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As of January 2, the Ministry of Energy has prepared preliminary data for the oil and gas sector in 2010. Oil production amounted to 505.194 million tons, gas production 650.311 billion cubic meters (Gazprom totaling 508.471 billion cubic meters). Oil exports were 246.816 million tons, while gas exports 167.1 billion cubic meters and primary oil refining 248.727 million tons. In 2011, the Ministry of Economic Developments expects oil production of 504 million tons and gas production of 679 billion cubic meters. The Ministry of Natural Resources and Ecology expects that 2010 results will show a reserves gain in Russia of 750 million tons of oil and gas condensate and 810 billion cubic meters of gas. This would be the sixth year in which the gain of oil and gas reserves exceeds the level of extraction.

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On December 22, Gazprom chairman Alexei Miller and the Republic of Sakha (Yakutia) head Igor Borisov signed a cooperation agreement to implement the East Gas Program. Before signing the agreement Gazprom sent a declaration to the republic's authorities on its intention to construct the Yakutia-Khabarovsk gas pipeline from the Chayanda deposit, one of the largest in Russia. In the future, the deposit could become the resource base to create a unified system of gas supply in Eastern Siberia and the Far East, as well as for deliveries to Asian-Pacific region (APR) countries. Another source of gas for the APR could become the Kovykta deposit. An auction will take place on February 15 for the property of the bankrupt RUSIA Petroleum, owner of the Kovykta license.

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On December 15, shareholders of the Caspian Pipeline Consortium (CPC) approved the final decision to invest \$5.4 billion to nearly double the annual capacity of the system to 67 million tons. Construction will begin in the spring of 2011, take place in three stages, and be completed in 2014. However, it remains unclear where the additional volume will be directed after the CPC expansion is done. Moving it through the already overloaded Turkish Straits is hardly an option. But the two bypass pipelines – Burgas-Alexandroupoulos and Samsun-Ceyhan – are so far only on paper.

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Developments in the Ukrainian Oil and Gas Sector

By Dr. Irina Paliashvili, President and Senior Counsel, and Tamara Lukanina, Senior Counsel
RULG - Ukrainian Legal Group

Despite some ongoing problems, 2010 was a significant year in developments for oil and gas subsoil regulations in Ukraine. Still, failure of the government to show sufficient political will means obstacles remain.

We have been reporting in *Russian Petroleum Investor* on the new developments in Ukraine's upstream oil and gas sector for several years (See "Update on Licensing for Subsoil Use and Trends for 2010," *Russian Petroleum Investor*, January 2010). Last year was an especially significant year because of the changes in the Ukrainian Government (GOU) and the new direction it took at opening the natural resources sector for investment. There have been a number of important developments, most notably the sharply increased interest in investment opportunities in shale gas and the Black Sea shelf, the new taxation regime stipulated by the recently enacted *Tax Code* and the changes (mostly positive) in the legal regime for production sharing agreements (PSA).

Although 2010 was a very active year for the natural resources sector, GOU so far has failed to transform its good intentions into practice and has not demonstrated sufficient political will to offer real opportunities. The main obstacles to the investment in this sector remain:

- confusing, conflicting, unstable and archaic legal environment;

- indifferent and at times hostile attitude of local bureaucracy, especially at mid-levels;
- government interference in the natural resources markets, including controlling gas prices;
- GOU favoring State-owned companies at the expense of private-sector companies;
- lack of transparency and clarity in GOU's actions.

Nevertheless, for the first time in several years, the prevailing mood in the investment community is modest optimism and anticipation.

I. Subsoil Licensing Regime in 2010

The GOU specifically addressed the problems in the Subsoil Licensing Regime in the Program of Economic Reforms for 2010-2014¹ which outlined the required measures and stages for reforming specifically oil & gas sector:

- harmonizing and improving licensing and other regulatory procedures for exploration and production of hydrocarbons;
- establishing equal rules for national and foreign investors in this sector.

Not much progress has been achieved so far. As in previous years, the procedures for granting subsoil licenses (special permits) and holding subsoil auctions in practice continued to be regulated not by law but by temporary GOU resolutions (licensing regulations), which are adopted on

an annual basis. It is interesting to note, however, that GOU adopted a decision, which took effect on 1 January 2011, abolishing the practice of temporary annual licensing regulations and requiring that starting from 2011 they must be adopted on a permanent basis. So far no such permanent licensing regulations were adopted.

In contrast to the previous years, however, 2010 was the first year when the licensing regulations were changed mid-year: in the first half of 2010 the licensing regulations in effect were the two Cabinet of Ministers Resolutions adopted on 17 June 2009 and extended for 2010; in the second half of 2010 the above Resolutions were replaced by Resolutions "On Approving the Procedure for Granting Special Permits to Use Subsoil in 2010" No. 596 dated 23 June 2010 and "On Approving the Procedure for Holding Auctions for Sale of Special Permits to Use Subsoil in 2010" No. 662 dated 21 July 2010.

Analysis of the licensing regulations applicable in the second half of 2010 shows the following negative and positive trends.

Negative Trends:

- The list of cases when subsoil licenses may be granted without an auction or tender (i.e. on a non-compete and non-transparent basis) was expanded from five to fourteen.
- A possibility of granting subsoil licenses based solely on a GOU decision without stipulating any specific requirements or grounds

(again on a non-compete and non-transparent basis) was introduced.

- The procedure of negotiation and adoption of decisions by the Ministry of Ecology and Natural Resources (“Ecology Ministry”) on granting subsoil licenses without an auction or tender was made more complex. Thus, there are two different interdepartmental agencies (an interdepartmental subsoil use *commission* and an interdepartmental subsoil use *working group*), both of which are empowered to make decisions on granting subsoil licenses depending on specific grounds from among the grounds stipulated by the Licensing Regulations. The composition of those agencies was renewed in 2010.
- Although the licensing regulations provided for the possibility to grant subsoil licenses at *tenders* for use of strategic minerals (instead of *auctions*), no clear procedure was established for holding such tenders and as a consequence no such tenders were held at all.
- The Ecology Ministry received the right unilaterally to amend licensing agreements made with a subsoil user, which are an integral part of the subsoil licenses (while the previous licensing regulations expressly prohibited such unilateral amending).
- The fee for extension of an exploration subsoil license was considerably increased from 1 percent to 5 percent of the initial price it was sold at the auction, and the fee for extension of a production subsoil license was

raised to 20 percent (in contrast to 10 percent in 2009).

Positive Trends:

- While the previous licensing regulations deprived the holders of exploration subsoil licenses from an opportunity to convert them into production subsoil licenses, the current licensing regulations allow a holder of an exploration subsoil license, which conducted geological exploration and calculated and approved the reserves according to the established procedure, to obtain a production subsoil license without the need to compete for it at an auction.
- The list of cases when a subsoil license may be reformulated (transferred) was expanded, although it still remains extremely limited.

In practice in 2010, as in 2009, the GOU offered a negligible number of subsoil licenses for hydrocarbons at auctions and only four auctions were held. At the same time, the GOU continued to grant subsoil licenses on a preferential basis to state-controlled companies without an auction (or tender) and continued to adopt decisions to this effect. The lack of transparency became even more evident because some of these decisions were not even published.

For example, the Cabinet of Ministers Ordinance No. 316 “On Granting Special Permits to Use Subsoil” dated 2 March 2010 was never published and only became known because of a court dispute that followed. According to the court materials, the claim was filed by Ukrneftebureniye challenging a provision of the above ordinance, which obliged the Ecology Ministry to grant a subsoil license for Sakhalinskiy oil and gas condensate deposit (Kharkiv region) to the state-

owned company Naftogaz Ukrayiny (Naftogaz). The court ruled the above ordinance illegal and invalidated it. The Cabinet of Ministers together with Naftogaz appealed, but on 1 December 2010 the court of appeals upheld the ruling. A positive aspect of this story is that the court precedent was established protecting the right to obtain a subsoil license against illegal actions of the GOU.

Another example, when the GOU decision was published, but still is perplexing on many levels, is the Cabinet of Ministers Ordinance No. 2295 adopted on 22 December 2010 granting a coal mine (Zasiad’ko Coalmine in the Donetsk region) the right to obtain combined exploration and production licenses for nine oil and gas deposits for a term of 20 years. First, the licenses were granted on a non-compete basis (without an auction or tender). Second, the licenses were granted not to an oil and gas company, but to a coal mine. Third, GOU very rarely grants 20-year combined E&P licenses, but in this case such licenses were granted, and for quite a large number of deposits.

II. Activity Licenses

In Ukraine a number of activities related to exploration and production of mineral resources were subject to licensing, i.e. a company in order to engage in these activities first needed to obtain a relevant license (activity licenses). A separate activity license was required for exploration and for production (extraction of minerals) activities. These activity licenses were issued by the State Geological Service. Effective 17 October 2010, such types of economic activity as exploration and production of minerals are no longer subject to licensing².

This means that, at present, E&P work may be carried out by any

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company without the need to obtain Activity licenses. Such a company may be itself the holder of a subsoil license or may be subcontracted by another company that holds a subsoil license, but neither needs Activity Licenses any longer.

III. Joint Activity Agreements (JAA) in 2010

In 2010, as in 2009, there were the same restrictions and risks in place for entering into joint activity agreements (JAA) with state-controlled (more than 50 percent stake) companies, which in order to enter into a JAA must obtain a prior approval of the GOU, while the procedure for obtaining such an approval does not exist (making this exercise at best non-transparent or entirely impossible).

In general the JAAs, which have been the main investment vehicle in the subsoil sector for years, remain under attack by GOU. In particular, the tax authorities keep insisting on their long-standing position that the *rights of ownership* to the extracted minerals may belong only to the subsoil user that obtained the special permit to use subsoil, and such rights cannot be contributed (assigned) under the JAA³.

Moreover, in December 2010, a new version of Article 14 of the Law "On Oil and Gas" was adopted⁴ (taking effect on 1 January 2011) confirming that contributing the rights arising out of subsoil licenses into a JAA is prohibited.

At the same time, in contradiction to the above position, another new law adopted in 2010, the Law "On the Fundamentals of the Natural Gas Market Functioning," expressly stated that companies, irrespective of the form of ownership, which own natural gas by virtue of the right of

ownership, *including the right arising out of JAAs*, may be considered owners of such gas.⁵

The confusing and inconsistent attitude of GOU towards JAAs remains a serious risk factor for using them as investment mechanisms in the oil and gas sector.

IV. Production Sharing Agreements (PSA) Regime

2010 saw many significant, mostly positive, developments in the PSA regime, which is an alternative to the subsoil licensing regime.

(A) PSA Amendments Law

Over the years there were several attempts to amend the existing investor-friendly PSA Law. Some of these amendments, especially those pursued by GOU in 2009, would have made any PSA-based investment prohibitive, and were furiously opposed by the investment community. Fortunately in 2010, an older set of amendments introduced by a parliamentary deputy a few years ago and adopted as a law, but not signed by the President at that time, was revived, improved and adopted as a new Law (PSA Amendments Law)⁶. In a dramatic development, the PSA Amendments Law was vetoed by the President and then re-adopted taking into account all proposals by the President.

In general, the PSA Amendments Law will have a very positive effect with one important caveat: one of the Presidential veto's provisions cancelled the stability clause (guarantees against changes in the legislation for the duration of the PSA) contained in Article 27 of the original PSA Law, which the investors consider essential for such long-term and high-cost investment. Although there are similar stability clauses in other laws currently in effect (for example, in

the Law "On Investment Activities"), which broadly cover the PSAs, the GOU was strongly criticized for this move because it altered the PSA regime to the extent that it may become unattractive and too risky for international investors. Many investors declared both publicly and privately that no investments should be expected under the PSA regime unless the GOU restores the stability clause. The GOU swiftly made amends by introducing a strong stability clause with regards to the PSAs taxation regime in the recently adopted Tax Code and supporting the re-introduction (by a parliamentary deputy) of the general stability clause into the PSA Law, which is currently pending in the Parliament.

The following provisions of the PSA Amendments Law should be specifically mentioned:

- (1) The priority of PSA Law over other laws in the sphere of PSA regime is reinforced.
- (2) The provision on the parties to the PSA was reformulated stipulating that the state shall be represented in a PSA (solely) by the Cabinet of Ministers of Ukraine, and effectively removing local authorities as another counterparty representing the state vis-à-vis the investor.
- (3) The procedure for granting a *land plot* for PSA purposes (along with granting of a *subsoil area*) was provided.
- (4) For the first time a possibility for converting presumably any subsoil license into a PSA without a tender (based on a decision of the Cabinet of Ministers) was provided. This provision potentially may have a revolutionary effect if the existing subsoil license holders apply *en masse* for converting their subsoil licenses

into PSAs; but so far this provision remains only theoretical, and no implementation regulations or procedures have yet been adopted. It remains to be seen how (if ever) this provision will be implemented in practice.

(5) The procedure for extending a PSA was simplified (at present this does not require preliminary approval of the Cabinet of Ministers of Ukraine and local self-government agency);

(6) The list of cases for early termination, restriction or suspension of the right to use subsoil under a PSA was considerably shortened.

(7) The state undertook an obligation to index the costs to be reimbursed to the investor by means of cost-recovery production, in case such costs were not timely reimbursed.

(8) Taxation conditions stipulated for PSA purposes were improved.

(9) A number of other laws (primarily the Subsoil Code) were improved and harmonized with the PSA Law, creating a more clear and transparent legal framework for PSAs, including in the exclusive (maritime) economic zone and the continental shelf of Ukraine:

- some of the authorization procedures in the sphere of subsoil use based on PSAs have been simplified (for instance, it was established that a PSA shall be a basis for issuance of subsoil licenses and the rights to use subsoil occur on the day of signing of the PSA);
- selected legal loopholes of the customs legislation applicable to the hydrocarbons extracted in the custom territory outside of

the state border of Ukraine, but within its exclusive (maritime) economic zone, were eliminated;

- some conflicts in the law that negatively affected PSA regime were eliminated – for example, granting of authorization documents within the continental shelf and exclusive (maritime) economic zone were regulated.

(B) Law on Public Private Partnership

In 2010 the Law “On the Public Private Partnership” (PPP Law)⁷ was adopted. Although the PPP Law is of declarative nature, it does apply, *inter alia*, to PSAs, which caused additional contradictions and risks to the PSA legal framework. An amendment separating the PPP Law and the PSA Law was introduced and is currently pending at the Parliament.

(C) Pending Settlement of the Vanco Dispute

The PSA regime in practice has been paralyzed since the GOU challenged in 2008 the PSA it signed in 2007 (following the tender in 2006) with Vanco International (US) covering the large deepwater Prykerchenska block in the Black Sea. The dispute was referred to arbitration before the Stockholm Chamber of Commerce. In 2010, the GOU made a widely praised move towards the amicable settlement of this dispute, avoiding huge potential reputational and material costs. It is expected that the dispute will be settled in the near future, reassuring investors to seek new opportunities under the PSA regime.

(D) Practical Opportunities for PSAs

Although no PSA tenders have been announced in 2010, the GOU entertained several initiatives by investors

requesting PSA tenders for various subsoil areas, and even placed some of these areas on the list of PSA-eligible deposits.

While PSA regime may be applied to any subsoil areas onshore and offshore, in practice it is understood that the PSA mechanism will be offered mostly for Black Sea continental shelf (both shallow and deepwater) and possibly for some shale gas areas. There have been many encouraging signs that finally 2011 may become a pivotal year for real PSA investment opportunities.

V. Other Developments in the Natural Resources Sector

(A) New Legislative Acts Adopted in 2010

(1) The long-awaited Law “On the Fundamentals of the Natural Gas Market Functioning”⁸ considerably liberalized the natural gas market, providing for:

- free choice of natural gas suppliers and the terms and conditions for such supply;
- liberalized conditions for trade in natural gas, in particular at auctions, exchanges and through tenders;
- specified types of activity in the natural gas market subject to licensing (transportation by major pipeline, distribution of natural gas and associated gas, supplies as per regulated and unregulated tariffs, storage of natural gas);
- access to the single gas transmission system of Ukraine based on the principles of equality of rights of all natural gas market participants;
- functions of authorized state agencies concerning regulation

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and control in the sphere of the natural gas market.

The above Law will be enacted by stages starting from 1 January 2012 (first stage) and from 1 January 2015 (second stage).

(2) Adoption of the Law "On the Fundamentals of the Natural Gas Market Functioning" facilitated Ukraine's accession to the Treaty establishing the Energy Community (Energy Community Treaty of 2005, Athens). In December 2010, the Parliament adopted the Law "On Ratification of the Relevant Protocol on Ukraine's accession to the Energy Community (EC). Ukraine is expected to notify the Secretary General of the Council of the European Union as the Depository for the Treaty, which will complete the accession procedures. Therefore, it is expected that in early 2011 Ukraine will become the tenth party to the Energy Community.

(3) *Tax Code* was adopted on 2 December 2010⁹ and took effect on 1 January 2011, establishing the following important provisions for the natural resources sector:

- conditions for payment and amounts of the rent for transportation of oil and transit of gas and ammonia through the Ukrainian territory;
- conditions for payment and rates of the rent for oil and natural gas and gas condensate produced in Ukraine, increasing the rent for production of oil, gas and gas condensate by approximately 40 percent. According to Article 258, the rate of the rent for oil and gas condensate extracted from a depth of up to five thousand meters was increased from 1529.9 UAH per ton to 2141.86 UAH per ton; and from deeper depths – from 566.1 UAH per ton

to 792.54 UAH per ton. The rate of the rent for natural gas including oil (associated) gas extracted from a depth of up to five thousand meters increased from 200 UAH per 1,000 cubic meters to 280 UAH per 1,000 cubic meters; from a depth of over five thousand meters – from 100 UAH per 1,000 cubic meters to 140 UAH per 1,000 cubic meters.

- conditions for payment and rates of fees for subsoil use;
- special (and preferential) tax regimes including for PSAs.

(B) The GOU Activities Aimed at Attraction of Investors into the Natural Resources Sector

(1) In October 2010, the Cabinet of Ministers¹⁰ approved the draft memorandum of cooperation between the Cabinet of Ministers, Naftogaz, the Russian Federation government and the TNK-BP group of companies concerning exploration and production of gas in Donetsk region. According to unofficial publications, TNK-BP is interested in six subsoil areas in the region and may invest \$50 million in exploration of those areas during the upcoming three years. It is also reported that the above memorandum was signed on 27 October 2010 and that TNK-BP has already set up an LLC, TNK-BP Exploration and Production of Ukraine (TNK-BP Rozvidka ta Vydobutok Ukrayiny) for production of gas from unconventional sources in Ukraine.

(2) The GOU initiated an investment project titled "Supplies of Liquefied Natural Gas to Ukraine and Construction of the Regasification Terminal."¹¹

(3) With the aim of attracting investments into development of hydrocar-

bon deposits in the Black and Azov Sea shelf, the Ministry of Fuel and Energy and Naftogaz developed in 2010 a "Concept of Development of Hydrocarbon Resources of the Ukrainian Economic Zone of the Black Sea and the Sea of Azov Until 2019," which is currently being considered by GOU.

(C) Shale Gas

Shale gas became a focus of attention in Ukraine's upstream sector and many international oil companies are looking into these opportunities or even announcing their shale gas plans. The GOU was caught unprepared for this active interest and is eager to learn the experience of other countries, most notably the US and Poland.

So far there is no proper legislative framework for exploration and production of shale gas in Ukraine, Shale gas even appears to be outside the scope of legislative regulation applicable to such traditional fuels as oil and natural gas (such as the Law "On Oil and Gas" and other laws and regulations).

Therefore, it is not clear at the moment how subsoil licenses for E&P of shale gas can be obtained. A reliable alternative is PSA regime, but so far the GOU has not offered any shale gas opportunities under either licensing regime or PSA regime.

(D) Parliament Hearings on the State's Monopoly in Hydrocarbons Extraction

On 1 July 2010, the Verkhovna Rada of Ukraine adopted Resolution No. 2386 to hold parliamentary hearings on the subject of "Condition and Prospects for Hydrocarbons Extraction in Ukraine and Introduction of the State's Monopoly on this Activity." The actual hearings were held on 12 January 2011.

The idea of introducing the state's monopoly on extraction of hydrocarbons in Ukraine was proposed by the Communist faction in the Parliament. It was shocking to the investment community and quite contrary to what the new GOU has been declaring since it came into power in early 2010. Fortunately, at the actual hearings this idea was rejected outright by most of the participants, including by the GOU, and the hearings instead turned into a healthy debate on how to improve the oil and gas sector and make it more attractive for investment.

- 1 Cabinet of Ministers of Ukraine ("CMU") Ordinance No. 892 dated 14 April 2010.
- 2 Law No. 2608 dated 19 October 2010.
- 3 State Tax Administration Order No. 185 dated 25 March 2010.
- 4 Law No. 2856 dated 23 December 2010.
- 5 Law No. 2467 dated 8 July 2010.
- 6 Law No. 2562 dated 23 September 2010.
- 7 Law No. 2404-VI dated 1 July 2010.
- 8 Law No. 2467 dated 8 July 2010.
- 9 Law No. 2755 dated 2 December 2010.
- 10 CMU Ordinance No. 2126 dated 25 October 2010.
- 11 CMU Ordinance No. 992-r dated 31 March 2010.

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Projects

Yamal LNG Expands Resource Base

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Prime Minister Vladimir Putin has instructed the distribution of four block licenses that could become a new additional liquefied natural gas (LNG) resource base on Yamal peninsula in 2011. These are the offshore Severo-Ob-sky and Vostochno-Tambeisky blocks in the Kara Sea's Gulf of Ob, along with the Utrenny(or Salmanovskiy) and Geofizicheskoy blocks onshore in the Yamal-Nenets autonomous region. Gazprom and NOVATEK will construct an LNG plant on the Yamal peninsula. The Russian government has also instructed the establishment of zero export customs duties effective 2012, as well as a zero mineral extraction tax level for natural gas and gas condensate extracted on Yamal for liquefying.

Russia has postponed developing Yamal for decades, but traditional regions are now running out of gas and the quality of that gas is diminishing. In addition, Yamal means potential access to new markets. Over the past year, foreign companies have been making proposals and the government has been considering ways to make Yamal projects cost-efficient. In October in Novy Urengoi, Russian Prime Minister Vladimir Putin assembled the heads of Russian companies to review the General Plan for Gas Sector Development for the Period until 2030 and promised exemptions for Yamal.

Yamal is a new and virtually unexplored oil and gas province. The peninsula has about 22 trillion cubic

meters of gas resources, and the gas reserves in explored fields amount to 16 trillion cubic meters (35 percent of all Russian proven reserves); condensate reserves make up 230 million tons and oil reserves amount to 292 million tons. Eleven gas and 15 gas condensate fields have been discovered directly on Yamal peninsula. Gazprom CEO Alexei Miller said that Yamal may produce 360 billion cubic meters of gas by 2030.

It is very likely that Yamal will be first liquefied natural gas (LNG) project implemented with the participation of Russian companies. Yamal LNG production is a pilot project and envisions developing the South Tambeiskoye deposit with 1.26 trillion cubic meters of gas on category C1+C2. NOVATEK owns a controlling stake.