

## Rosneft and BP: oil, money and foreigners

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### Summary

- Last week's announcement that Rosneft would agree to buy BP's stake in its TNK-BP joint venture will almost certainly be the Russian deal of the year. The tie-up sharply increases the stake of the Russian state in the Russian oil industry and scale of BP's partnership with the Russian system. Like any deal that brings together oil, money, the Russian government and foreigners it offers a snapshot of contemporary Russian energy politics.
- For BP, the deal is a carefully calculated strategic gamble. The potential rewards of proximity to the Russian government, including future access to attractive Arctic fields, are substantial. However BP is also potentially doubling down on some of the trickiest political Russian aspects of their TNK deal.
- For the warring instincts in Russian energy politics, the BP-Rosneft deal looks like an attempt at a new modus vivendi, although one that is skewed in favour of the Kremlin and its allies. BP provides the foreign capital and expertise. The Russian state bolsters its grip on the sector with a counterbalancing co-investment.
- The deal clearly has President Putin's stamp, but interpreting Putin's motives is more complicated than it might seem. The move is part of Putin's political balancing of his own instincts, his reading of Russian politics and the factions around him.

Last week's announcement that Rosneft would agree to buy BP's stake in its TNK-BP joint venture will almost certainly be the Russian deal of the year. The deal sharply increases the stake of the Kremlin in the Russian oil industry and scale of BP's partnership with the Russian state. In other words, BP has both exited and entered Russia in the same move.

Rosneft has agreed to buy both BP's stake in the TNK-BP joint venture and that of the Russian oligarch group Alfa-Access-Renova (AAR). The two deals will make Rosneft the world's largest listed oil producer. In return for its stake, BP is receiving a 12.84% shareholding in Rosneft and \$17.1bn in cash, \$4.8bn of which it will use to buy another 5.66% shareholding in Rosneft from the Russian government to bring its holding up to 19.75%.

The deal looks like a good one for Rosneft which, with its acquisition of TNK-BP, will gain an estimated \$5 billion in synergies and effectively will be left with only Lukoil for independent competition in the energy market. For BP, the deal is a carefully calculated strategic gamble. The potential rewards of proximity to the Russian government, including future access to attractive Arctic fields, are substantial. It will be a number of years however before the verdict is in.

The motivations behind the deal for Russian President Vladimir Putin are economic and tactical. Putin is aware of international investors' worries about 'Russian risk' and has already distanced himself from the deal so as to emphasise its commercial character. Needless to say, in reality he could not be closer to it. Like any deal

that brings together oil, money, the Russian state and foreigners the deal is a snapshot of contemporary Russian energy politics. This Global Counsel Insight studies that picture.

### More Russia, please

The dissolution of the TNK-BP partnership will be a source of great relief for BP. While the company continued daily operations, the partnership had become strategically rudderless and board meetings had almost ceased to take place. The nadir came in March 2011 when BP's first attempt to partner Rosneft was blocked by legal proceedings initiated by the oligarchs who held the other half of the TNK-BP business.

At the heart of the problem was the difficulty of moulding a single development strategy between a foreign global energy giant and a group of Russian oligarchs. Whilst BP saw TNK-BP as a long term prospect for oil production, AAR were more interested in paying out dividends. The consequent failure to increase investment was leading to falling production levels, which had become a source of serious concern for BP, and indeed for the Kremlin.

Nevertheless, the deal has been a lucrative one for BP. BP's TNK-BP stake is being sold for \$17.1 billion - \$9.1 billion more than they paid for it in 2003. Since 2003, BP has received \$19 billion in dividends. By market capitalisation TNK-BP was the second largest company in Russia. On paper the investment hardly looks like a disaster.

Whilst most analysts agree that BP are well out of the relationship they have just left, there is a degree of ambivalence about the fact that in some critical respects they seem to be doubling down on some of the more ambiguous aspects of doing business in Russia. The final cash to equity balance - \$12.3bn in cash and a 19.75% stake in Rosneft - provides some resource for financing BP's current cash needs, including funding its as yet unknown Gulf of Mexico liabilities. But it is also a substantial reinvestment in Russia and in Russia via a state-owned entity.

This is certainly a tactical gamble. But it is also a strategic move that could be handsomely

rewarded in the future. Whatever else it might have learnt from its experience in TNK, BP will have concluded that western energy majors can make money in Russia. Many of Russia's most attractive oil prospects lie unexplored in the Arctic. With its large stake and seats on the nine person Rosneft board, BP will feel that it has put itself at the head of the queue for accessing and exploiting these.

Over the decade it is likely to take to start to bring these resources within the scope of commercial access, BP will have to navigate its way through the Russian political system very carefully. Being a minority shareholder in a Russian company, even with two seats on the board, is never a comfortable place to be. BP would no doubt argue that this is a decade to cement itself as the partner of choice for a Russian state that shows no signs whatsoever of wanting to limit its own prerogatives over the management of Russian hydrocarbon resources. How this new 'insider' status plays out for BP is an interesting question - both with other big Russian state-backed players such as Gazprom, and with policymakers in the EU and the United States.

From Rosneft's point of view, and assuming that there are no complications in securing the AAR half of TNK-BP, the deal will deliver on a level of energy market scale that CEO Igor Sechin has been trying to achieve since his proposed Gazprom-Rosneft merger collapsed in 2005. Rosneft is aware that it needs the technical expertise of an international oil major to exploit Arctic fields. To hand this role to BP uncontested is a significant concession but the Russian state's remaining 70% share of Rosneft will ensure that further compromises with its Western partner are kept to a minimum.

However, the scale of the two transactions will put serious strain on the Rosneft balance sheet. As a result Rosneft has reportedly turned to a number of global commodities traders to help to finance the deal through pre-payments on future deliveries. This has not however stopped Moody's putting both Rosneft and TNK-BP on downgrade watch.

## The icing and the cake

The acquisition of TNK-BP is clearly a major landmark in the development of Russian energy politics. In a country where oil revenues account for half of the government's budget the industry is obviously economically vital. But prerogatives over the management and profits of the energy industry are also a battleground for views at the highest level of the Russian government and Russian politics over how loosely the state - or at least the group of individuals who represent the state - can or should grip the production of these revenues.

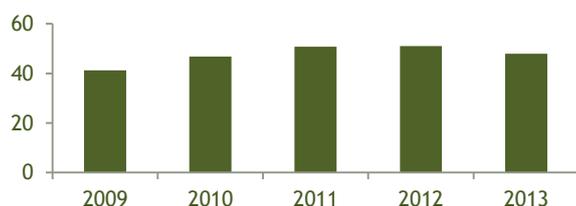


Chart 1: Oil revenue as % of total Russian federal government revenue

Source: IMF

Russia's perennial problem has always been that energy revenues are not the icing on the governmental cake, but the cake itself. Even without Putin's electoral spending commitments on defence, public sector pay and pensions, when oil revenues are excluded, the federal government will run a budget deficit of 10.6% this year. The Russian Central Bank has warned that Russia's surplus of petrodollars will run out by as early as 2015. With the acquisition of TNK, through Rosneft the state will gain direct control over additional production of around two million barrels a day.

Although it is of course grossly oversimplified to cast this debate as a division between liberalisers and statists, there is nevertheless a general tension at the top of the Russian system between the case for state control of Russian energy resources and the case for greater efficiency in their extraction through the participation of foreign investment and foreign expertise and the inevitable sharing of profits. Prime Minister Medvedev is broadly perceived to be in the latter camp. Sechin in the former. While Putin has acted as a balancing force and an arbiter of the two

camp, his instincts in key sectors such as energy have generally been more with Sechin.

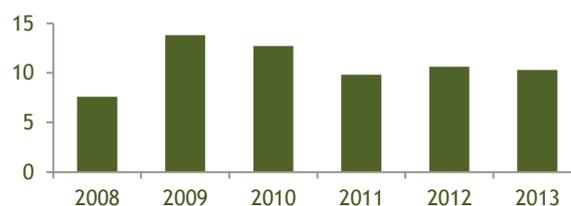


Chart 2: Russian Federal government deficit excluding oil revenues (%GDP)

Source: IMF

From this point of view the BP-Rosneft deal looks like an attempt at a new modus vivendi, although one that is skewed in favour of the Kremlin and its allies. BP provides the foreign capital and expertise. The Russian state bolsters its grip on the sector with a counterbalancing co-investment alongside. Is this a defeat for Medvedev? Perhaps - he has certainly been silent on the deal. Is it a victory for Sechin? Without question. Will the fact that Medvedev was the primary obstacle to Sechin's 2005 bid to win control of Gazprom be lost on Sechin? Certainly not.

## The state of play

But this personal tussle aside, what lessons can be extracted from the deal about Russia risk and the future of Russian energy politics? The deal seems to support an argument that Mr Putin's electoral wobble at the end of last year has only strengthened his instinct that keeping a tight grip on the energy resources of the Russian economy is key to asserting political control.

Certainly, when compared to the previous inability of Rosneft to untangle BP from its AAR partners, the acquisition of both halves of the company is strikingly assertive. This suggests that presidential preferences were indicated clearly and unambiguously. Interestingly, though, this time President Putin has kept himself out of the photographs to mark the deal, only meeting BP executives in private.

For inward investors in Russia, the state purchase of TNK-BP needs careful reading. On the one hand,

it has put a major dent in hopes that Medvedev's much vaunted privatisation plan - which in theory includes the complete sale of the state's stake in Rosneft by 2016 - and long-awaited WTO accession would lead to significant loosening of the state's grip on some of the key levers of the economy. The deal has actually shrunk the scale of foreign proportion of ownership of the Russian energy sector.

On the other hand, what most investors want is a sense of stability, and Putin is asserting the basic parameters of sectoral ownership here, not micromanaging. Exactly how the state will assert that ownership remains to be seen. The worst possible outcome would be for the stake in the energy sector to become the terrain for personal and factional power struggles. This would simply elevate BP's TNK problems onto a much bigger state canvas. This is ultimately the big question and the big unknown.

In this light, Putin's comments about the BP Rosneft deal at the Valdai Discussion Club last week are interesting. The decision to project ambivalence about the deal and to raise the question of the state's growing market share at the expense of foreign stakes suggests he understands his international perception problem very well.

He is well aware that capital outflows - which totaled \$80bn last year - are continuing to hurt the Russian economy and that Russian equities trade at a significant discount to other emerging markets. He may even believe that his government is exercising control at an unfortunate cost in efficiency and competition. Nevertheless, it is inconceivable that the deal would have gone ahead if Putin had expressed serious misgivings.

One high profile acquisition in the most prominent sector in the Russian economy cannot be taken as a definitive sign of Mr Putin's vision for the Russian economy, let alone some kind of evidence for a return to Soviet-style control. Like the furor over the jailing of the Pussy Riot singers, his renewed emphasis on orthodox values and the creation of a new agency to inspire patriotism in young people, the move is part of Putin's political balancing of his own instincts, his reading of

Russian politics and the factions around him. Whether this assertiveness in the economic and social spheres is a product of Mr Putin's confidence or insecurity is hard to tell.

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