

Russian Roulette

BP to hold 19.75% stake in Rosneft

Introduction

On 22nd October BP plc announced it had agreed heads of terms to sell its 50% stake in TNK-BP to Rosneft. BP's official announcement of the proposed deal refers to Rosneft's 2011 oil reserve replacement ratio of 127% and dividend of 25% of IFRS net income. However, there are a number of areas of concern for BP shareholders including the potential impacts of a proposed Russian government divestment in 2015, a threat to Rosneft's continued dominance in the Russian Arctic, allegations of a lack of corporate transparency, and Rosneft's questionable environmental record.

This briefing provides a summary of the proposed deal and background on Rosneft. It highlights issues shareholders may wish to discuss with BP and proposes some questions for investor engagement.

The proposed deal

- BP will sell its 50% shareholding in TNK-BP to Rosneft for \$17.1bn in cash and Rosneft shares representing a 12.84% stake in Rosneft.
- BP will use \$4.8bn of the cash consideration to acquire a further 5.86% stake in Rosneft from the Russian government.
- On completion of the proposed transaction, BP expects to hold 19.75% of Rosneft shares, including BP's existing holding of 1.25% ,and to have received \$12.3bn in cash.
- BP will be granted 2 seats on Rosneft's board.¹

Rosneft

Background

Created by a decree of the Russian President Boris Yeltsin in 1993, Rosneft became a joint stock company in 1995. As of 1 October 2012, the Russian government holds a 75.16% stake in Rosneft via OJSC Rosneftegaz, plus a direct stake of 0.000000009% via its state property management agency.² Post the BP deal, the Russian government's stake will fall by 5.86%. The current chairman of Rosneft, Mr. Igor Sechin, has been described by the Financial Times as "*the third man*" in the country (after Putin and Medvedev)³ and by Forbes as the "*Darth Vader*" of Russian politics.⁴

INVESTOR BRIEFING

Igor Sechin

Born in 1960, Sechin studied languages at the Leningrad State University and worked in Mozambique and Angola in Soviet diplomatic and trade organisations. Media commentators have suggested that Sechin's role was in fact one of intelligence gathering for the KGB.⁵

From 1998 Sechin worked for the Leningrad Soviet alongside Vladimir Putin. Over the years Sechin's career tracked closely that of Putin, serving as his deputy as Putin progressed from vice mayor of St. Petersburg, to a member of the Yeltsin administration, to Prime Minister and finally to President. From 1999 to 2004 Sechin served as President Putin's Deputy Head of Administration.

The growth of Rosneft - controversial acquisition of Yukos' assets

In 2004 Igor Sechin was appointed as Chairman of what was then a relatively small state-controlled oil company, Rosneft. Rosneft's growth into one of Russia's largest oil companies corresponds directly to the demise of Yukos. Owned by Mikhail Khodorkovsky since its privatisation in 1995, Yukos had been one of Russia's two largest oil producers in 2003 (80.7 million tonnes against Lukoil's 81.5 million)⁶. In 2003, Khodorkovsky was arrested and subsequently convicted of tax evasion and fraud.

For many years it has been alleged that his conviction was 'selective targeting' motivated by his open financial backing of political opposition⁷ and his vocal criticism of Rosneft. (In a televised February 2003 meeting with Putin, Khodorkovsky reputedly criticised Rosneft's purchase of Northern Oil, a small oil company, for a premium price that according to him indicated "*kickbacks to Rosneft's leadership.*"⁸) Yukos's assets were frozen and auctioned off to pay outstanding tax liabilities.⁹ A number of UK MPs including former foreign secretaries David Miliband and Sir Malcolm Rifkind have publicly condemned the trial against Yukos's former owners, believing it to be politically motivated.¹⁰

Its largest subsidiary was sold at auction in 2004 to a previously unknown company called Baikalfinansgroup. The ultimate beneficiaries of Baikalfinansgroup are unknown, but this company was purchased by Rosneft 2 days later for a rumoured sum of 10,000 roubles (£200)¹¹.

Following the purchase, the value of Rosneft's total assets increased from \$6.8bn in 2003 to \$25.99bn in 2004¹², and Rosneft's earnings quadrupled between 2004 and 2005.¹³

Ongoing Yukos litigation and controversy

Yukos has continued to challenge the sale of its assets through the courts including taking cases against Rosneft to courts in the UK, US and Netherlands. In addition, Yukos's former managers sued the Russian government in the European Court of Human Rights for \$98bn in damages¹⁴: the court ruled in September 2011 that the rights of Yukos were violated but deferred a judgement on the damages. As part of the UK litigation, \$648 million worth of Rosneft's assets had been frozen in March-April 2010.¹⁵ This litigation is ongoing as of 2012.¹⁶

An uncertain future

Potential privatisation in 2015 and the level of government control

In 2011 the Russian government announced plans to dispose of the state's holding in Rosneft.¹⁷ On his return to the Presidency in 2012, Putin issued a decree indicating that the government's 0.000000009% direct holding in Rosneft would be retained by the government. No statements have been issued regarding the rights that would attach to such holding but a number of commentators surveyed by the news outlet Gazeta.ru¹⁸ suggested this might be a 'golden share' through which the Russian government would retain control over Rosneft.

Apart from the rights attaching to any minority holding retained by the Russian government post-2015, the potential divestment by the Russian government of its indirect majority holding in Rosneft raises significant strategic concerns for the company.

Access to the Arctic

One of the attractions to BP of the proposed deal is exposure as a shareholder to Rosneft's Russian Arctic operations. Under current Russian legislation, Rosneft together with Gazprom has exclusive access to bidding for hydrocarbon reserves in Russia's Arctic seas. This exclusivity arises from each company having more than 5 years' experience in offshore drilling and the Russian government holding 50% or more of the shares.¹⁹ Other oil companies have access to the Russian Arctic seas only by means of joint ventures with one of the Russian companies maintaining majority shareholder control.²⁰

If the law remains unchanged and the Russian government proceeds with the divestment of its state holding, Rosneft will lose one of its most important assets - access to new leases in the Russian Arctic seas.

However, the Russian government is already considering liberalising access to the Arctic. Within the Russian cabinet of ministers, a working group headed by Vice-PM Arkadii Dvorkovich is currently looking into opening up access to offshore fields to private companies.²¹ As shown by a public exchange of letters addressed to President Putin, Rosneft Chair Sechin (responsible for a presidential commission on energy) and Vice-PM Dvorkovich (head of the ministerial working group) are in conflict over the policy with Sechin wanting to further strengthen Rosneft's current dominant position in the Russian Arctic seas prior to any loss of exclusivity.²²

According to business paper Kommersant, Rosneft has applied to the Ministry of Natural Resources for fourteen more offshore Arctic licences in addition to its existing fourteen.²³ Dvorkovich and the ministers are reportedly reluctant to grant so many additional licences, preferring to retain the option of offering them to other companies.

It's clear that, in light of a shifting regulatory landscape in Russia, Rosneft faces challenges in maintaining its current dominance in the Russian Arctic seas.

Questions for investors in Rosneft including BP

- Does the Russian government intend to retain a ‘golden share’ in Rosneft after the disposal of the majority of its shares in the company and what rights would attach to that share?
- What is the company’s contingency plan in the event that the Russian government’s disposal of its majority shareholding results in a change to its current access to the Russian Arctic seas?
- What impact would the liberalisation of access to the Russian Arctic have on Rosneft’s Arctic operations?
- How many Arctic licences does Rosneft anticipate receiving prior to 2015?

Question for BP

- Why significantly increase BP’s shareholding in Rosneft at a time of such uncertainty about both the nature of the Russian government’s continued holding in the company and the extent to which Rosneft will retain a dominant position in the Russian Arctic seas?

Poor environmental track record

In the aftermath of the Gulf of Mexico oil spill, BP has expended significant resources on addressing the failings that led to the explosion on the Deepwater Horizon rig. The strengthening of the operating management system (OMS) and the introduction of an internal Safety and Operational Risk unit (S&OR) represent an attempt by the company to ensure that health and safety is embedded “*at the heart*” of BP.²⁴ However, these measures apply to projects where BP retains operational control. Accordingly, BP and its shareholders remain exposed to the operational health and safety and environmental practices of those companies with whom it chooses to enter into joint ventures and in whom it acquires significant shareholdings. Rosneft falls within each of these categories and its record should raise concerns for BP shareholders.

A report by the environmental regulator Rosprirodnadzor, whose results were published by the business paper Vedomosti, concludes that Rosneft was responsible for 2727 or 75% of spills in Russia’s largest oil province Yugra in 2011²⁵ while only extracting 25% of the total regional output that same year.²⁶ TNK-BP came second worst, though still performing significantly better than Rosneft: 784 spills (18%)²⁷ with 15.5% of oil extraction.²⁸ The report does not provide a breakdown of volumes of oil spilled by company, but the total figure provided for the region is 5289 tonnes (over 37,000 barrels).²⁹ Of the four companies featured in the report, Rosneft had the lowest overall environmental safety budget: US\$563 million compared to TNK-BP’s budget of \$897 million.³⁰ According to Rosneft’s own reporting, in 2010 it spilled over 0.03 units of oil per 1000 extracted, twice TNK-BP’s published figure for the same year (0.014).³¹

Questions for BP

- What due diligence is BP carrying out with respect to the health and safety and environmental policies and practices of Rosneft prior to completion of the proposed deal?
- What steps will BP take to bring Rosneft’s policies and practices in line with BP’s own OMS and S&OR regimes?
- Will BP report on CO2 emissions, oil spills, and health and safety incidents in Rosneft’s operations to its shareholders?
- Does BP foresee any risks arising from the continued litigation against Rosneft by Yukos?

Rosneft's Environmental Record

Rosneft's environmental reporting is patchy at best, but a simple review of cases of environmental liability of its one subsidiary (RN-Sakhalinmorneftegaz, operating Rosneft's onshore and minor offshore fields on and around Sakhalin island) suggests a pervasive culture of neglect for environmental standards and safety.

In February 2009, 150 tonnes (over 1050 barrels) of oil seeped from a water filtering station on Ekhabi field.³² A local oil spill management company head told visiting US embassy officials that *"there had been a "fairly big spill" ... He said this spill was "kept quiet" by the authorities, despite NGO attempts to publicize it.*"³³ Regulator Rosprirodnadzor initially estimated damages at 82 million roubles (£1.64mln)³⁴ but eventually charged the company 22 million roubles (£440 thousand)³⁵. According to Dmitry Lisitsyn of Sakhalin Environment Watch, the damages payment is significantly underestimated, as the calculation was based on a thickness of less than a millimetre rather than the actual thickness of several centimetres.³⁶

In September 2012 RN-Sakhalimorneftegaz was fined 800,000 roubles (approximately USD 26,000) for flaring 50% of associated petroleum gas from Odoptu-more field. The project's permits allow for flaring only up to 4% of the gas. The regional prosecutor associates the flaring with *"significant damage to ... the environment and public health."*³⁷

Apart from these incidents, a track record of dozens of administrative prosecution cases over the past 5 years suggests Rosneft's Sakhalin operations routinely rely on outdated, leaking equipment. The regional regulator, mostly prompted by the civil society group Sakhalin Environment Watch, levies fines against these breaches, but it appears from the continuing problems that the very low financial penalty involved (normally in the tens of thousands of roubles, or hundreds of US dollars) has not provided sufficient motivation for improvements to take place.

Conclusion

According to BP's official announcement, BP and Rosneft have an exclusivity period of 90 days to negotiate fully-termed sale and purchase agreements with the deal currently anticipated to conclude during the first half of 2013. Shareholders must ensure that prior to concluding this deal, BP undertakes thorough due diligence on issues including Rosneft's environmental record and Rosneft's access to the Arctic post-2015.

BP must be transparent with shareholders on critical issues such as the alignment of its OMS and S&OR functions with Rosneft's operating systems and its plans for reporting to BP shareholders on matters such as Rosneft's environmental and health and safety records, and the company's carbon emissions. Given Rosneft's track record it is advisable that BP shareholders insist that such reporting arrangements be put in place.

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The opinions expressed in this publication are based on the documents specified in the end notes. We encourage readers to read those documents. Those references which are only available in Russian have been reviewed by a native Russian speaker.

Endnotes

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