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Governors, Oligarchs, and *Siloviki*: Oil and Power in Russia

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Abstract

Recent discussion about the level of state involvement in the Russian oil industry has focused on ideological debate between pro-state and pro-private forces in the government and their views on how Rosneft's privatization should be handled. In a super-presidential system where corporate activity in the oil sector is closely tied to political elites, the forthcoming absorption of TNK-BP by Rosneft is a clear reflection of the growing fortunes of Russia's conservative forces. The rise of Rosneft under Igor Sechin as the national oil champion has now inaugurated a new chapter in the country's oil history. It has also left Russia's liberals with little political capital in asserting their control over the future of the domestic hydrocarbon sector. While privatization served a number of functions, such as enhancing the efficiency of the oil industry, it also had a political one: to undermine Russia's conservative elites by gaining control over key corporate assets under their stewardship.

The contest for control of Russia's oil industry has been an integral feature of the country's politics ever since the collapse of the Soviet Union. Therefore, an assessment of political elite dynamics and the competition for control over Russia's oil sector can explain why this industry has been subject to such rapid management changes, including the rise and demise of Russia's private oil corporations and the emergence of Rosneft as a national oil company (NOC).

Whilst the 1990s and 2000s saw different management styles evolve in the industry, much of that competition took place during a time when Russia could exploit its Soviet-era legacy fields. The rise of Rosneft as Russia's super National Oil Company (NOC) has been driven just as much by internal political elite dynamics as it has by the challenges which Russia's oil industry faces, as it attempts to tap more remote fields in East Siberia and the Arctic.

Introduction

Over the past twenty years, Russia's political leadership has shaped the oil sector on the basis of a continued search for the best model of managing a complex industry, using it for economic stability and growth as well as gaining access to Western financial and energy markets and technology. However, the Kremlin's strategic decisions on the development of the domestic oil sector have often been shaped by ongoing battles for lucrative corporate assets between different elite forces. At the same time, Russian leaders, from Yeltsin to Putin, strived to use this elite infighting for political consolidation and the strengthening of their own power. Therefore, the elective affinities of political elites to specific corporate oil assets confirm a neat institutional logic that has been in operation in Russia since the collapse of the USSR in 1991: the use of the oil industry as a maximalist vehicle for elite survival and political consolidation.

Whilst the 1990s will be remembered in Russian oil history for the emergence of privately-owned vertically integrated oil majors, the year 2013 will be hailed for the completion of one of the largest deals in global oil history: Rosneft's $60bn acquisition of TNK-BP. For a state-owned company that controlled only 4% of Russia's oil output in the late 1990s—and one that was almost swallowed by Gazprom in the early 2000s—Rosneft is now set to become the world's biggest publically listed oil producer, providing nearly 40% of Russia's oil output.

Yet, a thorough examination of the oil industry as a maximalist vehicle for elite survival—especially in a country where the weakness of democratic institutions gives special importance to inter-elite interactions—helps us to understand specific shifts in state energy policies. This can explain the rise of certain elite groups within Russia's political landscape and the changing role of the national energy champions, Gazprom and Rosneft, as well as the future risks for Vladimir Putin as he tries to balance different elite interests.

This report is based on a working paper A. Mehdi, S. Yenikeyeff, *When Markets Meet Politics: Continuity and Change in the Russian Oil Sector* to be published by the Oxford Institute for Energy Studies (OIES) in February-March 2013.

Russian Oil under Yeltsin

Regions versus Moscow

The initial Russian battle over natural resources and power pitted Russia's first president, Boris Yeltsin against powerful regional barons. Yeltsin had limited options when it came to building his power base: Russia's middle class was practically non-existent and its civil society weak. This meant that the rulers of Russian provinces represented the only real force in the country upon which Moscow leaders could rely both politically and economically.[1] The struggle over economic resources between Moscow and regional elites became the main theme of centre-periphery bargaining in Russia in the late 1980s and early 1990s, threatening the very existence of the Russian state. The federal centre and the regions exploited oil as a means of generating considerable rents under volatile economic conditions, thus ensuring a certain degree of social stability and the political survival of the ruling elites.

In order to secure the political support of local elites, Moscow agreed to grant regions considerable regulatory authority in relation to oil taxation and the petroleum markets, while transferring federal shares in some local oil and petrochemical companies to provincial authorities, turning regional administrations into oil exporters, and introducing the two-key system of oil licensing.[2] Under this system, a company wishing to explore oil resources in a given region had to obtain a license jointly granted by the relevant federal agencies as well as the specific regional administration. As a result, the regions emerged as the only force in the country to which the Kremlin could appeal for support. Moreover, following the collapse of the USSR, the communist and nationalist forces were on the rise, cashing in on social dissatisfaction with the liberal economic reforms of Yegor Gaidar's government. The partial privatization of the oil sector initiated by Boris Yeltsin in November 1992, though opposed by some regions, served two main aims: to tackle the problems with oil production decline and to create a new class of owners, who could choke the communist-nationalist rise and counterbalance the too-powerful regional elites.

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[1] See S. Yenikeyeff, *The Battle for Russian Oil: Corporations, Regions, and the State*, Oxford, Oxford University Press, forthcoming 2013.
[2] Ibid.

The liberal-conservative debates, 1992-1996

The first liberal-conservative debate about the degree of state involvement in the energy sector took place in 1992-93 when Boris Yeltsin brought several industrialist/conservative figures into a government hitherto dominated by the liberals. Yeltsin's idea was to politically counterbalance the growingly unpopular liberal reformers—led by Prime Minister Yegor Gaidar and his deputy Anatoly Chubais—with more conservative figures. These included the then head of the state concern Gazprom, Viktor Chernomyrdin and a career oilman and the governor of Tyumen region, Yury Shafranik.

Unlike the government's pro-privatization liberals, this duo insisted that the state should retain commanding heights in Russia's economically strategic hydrocarbon sector. Chernomyrdin objected to the idea of Gazprom's privatization and separation into several companies, arguing for the preservation of the unified gas system and ensuring the socio-economic and political stability based on subsidized gas prices.[3] Shafranik used examples of oil sector management in other resource-rich countries, such as Norway, to argue that the state should retain a controlling 51% share in the oil industry via the national oil company, Rosneft. The remaining 49% could then be used to create several private vertically-integrated entities.[4] Facing growing opposition to the liberal reform agenda in the Russian legislature, the Supreme Soviet, Yeltsin sided with Chernomyrdin and Shafranik. As a result, the restructuring of the gas industry on liberal terms was curtailed, and Rosneft was chosen as a national oil company to play a strategic role in the management of the domestic oil sector.

In April 1995, Boris Yeltsin signed a presidential decree turning Rosneft into a state-controlled joint stock company and enhancing its role in the oil sector by granting it specific privileges. Nevertheless, these new exclusive rights fell short of the initial conservative proposal, which amounted to turning Rosneft into a NOC with the de facto powers of a government ministry (as Table 1 illustrates). Although, Yeltsin kept Rosneft as the dominant player in the Russian oil sector, he viewed this conservative proposal as a threat to the liberal policy of reducing the state presence in the oil industry. Having curtailed the liberal plan to break-up and privatize Gazprom, Yeltsin needed to ensure a balance of power between the liberals and conservatives when it came to the future of the oil sector. Moreover, the Kremlin sought to rely on Vagit Alekperov's Lukoil with its model of a vertically integrated private company to improve the efficiency of the Russian oil industry.

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[3] S. Yenikeyeff's interview with Viktor Chernomyrdin, Kiev, Ukraine, 13 June 2008.
[4] S. Yenikeyeff's interview with Yury Shafranik, St Antony's College, Oxford, 25 November 2009.

Table 1: Rosneft's Enhanced Role in the Oil Sector in 1995

Conservative Draft Proposal	Yeltsin's Final Version—the Decree of April 1995
Commercial management of state shares in Russian oil companies	Management of non-core state assets remaining outside of the corporate structure of emerging oil companies
Managing state interests in relations with foreign companies operating under the Production-Sharing Agreement (PSA) regime	Trading hydrocarbon volumes granted to the Russian state under PSAs.
Assessing projects aimed at new hydrocarbon development	Becoming the main state contractor for research and development projects in the oil industry
Monitoring oil companies' adherence to the terms of geological and oil production licenses. Involvement in state decisions on the transportation of crude oil volumes via the Transneft export pipeline network	None

Source: Ukaz presidenta Rossiiskoi Federatsii No. 327 of 1 April 1995; "Bez gosudarstva v Rossii dolgo ne zhivut" [Without State, One cannot Live Long in Russia], *Kompaniya*, No. 13, 12 April 1999.

The fortunes of the government's conservative agenda and that of Rosneft started to change when Boris Yeltsin faced a serious challenge to his political survival ahead of presidential elections in 1996. His declining public support and the rising popularity of the Russian Communist party, led by Gennady Zyuganov, fuelled the liberal-conservative debate over the best way to ensure Yeltsin's political longevity. The conservatives proposed to court powerful regional governors. The liberals insisted that the incumbent should rely on the emerging Russian oligarchs as a new political power base which could ensure his electoral victory and political survival.[5] This liberal argument became the key factor behind Boris Yeltsin's decision to move away from the partial privatization of oil companies of late 1992-early 1995 to loans-for-shares auctions in November 1995.[6] Moreover, having forcibly dissolved the anti-reform Russian legislature in October 1993, the Russian president could implement his decisions with considerable ease and speed. In addition, the liberals argued that loans-for-shares auctions could resolve the problem of severe fiscal deficit.

In December 1995, the Russian government implemented a loans-for-shares scheme crafted by the financier Vladimir Potanin and liberal Deputy Prime Minister Anatoly Chubais. The scheme facilitated a transfer of state shares in key industries to private financial institutions in exchange for cash funds provided to the budget (see Table 2). This process also made sure that new owners were pre-selected by the government—without proper competitive procedures—on the basis of their political loyalty to Boris Yeltsin.

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[5] A. Ostrovsky, "Father to the Oligarchs," *Financial Times,* 13 November 2004.
[6] Yenikeyeff's interview with V. Chernomyrdin.

Table 2. Loans-for-shares Auctions in the Russian Oil Sector, 1995

Date	Company	Shares (%)	Contribution to the Russian budget (million US dollars)	Buyer
7 December	Lukoil	5	141	Lukoil-Imperial
7 December	Sidanko (now part of TNK-BP)	51	130	MFK Bank representing its consortium with Alfa Group
8 December	Yukos (now part of Rosneft)	45	159	Menatep Bank via its affiliate company “Laguna”
28 December	Surgutneftegaz	40.12	88.9	Company management via Surgutneftegaz Fund
28 December	Sibneft (later rebranded as GazpromNeft)	51	100.3	Neftyanaya Finansovaya kompaniya
28 December	Nafta-Moskva	15	20.01	Company’s management via ZAO “NaftaFin”

Source: Ye. Gaidar, A. Chubais, *Razvilki noveishei istorii Rossii* [Crossroads of the New Russia’s History], Moscow, OGI, 2011, p. 86-87.

After the first round of the elections, there was a serious chance that Yeltsin could still be defeated by Zyuganov a run-off. The conservative security officials, led by Yeltsin’s bodyguard, Alexander Korzhakov; head of the Russian Security Service (FSB), Mikhail Barsukov; and Deputy Prime Minister, Oleg Soskovets insisted that Yeltsin should avoid a second electoral round at all costs. After the militarized stand-off with the Russian parliament in October 1993, Yeltsin sought to avoid using force to stay in power, as it was liable to ruin his legitimacy in the West.[7]

Impact of private companies

In the event, Yeltsin sacked his conservative security chiefs and won the second round of the presidential elections with the help of the oligarchs, as a result Russia’s oil game changed dramatically. Having ensured Yeltsin’s victory, the liberal camp insisted that the successful experiment in using Russian big business to manage a complex political process could be applied to the challenges faced by the Russian economy at large and the domestic oil sector in particular. As a result, Boris Yeltsin gave carte-

7 See T.J. Colton, *Yeltsin: A Life*, New York, Basic Books, 2008.

blanche to the oligarchs rather than relying on Rosneft to deal with pressing problems in the Russian oil sector.

The state was no longer interested in keeping 51% of the domestic oil sector under its influence. On the contrary, in 1995 Rosneft's best assets were used to create a new private oil company, Sibneft, control of which was transferred to Yeltsin's confidant, Roman Abramovich. Another company, TNK was privatized in 1997-1999 in favor of Alfa Group and Renova, led by Mikhail Fridman and Viktor Vekselberg respectively.

The rapid rise of oil prices in the late 1990s and early 2000s led to a considerable increase in export revenues, enabling federal oil conglomerates to consolidate their existing assets and make further acquisitions in the oil sector. Oil companies also used this larger financial base to increase their role in federal and regional administrative and legislative bodies in order to secure a more beneficial political-economic and institutional environment for their continued corporate growth.[8] As a result, Russia's oil majors—with the notable exception of Surgutneftegaz—tended to base their growth on purchasing smaller companies with attractive oil assets. Hence, Russian oil majors emerged as regional monopolies influencing the domestic fuel market as well as hindering the development of independent small and medium oil companies. However, the mergers and acquisition wave provided an important service to the Kremlin by undermining the financial and industrial asset base of powerful regional elites and re-integrating the loose Russian Federation. Just as the government liberals had argued, Russia's private oil companies and financial-industrial groups emerged as the President's new power base and a political counterbalance to the regions. Moreover, Russia's big business provided another important service to the president by co-opting communist-led opposition forces in the Russian parliament—the State Duma.[9]

However, the rise of corporate power in Russia also created serious problems in the economic sector, namely fiscal instability caused by transfer pricing and other "tax optimization" strategies used by private oil players. At the same time, companies, such as Yukos and Sibneft, owned by financial groups were often accused of being more interested in boosting their capitalization via "easy oil" production from Soviet-legacy assets, than they were in investing in exploration and long-term development of their oil fields. Contrary to this, Surgutneftegaz and Lukoil, controlled by Soviet oil managers were at the forefront of a more sustainable approach to oil production and exploration drilling. The difference in company strategies between financiers and oilmen became the most prominent feature of the Russian oil industry in the late 1990s-early 2000 and defined its evolution.[10]

The aim of the three banker-controlled oil companies—Yukos, Sibneft, and TNK—was to sell a stake to a major international oil company

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[8] S. Yenikeyeff, *op. cit*. [1].
[9] Ibid.
[10] N. Poussenkova, *From Rigs to Riches: Oilmen vs. Financiers,* Rice University, 2004, <http://large.stanford.edu/publications/coal/references/baker/studies/pec/docs/PEC_Poussenkova_10_2004.pdf>.

as a way of legitimizing assets obtained during the Boris Yeltsin era, thus ensuring their protection by the international legal system.[11] This could explain the oil output and dividend drive of these companies and in particular, Yukos and Sibneft. Both companies had agreed to merge their assets and to sell a large stake in their new company to an American IOC, ExxonMobil or Conoco-Philips.

However, the rise of Yeltsin's successor, Vladimir Putin and his drive to bring the management of the domestic oil industry back under Kremlin control changed the fortunes of the Russian private oil players.

[11] S. Yenikeyeff, "BP, Russian Billionaires and the Kremlin: a Power Triangle that Never Was," *Oxford Energy Comment,* November 2011, p. 13, <www.oxfordenergy.org/wpcms/wp-content/uploads/2011/11/BP-Russian-billionaires-and-the-Kremlin.pdf>.

Russian Oil under Putin, 2000-2008

When Putin came to power in 2000, he recognized the importance of establishing a political balance between the pro-private (liberal-economic) and pro-state (conservative) camps in the government. The key shortcoming of the late Boris Yeltsin era was the institutional dominance of liberal economists. Therefore, one of Putin's first tasks was to counterbalance government liberals with conservatives. He brought several colleagues from his years working in the St Petersburg municipal administration to Moscow's corridors of power, including both ex-security service officials and liberal lawyers and economists.

Following Putin's election as Russia's president, Aleksey Kudrin and German Gref were appointed as Minister of Finance and Minister for Economic Development, respectively. Their main task was to come up with a solution to Vladimir Putin's key economic dilemma: how to capture revenues hidden by the private companies on the basis of transfer pricing, a practice which was prevalent in the oil sector at the time. He wanted a simple and effective taxation system which would ensure Russia's fiscal stability.

However, initial liberal efforts met considerable resistance from the company owners. German Gref allegedly failed to persuade Mikhail Khodorkovsky to change Yukos's tax optimization strategies. Moreover, Yukos was also accused of using its influence in the Russian parliament for political and economic gain, thus using its oil lobby to secure amendments to the government's tax legislation to its corporate advantage[12]. This failure of the liberal economists to succeed in changing the tax system and establish fiscal stability, created a window of opportunity for the *siloviki* group, headed by Igor Sechin, to rise to the fore.

Sechin allegedly argued for the full use of the state's coercive power against Khodorkovsky before the company could consolidate its political control over the Russian parliament, due to be elected in December 2003. Sechin also viewed Yukos' key asset, Yuganskneftegaz, as the jewel in the crown of a national oil company he sought to build on the basis of Rosneft. *Siloviki* also asserted that Yugansneftegaz's assets would turn small-scale Rosneft into a leading state-controlled company on the domestic market. This would improve the manageability of the Russian oil sector as a counterbalance to the increased influence of private oil companies which prioritized short-term commercial interests over long-term fiscal stability and

[12] "Kodorkovskij soznalsya. Aktsionery "Yukosa" pomogut SPS, Yabloky i KPRF" [Khodorkovski confessed. 'Yukos' Shareholders will help SPS, Yabloko, and KPRF], *Vedomosti*, 8 April 2003.

the sustainable development of the oil sector. The dismantling of Yukos was also to give an institutional financial-industrial base to *siloviki* vs. the liberals who traditionally benefited from their close ties with the banking community thus balancing the power base of President Putin. For this reason, in July 2004 Igor Sechin was made Rosneft's board chairman.

The prosecution and imprisonment of the politically-active Khodorkovsky allowed Kudrin and Gref to complete tax reforms initiated in 2000-2002, which had previously been sabotaged by the Yukos-controlled oil lobby in the Russian parliament. As a result, the demise of Yukos enabled the liberal economists within the government to create a taxation system which was simple to administer and effective in capturing previously-hidden revenues of oil companies.

Rosneft's failed merger with Gazprom

The balance of power between key elite groups and the issue of state manageability over the energy sector also played an important part in shaping the Kremlin's hydrocarbon policies. During Vladimir Putin's first term in office (2000-2004), Moscow looked at various scenarios of how to reconstruct the Russian hydrocarbon sector with greater state control and effective state capture of oil revenues. One of these scenarios involved a merger between Gazprom and Rosneft, announced in 2004. However, this merger was abandoned when the Yukos affair took place. The criminal prosecution of Yukos and Khodorkovsky for tax evasion led to the company's bankruptcy and his imprisonment. In December 2004, Rosneft obtained the core asset of Yukos, Yuganskneftegaz via a third party vehicle, Baikalfinansgrup for $9.35 billion.

It was not just this acquisition which put an end to the talk of uniting the two companies, a merger with Rosneft could also have exposed Gazprom's international business to potential lawsuits. At the same time, under Putin, Gazprom was initially chosen as the corporate base for Russian liberals in the energy sector. As such, the merger of liberal and conservative corporate institutional bases into a Gazprom-Rosneft state energy champion would have been counterproductive from a political point of view as it would undermine the balance of power within Putin's inner circle.[13] At the same time, the Kremlin also viewed the creation of a super-NOC on the basis of Gazprom and Rosneft as complicating the management of the hydrocarbon sector while undermining the state administrative capacity based on simplicity and efficiency. As a result, Putin settled for Rosneft and Gazprom becoming the Kremlin's two arms in their respective segments of the energy industry.[14] Meanwhile, in order to satisfy Gazprom's oil ambitions, Vladimir Putin allowed the gas conglomerate to buy Roman Abramovich's Sibneft. It is important to note that from the point of view of Rosneft's growth strategy, Yukos's key asset,

[13] R. Sakwa, "Putin Redux: Continuity and Change," Open Democracy, 14 September 2012, <www.opendemocracy.net/od-russia/richard-sakwa/putin-redux-continuity-and-change>.
[14] S. Yenikeyeff, *op. cit* [11], p. 7-9.

Yuganskneftegansk, was a more interesting commercial production unit, than Rosneft's former assets which were used to create Sibneft.[15]

Rosneft's 2006 IPO

Rosneft's 2006 initial public offering (IPO) covering 14.8% of its shares sought to reach three main goals. The first one was to "recycle" Yukos's assets swallowed by Rosneft, the second one was to secure Rosneft's access to international financial markets; and the third was to further Rosneft's ties with foreign oil companies taking part in the IPO, such as BP, Petronas, CNPC, Shell and ONGC.

Vladimir Putin asked the government's liberals to assist with Rosneft's IPO. Russia's Minister for Economic Development, German Gref, who had served as Chairman of Rosneft's board until July 2003, took an active part in promoting the partial privatization of the state oil company via its IPO. The liberal participation in this process was driven by their view that the involvement of foreign strategic investors in Rosneft's share capital would improve its corporate governance and transparency.

Once the IPO was complete, Russia's conservatives, led by Sechin, secured access to Western financial institutions and the corporate world, thus counterbalancing the government liberals who in the past were the only channel between the Kremlin and the West.

For the first time in Russia's post-Soviet history, the liberals and conservatives reached political and economic parity, with Vladimir Putin relying on his institutional dominance to act as arbiter between the two camps.

Putin-era billionaires

In addition to promoting liberal-conservative parity within the political elite, Vladimir Putin also facilitated the emergence of a new set of oligarchs as an additional political base within Russia's corporate universe. As a result, under Putin, several of his alleged friends from St Petersburg, emerged as the primary beneficiaries of profitable state contracts, particularly in Russia's most lucrative economic sector—the oil and gas industry. Figures such as Gennady Timchenko (co-founder of Gunvor, an oil trader) and the brothers, Arkady and Boris Rotenberg came to prominence as trading partners to Russia's national champions, Gazprom and Rosneft.

Having generated significant capital, these new players have begun to acquire corporate assets, often from state-controlled companies at a considerable discount. For example, in 2008 the Rotenberg brothers bought Gazprom's construction assets for $347 million and subsequently merged them into a private corporation, Stroygazmontazh—Russia's major

[15] Yukos and Sibneft, *Annual Reports*, 2001, 2002.

pipeline building contractor with an estimated value of $8-10 billion.[16] Moreover, Timchenko acquired over 20% in Russia's largest independent gas producer, Novatek, as well as important stakes in foreign and domestic oil and gas service, transportation and chemical companies.[17]

[16] "Rotenberg vzyal vernyi podryad" [Rotenberg Secured the Right Deal], *Vedomosti,* 11 May 2012.
[17] A. Mehdi, "Putin's Gazprom Problem," *Foreign Affairs*, May 2012.

Russian Oil under Medvedev and Putin's Third Term

The second debate over oil privatization

During his presidential term of 2008-2012, Dmitry Medvedev pushed for state withdrawal from Russia's leading industries, including the oil and gas sector. The first step in this direction was his request for public officials to step down from the boards of state-controlled companies.[18] As a result, Igor Sechin—then deputy prime minister responsible for the energy sector—resigned from the post of Rosneft Chairman and was replaced by the Vice-President of the Russian Academy of Sciences, Aleksandr Nekipelov. At the same time, Medvedev's economic adviser, Arkady Dvorkovich and the liberal wing in the old Putin government, represented by Deputy Prime Minister Igor Shuvalov, the Minister for Economic Development Elvira Nabiullina pushed for privatization of state oil companies Rosneft, Zarubezhneft, Transneft and shipping company, Sovcomflot. The liberals argued that Rosneft and Zarubezhneft should be completely privatized (with the government retaining a golden share) while the oil transportation monopoly, Transneft should be partially privatized (see Table 3). In the opinion of the liberals, this new wave of privatization will enable Russia to attract investments for industrial modernization and the promotion of greater transparency and efficiency of the state-dominated sectors of the domestic economy and bring financial resources to the state coffers.

However, these liberal privatization attempts have been hindered by the conservative wing of the Russian government, represented by the *siloviki*. The conservatives did not completely reject the future privatization, but demanded its delay until the external economic situation sufficiently improves to make the sale of state assets in the oil sector more profitable for the state and the government. The *siloviki* also highlighted Rosneft's strategic importance for monitoring the domestic oil industry, attracting foreign investment and technology for new large-scale projects in East Siberia and the Arctic, being a key tax contributor to the Russian budget, as well as potentially becoming a global national oil company (NOC) which will promote Russian energy interests abroad.

[18] A. Topalov, "Rosneft' bez Sechina" [Rosneft' without Sechin], <Gazeta.ru>, 12 April 2011.

Table 3. Proposed Privatization of the Russian Oil Sector in 2012-2016

Company	State Share on 20 June 2012	Proposed State Share on 31 December 2016
Rosneft	75.16%	0% (golden share)
Zarubezhneft	100%	0% (golden share)
Transneft	78.1%	75% + one share
Sovcomflot	100%	0%

Source: Russian Government order no. 1035-p, Moscow, 20 June 2012

In order to avoid growing political divisions within the ruling elite, in Spring-Summer 2012, Vladimir Putin chose a conciliatory strategy which incorporated both liberal and conservative agendas. First, he recognized that the second wave of privatization should go ahead as planned by the liberals. Second, Putin asserted that state assets would not be sold cheaply and suggested that the state holding company Rosneftegaz could consolidate energy assets offered for privatization under its umbrella as suggested by the conservatives. [19] As a result, Rosneftegaz could participate in this privatization in order to avoid the sale of the state oil and gas assets too cheaply.[20] Third, Rosneftegaz could also act an investment vehicle financing state energy assets in order to boost their capitalization before privatization.[21]

Although Putin's decisions secured some temporary respite for the parties involved in the battle for and against the second wave of privatization of the Russian oil sector, this elite infighting is likely to continue in the months and years to come. Putin once again found a solution which seemingly incorporated the liberal and conservative agendas in relation to Rosneft, but in reality gave the upper hand to Igor Sechin.

Rosneft's acquisition of TNK-BP

In July 2012, Rosneft announced its intention to buy a stake in Russia's third largest oil company TNK-BP.[22] This joint venture was created in 2003–2005 by the international oil company BP and the AAR consortium of three

[19] E. Derbilova, "Luchshe men'she, da pozzhe" [It is Better to Do Less and Later], *Vedomosti,* 28 August 2007; O. Gavshina, "Sdachi ne nado" [Keep the Change], *Vedomosti,* 2 July 2012; E. Derbilova, "Sechin ostaetsya" [Sechin is Staying], *Vedomosti,* 18 February 2008; A. Gudkov, N. Skorlygina, "Rosneftegaz sobiraet aktivy" [Rosneftegaz Gathers the Assets], *Kommersant,* 4 June 2012.

[20] *Vesti,* 24 May 2012, <www.vesti.ru/doc.html?id=802774>.

[21] Ukaz prezidenta Rossikoi Federatsii [Decree of the President of the Russian Federation], No. 695, Moscow, 22 May 2012.

[22] Rosneft Press Release, 24 July 2012, <www.rosneft.com/news/pressrelease/24072012.html>.

billionaires with Russian connections—Mikhail Fridman, Len Blavatnik, and Viktor Vekselberg. Because this joint venture was established on a 50/50 basis, its operations have been constantly exposed to situations of corporate governance deadlock and infighting between AAR and BP over company strategy. The latest example of this was the collapse of a strategic deal between BP and Rosneft over Arctic development. The agreement was blocked by AAR in international courts as breaching the TNK-BP shareholding agreement. [23] As a result, BP decided to sell its share in the Russian company to Rosneft in order to pursue other lucrative opportunities, potentially including those in the Russian Arctic.[24] AAR consortium also opted to withdraw from TNK-BP's share capital, consequently offering it to Rosneft as well.

Insert 1. Rosneft-BP Deal

Rosneft agreed with BP to acquire its 50% stake in TNK-BP for:

- $17.1 billion in cash;
- 12.84% shares in Rosneft;
- Under the agreed terms, Rosneft shares are valued at $8 per share, implying total consideration of $28.0 billion;
- BP has offered to re-invest $4.8 billion of the cash proceeds to buy a further 5.66% stake in Rosneft from Rosneftegaz;
- BP will become the second largest shareholder in Rosneft with a 19.75% stake;
- Under Russian law, BP will be entitled to two board seats in Rosneft's nine-member Board.

Now that Rosneft has managed to secure a syndicated loan from international financial institutions, it will become the largest partially privatized national oil company. At the same time, in part payment for its share in TNK-BP, BP will become the largest private shareholder in Rosneft holding almost 20-percent equity in the Russian state-controlled oil champion (See Insert 1, "Rosneft-BP deal").

TNK-BP offers lucrative international opportunities for Rosneft due its assets abroad. TNK–BP started to emerge as an international company in 2010-2011, when it agreed to buy BP's $1.8 billion worth of oil and gas assets in Vietnam and Venezuela as well as $1 billion worth of Amazon oil exploration blocks from Brazil's HRT Particiapoes.[25] In the context of Igor Sechin's ambition to expand Rosneft's presence beyond Russia as a way to diversify its largely domestic asset base, a purchase of TNK-BP is an important international opportunity for the Russian state oil company. At the same time, with BP as an equity investor, Rosneft will find an important foreign partner with highly ranked and unique technological and management skills, as well as access to international finance.

Government liberal economists, led by Arkady Dvorkovich, initially objected to Rosneft's acquisition of additional private assets. However, BP's increased involvement in Rosneft's share capital in fact corresponds to the announced intention of the Russian state to reduce its presence in the domestic oil sector.

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[23] S. Yenikeyeff, *op. cit.* [11].
[24] "BP Announces Plans to Sell Stake in TNK-BP", <BBC News>, 1 June 2012.

[25] K. Melnikov, "TNK–BP proburit Braziliyu" [TNK-BP will Drill Brazil], *Kommersant*, 1 November 2011.

There were several reasons which compelled Vladimir Putin to back Igor Sechin's argument for turning Rosneft into a partially privatized Russian national oil company. Naturally, Rosneft's low equity valuation and its strategic contribution to the Russian budget played an important role in shaping Putin's final decision to allow the takeover of TNK-BP. However, the truly crucial factor behind Kremlin thinking was the need for a national oil champion to manage the domestic oil industry's jump from traditional brownfield sites of the Middle Volga region and West Siberia to greenfield sites of East Siberia and the Arctic. It is questionable whether Russia's private vertically-integrated oil companies can provide adequate investment in new upstream production, modernize Russian refineries and maintain the existing infrastructure. To a large extent, the revival of the Russian oil industry during the 2000s—buoyed by high oil prices and increased cash flows—rested on private oil companies being able to leverage Soviet legacy assets, including existing brownfield sites.

Therefore, it is not surprising that Vladimir Putin opted for Igor Sechin's proposal of relying on state-controlled Rosneft and its partnerships with IOCs, such as ExxonMobil, ENI, Statoil and BP, for boosting East Siberian and Arctic development. Moreover, it can also be argued that Igor Sechin manipulated inter-IOC competition and BP's problems with the AAR consortium to become the key broker within the Russian political and corporate establishment to strike deals with international oil companies (See Insert 2 "What do BP and Rosneft get out of the TNK-BP Deal?"). This helped Sechin to consolidate control over two key powerbases: offshore access for IOCs into the Russian upstream and Rosneft's access to international upstream projects and financial institutions. Moreover, Sechin can now use Rosneft's partnerships with IOCs to gain more leverage over the Russian government, particularly over the issue of tax breaks for East Siberian development where it has often fought battles with the liberals over the appropriate rate of Mineral Extraction Tax (MET) for greenfield sites, such as Vankor.

Insert 2. What do BP and Rosneft Get Out of the TNK-BP Deal?

BP

- End to shareholder conflict with AAR.
- BP will be able to share in upside of higher production and profits from Rosneft's JV with IOCs for Arctic exploration with the potential to gain access to continental shelf.
- Cash for leveraging its legal exposure following the disaster in the Gulf of Mexico.
- 20% equity in Rosneft allows BP to gain access to Rosneft's international projects and to capitalize on synergies between Rosneft and TNK-BP's East Siberian projects.
- Long-term production profile for at least next 50 years.

Rosneft

- A major IOC shareholder holding 20% equity in Rosneft—unprecedented equity model in IOC-NOC relations.
- Derail the liberal privatization agenda. Allows Sechin to direct BP's role in Russia's oil and gas universe.
- Ability to use BP as an external support pillar in Rosneft's economic and political interactions within Russia, especially over MET exemptions for difficult projects.
- Gas assets: 0.2 mmboe/d gas production (including Slavneft) and huge Rospan project.
- As part of Rosneft's attempt to diversify asset base: it gains international assets in Venezuela, Vietnam, and Brazil.
- Downstream assets in the refining sector – JV in Germany.
- Access to BP's oil trading business.

As was the case of Rosneft's IPO, the government *siloviki* also further expanded their service to the Kremlin as its additional channel to the global corporate and financial establishment. In the past economic relations with the West was the prerogative of government liberal economists.

More Battles Ahead?

Vladimir Putin has so far agreed that Rosneft can build its growth strategy on the basis of Russia's private corporate assets and contracts. These developments include the company's acquisition of TNK-BP, its replacement of Novatek as a domestic gas supplier to some companies in the power sector and partial withdrawal of oil exports contracts from Gennady Timchenko's Gunvor which in the past controlled over 30 % of Russian oil exports. Partnerships with IOCs provide Rosneft and Igor Sechin with additional support in case of conflicts with Putin-era billionaires, such as Gennady Timchenko over oil exports and gas projects. For example, Rosneft could use BP for oil trading without reliance on Timchenko's Gunvor.

Rosneft could soon start using its new upstream assets and recently forged alliances with leading international oil companies for aggressive expansion into the gas sector. Although, at present Igor Sechin is backing Gazprom's gas export monopoly and is playing down Rosneft's gas and electricity ambitions, these two state oil and gas champions could soon find themselves at logger-heads. This could especially be the case given that Rosneft now has a reliable partner through its joint venture with Itera to market Rosneft's gas, as well as to gain future access to Itera's gas business in energy-rich Turkmenistan. This JV will become increasingly important, as Rosneft plans to produce up to 100bcm of gas by 2020.

The question remains whether the growth strategy of the Russian state oil champion could destabilize the existing status quo between Rosneft and Gazprom while provoking Igor Sechin's battles with the oil and gas oligarchs of the Yeltsin and Putin eras. The Kremlin under Putin or his future successor may find it challenging to manage future contests in the domestic oil and gas sector along the old lines of political consolidation and could be compelled to create a new political and economic landscape in Russia.

Igor Sechin's ability to protect his elite base and to manage Rosneft as a super NOC also depends on how the BP-Rosneft equity deal is developed and maintained. Rosneft will need to take on a huge amount of debt to consolidate control over TNK-BP. Thus, it is yet to be seen whether BP will be able to afford its long-term equity partnership with Rosneft. This may become a pressing issue for BP and its shareholders particularly in the circumstances of Rosneft's large financial exposure and potential concerns about its capital efficiency. BP also has to be wary of its own, growing legal exposure in the US following the 2010 environmental disaster in the Gulf of

Mexico.[26] At the same time, the future of BP-Rosneft equity arrangement will reveal whether this model could become a growing trend in the global oil business dominated by national oil companies while IOCs are being forced to search for new ways of working with NOCs.[27] The key dilemma for IOCs is how to avoid becoming hostage to political dynamics in resource-rich countries, including Russia.

[26] See A. Mehdi, S. Yenikeyeff, *When Markets Meet Politics: Continuity and Change in the Russian Oil Sector* to be published by the Oxford Institute for Energy Studies (OIES) in February-March 2013.