

# Russian Roulette

## The impact of sanctions against Russia on international oil companies

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### Background

The deterioration of Russia's diplomatic relationships with the US and Europe - culminating in the introduction of economic sanctions - threatens the commercial viability of a number of alliances between international oil companies (IOCs) including BP, Exxon, Statoil and Eni and Russian state-controlled companies Rosneft and Gazprom. As detailed in our 2013 report *Russian Roulette: International Oil Company Risk in the Russian Arctic*,<sup>i</sup> these alliances involve an exchange of IOC technical expertise and capital in return or access to the Russian offshore Arctic. They also rely on long-term political stability and support from Russia in the form of favourable tax incentives and the renewal of licences.

The political situation is fluid and subject to change depending on continuing events in Ukraine. However, even if sanctions are lifted in the near future and diplomatic relations improve, the events of the past several months should raise ongoing concerns about political risk for investors in IOCs in business with Gazprom and Rosneft.

This briefing outlines the main European and US sanctions that impact IOCs operating in Russia. It details the impact of these sanctions on planned joint ventures involving Exxon, Statoil, Eni and Shell. It also examines the unique consequences for BP as a holder of a 19.75% stake in Rosneft resulting from the financial impact of sanctions on Rosneft. Finally, it suggests a number of questions for BP shareholders to ask in assessing risk.

### Sanctions

US and EU corporations are barred from providing goods, services or technology<sup>ii</sup> to Russian deepwater, Arctic offshore or shale oil projects. EU sanctions only prohibit new contracts,<sup>iii</sup> whereas the US measures cover existing contracts too, with a 2 week wind-down period for prohibited activities.<sup>iv</sup> US, EU and Norwegian sanctions are targeted specifically at projects "that have the potential to produce oil"<sup>v</sup> (US) or "oil exploration and production" (EU and Norway), meaning that purely gas extracting projects such as the paused Shtokman field are not affected.

Rosneft (as well as Gazprom's oil subsidiary, Gazprom Neft) cannot borrow money for more than 90 days on US and Norwegian markets<sup>vi</sup> and 30 days on EU markets.<sup>vii</sup>

Igor Sechin (Rosneft CEO and Chairman of Rosneftegaz – Rosneft's controlling shareholder on behalf of the Russian government) is barred from entering the US

or doing business with US citizens<sup>viii</sup> – but only in personal capacity rather than as head of Rosneft.

## Impact on IOCs

This section outlines the impact of sanctions on key IOCs in Russia.

### Rosneft and BP

Rosneft's current CEO Igor Sechin has been described by the *Financial Times* as “*the third man*” in the country (after Putin and Medvedev),<sup>ix</sup> by *Forbes* as the “*Darth Vader*” of Russian politics,<sup>x</sup> and by Russian business daily *Vedomosti* as the second most influential person in Russia after Putin.<sup>xi</sup> Sechin has been on Rosneft's board since 2004. As of 1 November 2014, the Russian government holds a 69.5% stake in Rosneft via OJSC Rosneftegaz (of which Sechin is chairman), plus a direct stake of 0.000000009% via its state property management agency (which may become a ‘golden share’ if the company were to be privatised). BP became a 19.75% shareholder in Rosneft in 2012.<sup>xii</sup>

As Rosneft's largest shareholder after the Russian government, the 2012 deal prescribed BP two seats on Rosneft's board of directors.<sup>xiii</sup> BP CEO Bob Dudley has taken up one seat. According to Russian business press (*Vedomosti* and *Kommersant*), in March 2014 BP was planning to nominate a second director. Sources close to BP speaking to *Kommersant* said that Rosneft CEO Igor Sechin would not agree to a second BP manager on the board.<sup>xiv</sup> Indeed, the final list of director candidates did not include a second BP nominee.<sup>xv</sup> Recent press reports quote Bob Dudley as saying “*There's even a possibility BP will have two seats on the Rosneft board next year*”<sup>xvi</sup> (emphasis added).

**BP** is a 19.75% shareholder in Rosneft and so is exposed in that capacity to all of the impacts of sanctions on Rosneft, unlike the other IOCs whose exposure is at most limited to the loss of the joint venture (JV).

**Exxon** was to spend \$3.2bn over 3 years on exploration drilling in the Russian Arctic in a JV with Rosneft. The JV is 33% owned by Exxon and operated and financed by Exxon.<sup>xvii</sup> Financial sanctions against Rosneft were announced in July;<sup>xviii</sup> Exxon started drilling on 9 August. The signal to begin drilling, according to Rosneft's press release, was given by President Vladimir Putin by video link.<sup>xix</sup> The US sanctions targeting Arctic JVs came into force while drilling was underway. Exxon applied for an extension to the two week deadline in order for the well to be made secure, during which time the drillers hit oil.<sup>xx</sup> Exxon cannot recommence exploration while sanctions are in place. Oxford Institute of Energy studies estimated the cost of the one well drilled to be \$600-\$700 million, dubbing it “*one of the most expensive ever drilled in the history of the global oil industry*.”<sup>xxi</sup> According to company announcements at the time the JV was signed, the final investment decision on Kara Sea drilling was expected to be made in 2016 or 2017. If this deadline is missed owing to sanctions, the JV may lose its exploration license if it is not renewed.

**Statoil** intends to drill six wildcat wells between 2016 and 2021 as part of its JV with Rosneft (33% owned by Statoil and operated and financed by Statoil). The Norwegian government has introduced sanctions similar to those of the EU, prohibiting Norwegian companies from providing services and technologies to Arctic offshore, shale oil and deepwater oil projects in Russia. These exclude obligations under contracts concluded before 16 August 2014 for technologies and 11 October 2014 for services.<sup>xxii</sup> This would prevent drilling on Statoil and Rosneft's Russian projects if a contract for drilling services has not yet been signed. Statoil has issued a holding statement saying it was “*reviewing*” joint projects with Rosneft to comply with sanctions.<sup>xxiii</sup>

**Eni** intends to drill two exploration wells in 2015-2016 in a block it shares with Rosneft in the Black Sea, and two wells in 2020-2021 in a block it shares with Rosneft in the Arctic (JV 33% owned by Eni and operated and financed by Eni except works outside of license obligations).<sup>xxiv</sup> If drilling is prevented by sanctions, the JV may lose its exploration licenses if they are not renewed.

**Shell and Gazprom** have paused their shale oil exploration JV.<sup>xxv</sup> The two companies were also in negotiation on an Arctic offshore exploration JV, but sanctions prevent any such deal proceeding.

## Financial impact on Rosneft

If sanctions continue, Rosneft may find itself unable to meet its debt obligations as well as its capex plans in the medium to long term.

Rosneft is \$55bn in debt<sup>xxvi</sup> and extraction rates from its older Siberian fields are declining: the company's overall extraction rates have reached the lowest level since buying TNK-BP.<sup>xxvii</sup> Rosneft needs to invest more than \$21bn annually until 2017 to launch new fields and upgrade refineries.<sup>xxviii</sup> It is obliged to repay \$12bn by end of 2014 and \$17bn more next year<sup>xxix</sup> to consortiums of Western banks<sup>xxx</sup> to fulfil its obligations under the acquisition of TNK-BP. Normally Rosneft would generate a large proportion of its cashflow through prepay deals: i.e. a lender pays the company a bulk sum and oil supplies are used as collateral. While the impact of sanctions on prepay deals is unclear, experts surveyed by the *Financial Times* argue that Western banks will be unlikely to finance any new prepays to Rosneft.<sup>xxxi</sup>

In responding to these potentially significant financial impacts, Rosneft first sought funds from the Russian government. Rosneft requested \$48.8bn from the Russian state's National Welfare Fund (which secures the country's state pensions).<sup>xxxii</sup> The request is under discussion in Russia's finance and energy ministries.<sup>xxxiii</sup> According to energy ministry announcements, Rosneft is requesting the funds to cover its investment plans. However, analysts surveyed in the Russian press suggest the money would actually be used to cover Rosneft's debt.<sup>xxxiv</sup> Secondly, Rosneft is cutting costs. *Kommersant* business daily reported that Rosneft's Moscow headquarters would see staff cuts of up to 25 percent from the current 4,000 workforce in September. Rosneft fired two senior managers (vice-presidents), allegedly in relation to mismanagement of the VNHK refining subsidiary, but media commentators contextualised the decision within the need for cost cutting.<sup>xxxv</sup> Thirdly, Rosneft has sued the EU over financial sanctions.<sup>xxxvi</sup> A commentator for the Russian business news website *Slon* argued that while the court case is unlikely to lift the sanctions, Rosneft is 'saving face' by declaring that the sanctions are unlawful.<sup>xxxvii</sup> Finally, Rosneft may use prepay deals with Chinese companies and loans from Chinese banks to plug its financial gaps.<sup>xxxviii</sup> A Rosneft source told *Reuters* the company had enough liquidity to last the next 12-18 months due to credit lines offered by the Chinese state oil company CNPC. The same source told *Reuters*: "We are planning to cut debt further without reducing capex. We need to maintain huge investments to launch new East Siberian fields. After 2017 capex will drop."<sup>xxxix</sup> Financial risk is therefore potentially significant if the sanctions stay for longer than 18 months.

## Impact on Rosneft's Arctic plans

If sanctions persist, it is questionable whether Rosneft can continue exploratory Arctic drilling. The company lacks both the capital and the technical expertise to do so; as explored in *Russian Roulette*, the JVs with Exxon, Statoil and ENI are all financed and likely to be operated by the Western partner. On 21 October 2014 Rosneft issued a plea to the Russian government to revise the terms of 60 of the exploration licenses carried by the firm - including offshore licenses - due to

the impacts of sanctions and the loss of Exxon as a partner, according to energy minister Sergei Donskoi.<sup>xi</sup>

In this context it should be a source of concern for BP shareholders that Rosneft CEO Igor Sechin was quoted as saying in response to Exxon's exclusion from the Arctic JV by the sanctions: "*We will continue drilling in any case, on our own, always and everywhere. If partners can take part - that's good, if they can't - we will carry on alone.*"<sup>xli</sup>

According to reports in the Russian press, Gazprom - the country's second largest oil and gas corporation, and also state-controlled - has offered to assist Rosneft's Arctic drilling.<sup>xlii</sup> Whether the offer of support from Gazprom is serious or not, it is not one BP should allow to be considered given Gazprom's offshore drilling safety record. In 2011, a rig commissioned by Gazprom subsidiary Gazflot to drill in icy Okhotsk Sea waters capsized and sank during towing, killing 53 out of 67 crew. Gazflot had continued drilling outside of the approved season and without carrying out all necessary assessments.<sup>xliii</sup> Further details and other cases are outlined in *Russian Roulette*.

## Political Risk

Frontier projects in icy waters are likely to have longer development times than large scale extraction projects elsewhere. To profit from operations in Russian Arctic waters, the IOCs would need to maintain both stable terms with their Russian partner companies and government support in the form of tax breaks and renewed licenses for extraction for several decades (beyond 2030). The current sanctions demonstrate that Russia's overall political stability and international standing are additional factors in ensuring multi-decade certainty of access for IOCs to the Russian offshore Arctic.

In the short to medium term, BP as Rosneft's shareholder risks negative backlash from any perceived connection between Rosneft and seemingly politically motivated actions against other Russian companies. Rosneft's elevation to a leading global oil company has controversial origins in the acquisition of the assets of Yukos. Indeed the fallout from that event continues with former Yukos shareholders suing the Russian state for \$50bn damages.<sup>xliv</sup>

In this context BP and its shareholders might wish to pay particular attention to recent events involving another Russian oil company.

In September 2014, Vladimir Yevtushenkov - controlling shareholder of Sistema Holding, which in turn controls Russian oil company Bashneft - was arrested on charges of theft and laundering of Bashneft shares and put under house arrest. Unlike ex-Yukos owner Mikhail Khodorkovsky, who spent eight years in prison for a tax fraud conviction widely believed to be politically motivated,<sup>xlv</sup> Yevtushenkov is understood to be loyal to Putin's rule.<sup>xlvi</sup> Khodorkovsky, among other commentators, believe the arrest to be politically motivated. In an interview to *Vedomosti* business paper, Khodorkovsky suggested that Rosneft CEO Igor Sechin's wish to take over Bashneft was linked to Yevtushenkov's case.<sup>xlvii</sup> A Moscow court ordered the state seizure of Sistema's stake in Bashneft on 30 October 2014.<sup>xlviii</sup>

Regardless of Rosneft's alleged involvement in the case of Bashneft, the prosecution of Yevtushenkov shows that oil business operations in Russia are subject to arbitrary intervention by the state.

## Questions for investors to ask BP

Given that it was presented to shareholders as a key term of the share acquisition in Rosneft, why has BP not yet appointed a second director to the board of Rosneft and when in 2015 does BP expect to confirm the appointment of its second appointee?

Given the contribution made by Rosneft's performance to BP's earnings, what is the anticipated financial impact on BP in the next two quarters of the current sanctions?

BP has taken a more cautious approach to offshore Arctic drilling than its peers. What is BP's reaction to Igor Sechin's comments regarding Rosneft potentially continuing this high-risk activity without Exxon?

How is BP using its influence to ensure that Rosneft does not acquire any assets appropriated in controversial circumstances, e.g. assets belonging to Bashneft?

## Conclusion

Political risk in Russia - in the form of extensive sanctions aimed specifically at the oil sector - presents clear risks to a number of international companies with strategic objectives in that country. For BP, the potential exposure to the as yet unquantified financial impact on Rosneft is greater owing to its position as a significant minority shareholder. It's vital that investors in IOCs attempt to assess the financial risks of the current political situation. With Exxon prohibited from operating in the Kara Sea, BP and its shareholders should also seek urgent clarification regarding Rosneft's financial and technical capacity to drill without Exxon.

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## About ShareAction

ShareAction (Fairshare Educational Foundation) is a registered charity that promotes responsible investment practices by pension providers and fund managers. ShareAction believes that responsible investment helps to safeguard investments as well as securing environmental and social benefits.

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