment in the long run anyway?

– Yes, it is.

– In such a case, how many Arc7 ice-class tankers do you need for Arctic LNG 2?

– It depends on many factors. We are now negotiating with Atomflot to ensure that our tankers are able to travel at a speed of at least 8–9 knots even in heavy ice conditions. The number of Arc7 tankers will eventually depend on whether icebreaker assistance provides for such speed. For instance, the program is in place for the construction of new nuclear-powered icebreakers. Three LK-60 icebreakers were to be manufactured, but we have seen none so far though one icebreaker should have been commissioned already. I have discussed this issue with Alexey Rakhmanov, head of USC (the United Shipbuilding Corporation – *Kommersant*), and he said that it would produce an icebreaker per year starting from 2019. Prime Minister Dmitry Medvedev held a meeting on the same matter, which effectively approved the decision to increase this number up to five LK-60 icebreakers.

In addition, NOVATEK is also considering the construction of own 40 MW LNG-powered icebreakers. Rosatom was exploring the same solution that we are now discussing together. Ideally, we would like to use LNG-powered icebreakers in the Gulf of Ob and the Kara Sea. Based on its current specifications, such icebreaker may travel for some 30–32 days before refuelling. At the same time, nuclear icebreakers could be used to the east of the Gulf of Ob, from the Kara Sea to the Bering Strait. If Lider-type icebreakers finally arrive, there is a 100% chance that we will be able to transport LNG to the east along the Northern Sea Route (NSR) all year round.

– Do Arc4 tankers with icebreaker assistance provide an alternative to Arc7?

– Yes, they do. The Russian Government has adopted a resolution for the NSR to be operated by Rosatom. Just in time as our dialogue on joint development of the ice-breaking fleet and our discussions about LNG icebreakers center around the terms and conditions of the NSR navigation. We expect that five LK-60 icebreakers to be commissioned in 2019 through 2023 will cover navigation between the Kara Sea and Bering Strait while navigation to the west of Novaya Zemlya will be covered by LNG-powered icebreakers.

– You established Maritime Arctic Transport and signed a cooperation agreement with Sovcomflot. How will this company operate and what is the role of Sovcomflot?

– Sovcomflot should play a leading role, especially in terms of management expertise. Possibly, we may invite a foreign partner to this company. Crewing is key. Another issue is financing for the fleet construction. Though solved by our shipowners within Yamal LNG, financing is still a problem, as far as we know. Therefore, I believe that this company will help streamline the management of the entire tanker fleet in this area and enable shipowners' to raise financing for the construction of new tankers.

– Will this company also own icebreakers? Who will operate these?

– We are considering whether it is feasible. Icebreakers differ from tankers in terms of operation as well as crewing arrangements. We are considering cooperation with Atomflot in terms of icebreaker operation and crewing arrangements.

– Who will own icebreakers and tankers?

– Ownership and financing is yet to be decided. For us, it is important to provide for a single operator of the fleet and secure financing for its construction. The final solution depends on what our partners, Sovcomflot and, possibly, a new partner, will choose.

– **This is a non-core business for you which has its own risks. Why are you doing it?**

– I believe that we mitigate our existing risks instead of accepting additional ones. NOVATEK's investments will be moderate. Sovcomflot and prospective partners need us as a guarantor of freight volumes. This is our contribution to the company while they will bring in professional competencies in fleet construction and operation.

– **You said that you had been discussing the construction of Arctic LNG 2 tankers with the Zvezda shipyard, which is being built by Far Eastern Shipbuilding and Ship Repair Center (FESRC), a consortium of Rosneftegaz, Rosneft and Gazprombank. To the best of my knowledge, Zvezda offered a price 60% higher than that in South Korea.**

– Discussion is a misnomer since we have signed an agreement along with a work schedule that provides for specific types, the number and delivery schedule of vessels required for our shipowners' (rather than for NOVATEK, I want to stress it specifically). We are negotiating commercial terms based on technical specifications, including prices and warranties. There are no specific figures. Everything is yet to be agreed.

– **But we know that Zvezda cannot build LNG carriers for the time being.**

– Do you? I don't know that. Our potential shipowners audited Zvezda in late April and documented what capacity the shipyard had and what it didn't have. We plan to start signing LNG shipping contracts with shipowners (and they, in turn, with shipbuilders) in early 2020. I think that Zvezda has every chance of creating the capacity it needs within the remaining 18 months.

– **And what if it doesn't?**

– I'm the wrong person to answer that. FESRC says the capacity will be in place.

– **The question is how you will transport gas from Arctic LNG 2.**

– If Zvezda refuses building ships, they will be built elsewhere.

– **And if FESRC agrees, what are potential delivery and quality guarantees?**

– Guarantees should be as firm as to protect us from any risks and losses in any circumstances. This point was also discussed with the Government, and they understand the situation.

– **The Government is considering amendments to the Merchant Shipping Code to prohibit the navigation of foreign-built ships along the Northern Sea Route. NOVATEK is said to be nearly the only opponent to the amendments. Why are you against them?**

– These amendments make it almost impossible to meet the Russian President's goal of increasing cargo traffic on the Northern Sea Route to 80 million tons per annum. We should support the national shipbuilding industry rather than prohibit the navigation of certain ships in a particular region. This is why we suggested that the Government should draft a new law to support the Russian shipbuilding industry.

If we take a look back at the history of shipbuilding in the USA or the world's strongest ship construction industry of South Korea, or China, no country was able to create a world-class shipbuilding industry without government aid. Russian shipbuilders should be given maximum subsidies, all the way down to direct investments in the development of the industry. All our talks with Sovcomflot and other potential business partners focus clearly on one point – Russian shipyards should be prioritised. Another point is that the Government should help the shipbuilding industry to deliver a proposition that is going to be competitive in terms of price and timing.

– **Amendments to the Merchant Shipping Code provide for certain exemptions for NOVATEK. It means your LNG carriers will not fall under the ban.**

– NOVATEK refused to take part in discussing amendments to the Code. This idea is destructive at its root. I will stress it once again – we need a law aimed specifically at supporting the Russian shipbuilding industry. And it should provide for the maximum support possible. All those exemptions or no exemptions... You say there is a possibility of obtaining exemptions. But who will take this decision? What for? NOVATEK is a very large company, and it will give shipowners enough cargo to carry along the Northern Sea Route. We have signed an agreement with a Russian shipyard for Russian shipowners to place orders at. Isn't it enough?

You know that one of the first gas shipments by sea from Yamal LNG sold on the spot market went to the USA. How did it get there?

The USA prohibits traffic of non-US built vessels, but no single LNG carrier has been constructed at US shipyards. They simply cannot deliver their own LNG from the Gulf of Mexico to Boston!

Let us learn from the mistakes of others. By the way, Americans learnt the lesson and have developed amendments to remedy the inefficiencies created by the law.

– **Since logistics is crucial to your LNG deliveries, have you given a thought to entering the shipbuilding business?**

– Everyone should do their own business. A gas company produces gas; a shipbuilder builds ships.

– **Another increase in gas transportation tariffs is being discussed by the Government. Deputy Prime Minister Dmitry Kozak, who is in charge of the issue, has held a meeting recently. Do you expect tariffs to grow?**

– We do not expect tariffs to either grow or drop. We believe that tariffs should be based on a pricing mechanism that is clear for every market player. Both the Government and/or the Federal Antimonopoly Service, which is now responsible for setting tariffs, keep saying that a pricing methodology should first be developed and adopted. A recent inter-agency government meeting yielded good results. Dmitry Kozak gave instructions to estimate the tariff base and Gazprom's net operating expenses for gas transportation, and then calculate the share of capital costs in the tariff. Results should be produced in four to six weeks. This is when we will be able to get back to the issue of raising or not raising tariffs. Gazprom needs it more than others. And so does Rosneft as Russia's second largest gas producer and distributor, and so does NOVATEK because everyone wants to have a long-term view of its costs.

– **Did you raise the issue of regulating gas storage tariffs at the meeting?**

– Yes, we did. Tariffs as such have not been set yet but, as far as I know, FAS plans to introduce rules of non-discriminatory access to Gazprom's underground gas storage (UGS) facilities in the near future.

– **Do you have any problems accessing UGS facilities?**

– No, I cannot say so. Gazprom responds positively to almost any request we make. However, since UGS tariffs are not regulated, Gazprom raises them annually on 1 April. It is not a matter of tariff rates, but of transparent rules that are missing.

– **How significant is the matter of gas storage for you?**

– Gazprom was right at its time saying (to independent gas producers – *Kommersant*) that the Russian gas market goes far beyond large and solvent consumers and includes households. And at present, we supply

gas to almost 100% of industrial consumers and households in the Chelyabinsk and Kostroma regions. Smolensk is almost there, too. Household consumption largely varies by season, and we have to inject several billions of cubic metres into UGS facilities to meet peak demand in winter.

– Does it mean that it is more cost-efficient to store gas in Gazprom’s UGS facilities than adjust production at your gas fields?

– Gazprom deserves much credit for upgrading its storage facilities and increasing the maximum daily withdrawal rate from 350 to 600 million cubic metres in the last five or six years. It means Gazprom and we are now able to cover any peak demand in the coldest season. Gazprom has done a lot to improve its storage facilities. Although we are not totally satisfied with the pricing for gas injection, withdrawal and storage because we have a different point of view, it is still more cost efficient to inject and store gas in a UGS facility than adjust production.

– Gas consumption in Russia is stagnating. Do you give a thought to buying any assets on the consumption side – for example, any generation facilities – to monetise your gas?

– No, we don’t. As for stagnation, there is a great potential in streamlining the process of obtaining gas permits. There are so many regulatory barriers and steps in this process that it is very difficult for a consumer who wants to convert to natural gas to obtain such a permit. NOVATEK also raises the issue of introducing an investment tariff to develop the Unified Gas Supply System (UGSS) and regional gas pipelines. Take a boiler plant for example. It is, say, a fuel oil-fired boiler, and the regulator has set a tariff for it. And of course, fuel oil costs are included in the tariff. A gas pipeline is then built, and the boiler is converted to gas, which is much cheaper than fuel oil. The tariff is subsequently decreased, but the gas pipeline will never pay back in this situation. If the current tariff is RUB 100 and the boiler is converted to gas, the new tariff should be fixed for five years at, for example, RUB 98 for investments to pay back.

The same refers to the UGSS development. For example, there is a consumer. A part of the gas distribution network needs to be upgraded, with a high-pressure pipeline to be built, but it is not on Gazprom’s development programme. We should be given the right to present investment projects to the Government and have them approved. UGSS is single and indivisible. This is why we should have an opportunity to build a facility or a pipeline at our expense, transfer it to Gazprom for operation, and receive a discount off the transportation price for the amount of our investments.

– Are there consumers who need such a mechanism?

– There are consumers in the Moscow region where certain distribution network sections need to be debottlenecked. The same refers to the commissioning of new fields.

– Is NOVATEK satisfied with the status quo in the domestic market? Would you like to maintain your current output and sales levels in the medium term?

– We account for about 9–10% of gas production in Russia and around 18% of the domestic gas market. NOVATEK has to, and will be present in the domestic market. We are satisfied with the current share. We keep working on gasification and focus on mini LNG plants. We are carrying out two mini LNG projects to create the market as we consider it very promising. I will give you an example. In the Kostroma region, the pipeline corridor lies in the western part of the region, in hundreds of kilometres from its eastern border. Gasification with LNG will help solve the problem. We will transport there as much gas as they consume.

– At SPIEF-2018, Patrick Pouyanné, CEO of Total, asked Vladimir Putin to permit exports of pipeline gas from your joint project, the Termokarstovoye field. What do you think of its prospects?

– The matter is very much politicised, and not on our – Russian – part. Vladimir Putin is absolutely right that he, as you say, did not give a direct answer. Of course, the position of our partners is understandable – they invested in the development of the Termokarstovoye field that lies 350 km away from the UGSS. Its economic performance is far from being brilliant. It is clear that Total would like to export at least a part of produced gas to make its investments pay back faster. But the project is paying back slowly without exports. The decision to liberalise gas exports in the current situation would be untimely.

I am sure that more important is to develop LNG production (NOVATEK may export LNG – *Kommersant*). After we launch a 57 mtpa LNG plant in Yamal, Russia with Sakhalin and the third LNG production facility there will account for 14–15% of the world's gas market taking into account the global growth of LNG production. This is not much. Russia's share in the LNG market should be no less than Russia's share in global gas reserves, or 22–23%. It is very important to build Nord Stream 2 and the 38 bcm Power of Siberia to deliver gas to the Chinese market. No less important is to simultaneously develop LNG production.

Yamal and Gydan have enormous reserves. I think that altogether with Gazprom's reserves and undistributed license areas in the region, Russia is able to produce 130–140 million tons of LNG per annum. This is as much as one and a half of Qatar.

– This puts the Tambey Cluster at the forefront.

– Yes, it does. It has significant reserves. I discussed joint opportunities with Alexey Miller. According to Gazprom's strategy, these reserves will go into the pipeline in the mid-2030s. But I think that Gazprom will make a decision to produce LNG locally, and this will be right. I am not even speaking from NOVATEK's point of view. Gazprom might build an LNG production facility based on this resource base. The example of Yamal LNG will probably be a driver. Both NOVATEK and Gazprom have excellent reserves in that region, much better than hard-to-recover shale gas. We will remain competitive with LNG in any market. Russian gas needs to enter the global market in the form of LNG.

Interviewed by Yuri Barsukov

This is translation of the original interview (<https://www.kommersant.ru/doc/3695432>)