



THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY
RICE UNIVERSITY

**LORD OF THE RIGS:
ROSNEFT AS A MIRROR OF RUSSIA'S EVOLUTION**

By

NINA POUSSENKOVA
RUSSIAN ACADEMY OF SCIENCES

PREPARED IN CONJUNCTION WITH AN ENERGY STUDY SPONSORED BY
JAPAN PETROLEUM ENERGY CENTER
AND
THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY
RICE UNIVERSITY – MARCH 2007

DISCLAIMER

THIS PAPER WAS WRITTEN BY A RESEARCHER (OR RESEARCHERS) WHO PARTICIPATED IN THE JOINT BAKER INSTITUTE/JAPAN PETROLEUM ENERGY CENTER POLICY REPORT, *THE CHANGING ROLE OF NATIONAL OIL COMPANIES IN INTERNATIONAL ENERGY MARKETS*. WHERE FEASIBLE, THIS PAPER HAS BEEN REVIEWED BY OUTSIDE EXPERTS BEFORE RELEASE. HOWEVER, THE RESEARCH AND THE VIEWS EXPRESSED WITHIN ARE THOSE OF THE INDIVIDUAL RESEARCHER(S) AND DO NOT NECESSARILY REPRESENT THE VIEWS OF THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY NOR THOSE OF THE JAPAN PETROLEUM ENERGY CENTER.

© 2007 BY THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY OF RICE UNIVERSITY

THIS MATERIAL MAY BE QUOTED OR REPRODUCED WITHOUT PRIOR PERMISSION,
PROVIDED APPROPRIATE CREDIT IS GIVEN TO THE AUTHOR AND
THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY

ABOUT THE POLICY REPORT

THE CHANGING ROLE OF NATIONAL OIL COMPANIES IN INTERNATIONAL ENERGY MARKETS

Of world proven oil reserves of 1,148 billion barrels, approximately 77% of these resources are under the control of national oil companies (NOCs) with no equity participation by foreign, international oil companies. The Western international oil companies now control less than 10% of the world's oil and gas resource base. In terms of current world oil production, NOCs also dominate. Of the top 20 oil producing companies in the world, 14 are NOCs or newly privatized NOCs. However, many of the Western major oil companies continue to achieve a dramatically higher return on capital than NOCs of similar size and operations.

Many NOCs are in the process of reevaluating and adjusting business strategies, with substantial consequences for international oil and gas markets. Several NOCs have increasingly been jockeying for strategic resources in the Middle East, Eurasia, and Africa, in some cases knocking the Western majors out of important resource development plays. Often these emerging NOCs have close and interlocking relationships with their national governments, with geopolitical and strategic aims factored into foreign investments rather than purely commercial considerations. At home, these emerging NOCs fulfill important social and economic functions that compete for capital budgets that might otherwise be spent on more commercial reserve replacement and production activities.

The Baker Institute Policy Report on NOCs focuses on the changing strategies and behavior of NOCs and the impact NOC activities will have on the future supply, security, and pricing of oil. The goals, strategies, and behaviors of NOCs have changed over time. Understanding this transformation is important to understanding the future organization and operation of the international energy industry.

CASE STUDY AUTHORS

NELSON ALTAMIRANO

ARIEL I. AHRAM

JOE BARNES

DANIEL BRUMBERG

MATTHEW E. CHEN

JAREER ELASS

STACY L. ELLER

RICHARD GORDON

ISABEL GORST

SUMIT GANGULY

PETER HARTLEY

DONALD I. HERTZMARK

AMY MYERS JAFFE

STEVEN W. LEWIS

DAVID R. MARES

KENNETH B. MEDLOCK III

FRED R. VON DER MEHDEN

EDWARD MORSE

G. UGO NWOKEJI

MARTHA BRILL OLCOTT

NINA POUSSENKOVA

RONALD SOLIGO

THOMAS STENVOLL

AL TRONER

XIAOJIE XU

ACKNOWLEDGEMENTS

The James A. Baker III Institute for Public Policy would like to thank Japan Petroleum Energy Center, Accenture and the sponsors of the Baker Institute Energy Forum for their generous support in making this project possible.

ENERGY FORUM SPONSORS

ACCENTURE
ANADARKO PETROLEUM
THE HONORABLE & MRS. HUSHANG ANSARY
APACHE CORPORATION
ARAMCO SERVICES
BAKER BOTTS, L.L.P.
BAKER HUGHES
BP
CHEVRON CORPORATION
CONOCOPHILLIPS
EXXONMOBIL
GOLDMAN, SACHS & Co.
HALLIBURTON
JAPAN PETROLEUM ENERGY CENTER
MARATHON OIL CORPORATION
MORGAN STANLEY
NOBLE CORPORATION
SCHLUMBERGER
SHELL
SHELL EXPLORATION & PRODUCTION CO.
SIMMONS & COMPANY INTERNATIONAL
SUEZ ENERGY NORTH AMERICA, INC.
TOTAL E&P USA, INC.
WALLACE S. WILSON

ABOUT THE AUTHOR

NINA POUSSENKOVA

SENIOR RESEARCH FELLOW

RUSSIAN ACADEMY OF SCIENCES

Nina Poussenkova is currently a scholar-in-residence of the Carnegie Moscow Center. She cooperates with WWF-Russia and is a senior policy advisor of its Trade and Investment Program. Dr. Poussenkova is a member of the advisory board of the Greening of Industry Network. She has been involved in the Russian oil industry since 1991. Dr. Poussenkova worked for the Center for Foreign Investment and Privatization, a consulting company, and in equity research departments of Salomon Brothers and Lazard Freres investment banks. She is among the authors of the four-volume research report Russian Oil (Salomon Brothers, 1996) – one of the first major publications about the Russian oil sector. Together with Lev Tchurilov, the last U.S.S.R. Minister of Oil Industry, and Isabel Gorst, she wrote the book Lifblood of Empire: A Personal History of the Rise and Fall of the Soviet Oil Industry (PIW Publication, 1996). She participated in the James A. Baker III Institute project Energy Dimension in Russian Global Strategy with a paper “From Rigs to Riches.” Dr. Poussenkova graduated from Moscow State University’s Department of Economics. She defended her PhD thesis in the Institute of World Economy and International Relations of the Russian Academy of Sciences, where she works as senior research fellow.

ABOUT THE ENERGY FORUM AT THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY

The **Baker Institute Energy Forum** is a multifaceted center that promotes original, forward-looking discussion and research on the energy-related challenges facing our society in the 21st century. The mission of the Energy Forum is to promote the development of informed and realistic public policy choices in the energy area by educating policy makers and the public about important trends—both regional and global—that shape the nature of global energy markets and influence the quantity and security of vital supplies needed to fuel world economic growth and prosperity.

The forum is one of several major foreign policy programs at the James A. Baker III Institute for Public Policy at Rice University. The mission of the Baker Institute is to help bridge the gap between the theory and practice of public policy by drawing together experts from academia, government, the media, business, and non-governmental organizations. By involving both policy makers and scholars, the Institute seeks to improve the debate on selected public policy issues and make a difference in the formulation, implementation, and evaluation of public policy.

The James A. Baker III Institute for Public Policy

Rice University – MS 40
P.O. Box 1892
Houston, TX 77251-1892

<http://www.bakerinstitute.org>
bipp@rice.edu

ABOUT THE JAPAN PETROLEUM ENERGY CENTER

The **Japan Petroleum Energy Center** (JPEC) was established in May 1986 by the petroleum subcommittee in the Petroleum Council, which is an advisory committee to the Minister of International Trade and Industry. JPEC's mission is to promote structural renovation that will effectively enhance technological development in the petroleum industry and to cope with the need for the rationalization of the refining system. JPEC's activities include the development of technologies; promotion of international research cooperation; management of the information network system to be used during an international oil crisis; provision of financial support for the promotion of high efficiency energy systems and the upgrading of petroleum refining facilities; and organization of research surveys.

JPEC's international collaborations cover joint research and exchange of researchers and information with oil producing countries and international institutions and support for infrastructure improvement and solving environmental problems of the petroleum industries in oil producing countries.

Japan Petroleum Energy Center
Sumitomo Shin-Toranomon bldg. 3-9
Toranomon 4-choume
Minatoku Tokyo 105-0001, Japan

http://www.pecj.or.jp/english/index_e.html

All animals are equal,
but some animals are more
equal than others.
-G. Orwell, Animal Farm

LORD OF THE RIGS:

ROSNEFT AS A MIRROR OF RUSSIA'S EVOLUTION

Nina Poussenkova, Russian Academy of Sciences

Rosneft acquired Yuganskneftegas in 2004, and successfully held the biggest IPO in Russia, and the fifth biggest in the world in 2006. As a result, the company that was known only to experts in Russia's oil sector, turned into a household name for the international mass media and global investment community.

Overnight, it was transformed from a very modest player by Russian standards (21 mt of oil production in 2004) into the third biggest Russian oil company (75 mt of oil production in 2006) with proven oil reserves of 2.05 billion tons and gas reserves of 691 bcm as of December 31, 2005. It has main hydrocarbon production assets in West and East Siberia, Timan-Pechora, in the south of Russia and on the island of Sakhalin; two refineries with total throughput of 10 mt/yr, four oil terminals and more than 650 fuel stations.

As the national oil company it performs certain additional strategic functions which distinguishes it from its peers in Russia – thus, it is in charge of restoring the oil industry of Chechnya. Having Igor Sechin, deputy chief of the RF President’s Administration, as its BoD Chairman, it possesses a unique administrative clout and plays an important role in Russia’s domestic and foreign policy. Rosneft acts as a petroleum ambassador of Russia in Kazakhstan and Algiers. It declared East Siberia and the Far East the area of its strategic interests and turned into an important driving force of the new Eastern vector of Russia’s policy by establishing close business relations with China, Japan, India and Korea.

With a market capitalization of \$ 100 billion as of November 2006, it is the most expensive oil company in Russia. Rosneft aspires to become the number one crude producer in Russia in the nearest future and has ambitions to equal ExxonMobil and BP by 2010. If Rosneft acquires the remaining assets of YUKOS and expands its international presence, it will come close to achieving this goal. The Russian leadership, which strives to position the country as an energy superpower and the guarantor of global energy security, actively promotes and supports Rosneft in its expansion since it wants to have its own oil supermajor.

All these successes are particularly impressive given the fact that less than 10 years ago the company was on the verge of a complete collapse. Actually, Rosneft is a unique phenomenon in the Russian oil industry. On the one hand, for a long time it was one of the least important (and the least successful) players in the Russian fuel and energy sector, and a huge gap existed between its high official status and low actual capabilities. On the other hand, the ups and downs in its evolution faithfully reflect the development trends and the relative weight of the private corporations and the state in Russia’s oil business over the last 15 years.

THE LOSER'S STANDING SMALL

The Fading Glory

In September 1991, after the Soviet Union collapsed, Rosneftegas Corporation, a voluntary association of Russian oil enterprises, was formed to replace the U.S.S.R. Ministry of the Oil Industry. Lev Tchurilov, the last U.S.S.R. Oil Minister, was appointed its president, soon to be replaced by Alexander Putilov, formerly general director of Uraineftegas (subsidiary of LUKOIL).

The Privatization Race. In November 1992, Presidential Decree # 1403 which launched privatization in the Russian oil sector, established three vertically-integrated oil companies (LUKOIL, Surgutneftegas and YUKOS), and the state entity Rosneft on the basis of Rosneftegas. Rosneft was to carry out trust management of the state stakes in 259 out of 301 oil enterprises operating in Russia. Rosneft was commissioned to perform the following functions:

- assist operating and financial restructuring of joint-stock companies;
- ensure stable deliveries of oil, gas and petroleum products for the state needs;
- represent interests of the state in managing boards of companies which shares it held in trust management;
- coordinate state investments in the oil industry;
- organize production of oil-field equipment;
- facilitate inflow of capital into the sector by creating banks and investment companies;
- promote R&D programs and develop international trade, etc¹.

¹ See in greater detail J.Hudson, N.Poussenkova, Russian Oil. Prospects for Progress: Industry Background and Status, Salomon Brothers, volume 4, March 1996.

In 1993, Rosneft accounted for over 60% of the domestic oil production. With 100% hindsight, one might say that the very scope and diversity of functions of the state company turned out to be sort of a “time bomb”². Given galloping inflation, falling oil prices, disruption of the established economic ties between the U.S.S.R. republics, non-payments, and other maladies of the transition period, the state could not efficiently manage the organization that was comprised of enterprises dispersed from Sakhalin to Kaliningrad.

In addition to geographic diversity, its management problems were aggravated by an extreme structural complexity: Rosneft incorporated 26 oil producers, 23 refineries, petroleum product distributors, machine-building enterprises, R&D institutes and even gas processing plants (see Appendix 2). Since the old command-and-control system was destroyed, and market mechanisms were not yet developed, it was clear that the collapse of Rosneft in its initial form was predetermined from the very beginning.

The Shrinking Empire. In 1993-1994, new vertically-integrated oil companies (VICs) were formed, such as SIDANCO, Eastern Oil Company and ONACO, and Rosneft was forced to give up many of its producing and refining subsidiaries in favor of these new companies.

In April 1995, Rosneft was transformed into an open JSC by the presidential decree # 327. It was to carry out the following functions:

- trust management of state stakes in companies not included in the new VICs;
- general sponsorship of the oil industry R&D efforts;
- representation of state interests in production-sharing agreements (PSAs).

However, Rosneft continued to shrink. In August 1995, it was forced to cede Nizhnevartovksneftegas to the newly created Tyumen Oil Company. In the same month it suffered the most serious blow when it was deprived of Noyabrksneftegas, Omsknefteorgsyntez

² Vedomosti, 17.08.2004.

(the most efficient and modern refinery in Russia), Noyabrskgeophysica and Omsknefteproduct in favor of Sibneft which was allegedly established to help fund Boris Eltsin's 1996 election campaign.

The September 1995 Government Decree # 971 determined the new composition of Rosneft (see table below).

TABLE 1: COMPOSITION OF ROSNEFT

E&P	Refining	Marketing
Purneftegas	Komsomolsk	Altainefteproduct
Sakhalinmorneftegas	Krasnodarnefteorgsyntez	Severoosetinnefteproduct
Krasnodarneftegas	Tuapse	Kabbalknefteproduct
Stavropolneftegas	Moscow	Karachaevo-
Termneft		Cherkessknefteproduct
Dagneft		Kemerovoneftaproduct
Archangelskgeoldobycha		Krasnodarnefteproduct
Kalmneft		Krasnodar oil depot
		Kurgannefteproduct
		Murmansknefteproduct
		Nakhodkanefteproduct
		Severnefteservice
		Smolensknefteproduct
		Stavropolnefteproduct
		Tuapsenefteproduct
		Yamalnefteproduct
		Mosnefteproduct

Upstream: Losses Continue. This structure also did not turn out to be final. Thus, the Government Ordinance # 971 of September 1995 determined that 25.5% of the former state geological enterprise Archangelskgeoldobycha (AGD), which held 21 licenses for oil fields and 2 licenses for diamond deposits in the Timan-Pechora region, should be incorporated in Rosneft. This decision seemingly meant the victory of Rosneft over KomiTEK (which later became the subsidiary of LUKOIL) in the long war these two companies waged over this promising entity. It was assumed that AGD would partially compensate Rosneft for the loss of Noyabrskneftegas. Rosneft was also interested in AGD because the latter was the co-owner of Polar Lights, a joint venture with Conoco created to develop the Ardalinsk oil field, which produced some 1.2 million tons of crude in 1995. However, this triumph of Rosneft was not long-lived: it turned out that the controlling interest in AGD was held by MAPO-Bank, which was interested in diamonds rather than in oil. As a result, Rosneft formally included Archangelskgeoldobycha in its structure but could not control its cash and crude flows and did not invest in its subsidiary. Unable to tighten its grip over AGD, Rosneft purchased from it a 20% stake in Polar Lights. Having served its role as an intermediary MAPO-Bank ceded its controlling interest in Archangelskgeoldobycha to LUKOIL in 1997³.

Downstream: From Bad to Worse. In downstream, Rosneft was even more of a failure than in upstream. The cumulative output of its three refineries was only 4.7 million tons in 1996, less than half of the amount of oil Rosneft produced, and less than one quarter of its refining

³ Since Rosneft held a blocking interest in AGD, LUKOIL could not actively invest in the development of the company and tried to consolidate its shares. Rosneft refused to sell or exchange its stake and even blocked the decision on the additional share issue of AGD. In 1998, Conoco and LUKOIL signed a memorandum on the joint development of Timan-Pechora, and bought the second block of the state shares of AGD (23.5%) at an auction. In principle, the system of management of AGD and its subsidiaries that LUKOIL established permitted to disregard Rosneft. However, the clear strengthening of the state company's positions in the new political situation made it essential to search for an amicable solution. When Rosneft joined forces with Gazprom in 2001 to establish Sevmorneftegas (a JV between Rosshelf and Purneftegas; AGD held 13.6% of Rosshelf), LUKOIL took advantage of this situation and blocked the transfer of licenses to Sevmorneftegas. A compromise was reached in the late 2002: Rosneft ceded 25.5% of AGD to LUKOIL, and LUKOIL sold to Rosneft AGD's share in Rosshelf (13.6%) and in Polar Lights (30%) (see Oil and Capital, # 10, 2004, p. 116).

capacity. Rosneft's lack of success in refining and marketing its crude was highly paradoxical because southern Russia where two Rosneft's refineries (Krasnodarnefteorgsyntez and Tuapse refinery) operated suffered from an acute shortage of oil products. Other oil companies, led by LUKOIL, were able to undersell Rosneft in this region.

In October 1996, Krasnodarnefteorgsyntez, together with Purneftegas, was included in the list of insolvent companies of the Federal Insolvency Commission, though the issue of Pur's bankruptcy was settled in one week⁴.

Krasnodarnefteorgsyntez was to be sold off in 1997 to raise money to repay its tax obligation of \$ 32 million - quite a modest sum as compared to other oil companies' debts. It was somewhat surprising that the government would choose to draw the line with respect to a subsidiary of Rosneft rather than that of a debt-ridden privatized company. Perhaps one motive was to demonstrate that there would be no "sacred cows" in the course of the intensifying battle against tax dodgers.⁵ After three unsuccessful attempts, Krasnodarnefteorgsyntez was finally sold off in October 2000. The trader Atlas bought it for \$ 10.8 million, outbidding Rosneft, its former parent company⁶.

Moreover, shares of Moscow refinery and Mosnefteproduct were supposed to be kept in trust management of Rosneft under the ordinance # 971. However, Yuri Luzhkov, the Mayor of Moscow, began to claim that Rosneft could exert price pressure on the Moscow fuel market where the refinery is the key supplier. At that time, the Muscovites were still reeling from the shocking gasoline crises of the mid-1990s, and therefore it was not difficult for the Mayor to convince the government that he, rather than Rosneft, should control operations of the company that would supply Moscow with fuel. Luzhkov promoted the idea that it was necessary to

⁴ Oil and Capital, # 4, 1997, p. 38.

⁵ John Webb, Rosneft at the Crossroads, CERA, May 1997, p. 5.

⁶ Oil and Capital, # 12, 2000.

diversify sources of crude, while Rosneft would strive to establish its monopoly⁷. Thus, Rosneft lost the refinery and petroleum product supplier in the most lucrative city of Russia. In February 1997, Victor Chernomyrdin signed the ordinance on creating the Central Fuel Company thus depriving Rosneft of any hopes to hold a sizeable stake in the Moscow refinery.

Abandoning Hopes for Revival. Over the years, Rosneft made several attempts to somewhat restore its former glory, but they largely ended in a fiasco. Thus, its application bid to participate in the auction for 40.12% of Surgutneftegas held on November 3, 1995 within the framework of the notorious “loans-for-shares” auctions was not even accepted under the pretext that its bank guarantees were filled in incorrectly.

Rosneft also tried in vain to strengthen its position as a national company in charge of various key functions. In early 1995, Rosneft hoped to form the state entity, which would include, in addition to its own subsidiaries, Noyabrskneftegas, Omsk and Moscow refineries, and Mosnefteproduct – but lost the game to Sibneft and the Central Fuel Company.

Alexander Putilov realistically admitted that the project of creating the national oil company “was good, but time for its implementation already passed. Now it contradicts the established competitive environment. Commercial structures understand too well that this project will allow some entity to get priorities, therefore they’ll hardly permit its implementation. I’m absolutely convinced that the integration of companies on a voluntary basis is inevitable. But only after the wild post-privatization division of the market is over, and when owners will emerge who are interested in expanding capacities of the structures they acquired. It will be the secondary integration, because the initial integration happened when assets were distributed

⁷ Oil and Capital, # 4, 1997, 16.

between holdings under administrative decisions”⁸. And the future developments in the Russian oil industry confirmed his prophecy.

Then, in 1998, after the August 17 crisis, the government of Evgeniy Primakov intended to strengthen Rosneft by merging it with Slavneft and ONACO, the only other corporations with controlling interest still held by the state. It would have made Rosneft a truly powerful national oil company. It can be speculated that during the 1998 default, the government saw that the only way out of the chaos would be to strengthen the state role in economy. Essentially, the creation of the mighty national company was in line with this policy. However, Rosneft’s more influential private rivals foiled these plans because they were against the emergence of a strong competitor with a special status that would confer additional important privileges.

Leuna Fiasco. In general, Rosneft was treated like an unwanted child of the government, which it apparently did not know what to do with. Moreover, the country’s leadership did not have a clear long-term strategy of what to do in the oil sector in general. The fiasco of the Leuna-2000 project – construction of the refinery in Germany by Elf Aquitaine through MIDER⁹, where Rosneft - together with Surgutneftegas and Megionneftegas (subsidiary of Slavneft) - was to be a key player showed that the government was not willing (or able) to support the company it owned when its interests conflicted with those of more powerful private groups.

The Russian partners were supposed to deliver annually 10 mln tons of oil to MIDER for 15 years, and could get up to 24% of its authorized capital. They were expected to provide DM 240 million by July 1, 1995. Their contribution was to be made through deliveries of oil to the German refineries supported by additional export quotas and exemption from export duties. As a

⁸ Oil and Capital, # 6, 1997, p.31.

⁹ Elf Aquitaine won the tender for building an oil refinery in the vicinity of Leuna. In 1993, Elf registered Mitteldeutsche Erdöl-Rafinere (MIDER) and offered the RF Ministry of Fuel and Energy to become its cofounder in order to get a contract for the deliveries of Russian crude. The agreement was signed between Elf and three participants from Russia in Berlin in April 1994.

result, Leuna-2000 seemed a gift from Heaven to three companies – they would own very valuable assets and also get access to the European petroleum product market.

But it turned out to be too good to be true – because of the attitude of Russian authorities since the proposals of Germany and Elf violated the interests of certain major VICs and Transneft. Preparation of documents that Surgut, Rosneft and Megion needed to be involved in Leuna-2000 dragged on for so long that they became obsolete. Surgutneftegas quit the project, correctly assessing it to be a waste of time.

The long-awaited government ordinance concerning exports of 10 million tons per year to Leuna was issued on October 31, 1996, and its terms disappointed both the Russian and the French party. Therefore, Elf proposed to reduce Russian oil deliveries from 10 to 4 million tons per year and simultaneously to cut their stake in refinery. Rosneft and Megion refused saying that they were interested in no less than 24% stake. Thus, negotiations between Elf and the Russians came to a total impasse¹⁰.

In general, it seems that the state ownership was a mixed blessing for Rosneft. On the plus side, it was given the right to handle sales of the state's share of oil in PSAs. But Rosneft also paid a price for its close ties with the government, i.e. it had fallen behind other Russian companies in the development of commercial skills that were becoming increasingly necessary as Russia was making a transition to the market system¹¹. An indirect indication of this failure to develop market mentality was the average age of Rosneft's employees – 56 years in 1997 - one of the highest in the sector¹².

¹⁰ See in detail Oil and Capital, # 7-8, 1997, pp. 42-45.

¹¹ John Webb, p. 6.

¹² Oil and Capital, # 7-8, 1997, p. 28.

Poor Little Rich Girl

After losing many valuable assets over the 90s, Rosneft became quite a minor player in the Russian oil sector, accounting for less than 5% of the country's crude output and hydrocarbon reserves, and it remained a second-tier company up to its acquisition of Yuganskneftegas. Main hydrocarbon resources of Rosneft were located in West Siberia (over 40%), Timan-Pechora (roughly one third), Sakhalin (15%) and the south of Russia.

Rosneft's contribution to the fuel and energy complex until its takeover of Yuganskneftegas was very modest. It was number 7 or 8 among its larger oil sisters (see Appendix 1) in terms of virtually all operating indicators. It only did well in gas production, and had the smallest share of idle wells in the total well count. It was also one of the least efficient companies in the sector: in terms of lifting costs it lagged behind all its peers outperforming only Tatneft in 2002. Its number of personnel seemed frightening even among its peers that were notorious for their overemployment from the Western viewpoint. In 1996, 70,000 people worked in the company that produced only 13 mln tons of crude and 3 bcm of gas and refined 4.7 mln tons.

Purneftegas. Rosneft's key upstream subsidiary was Purneftegas located in the Yamal-Nenetsk Autonomous District that produced 8.4 mt of oil in 1996, i.e. more than one half of its total crude output. The greater part of the territory licensed to it was not well explored and had a significant potential for reserve increment. It had 255.1 mt of proved oil reserves and 502.7 bcm of proved gas reserves, 192.3 mt of probable oil reserves (296.7 bcm of probable gas reserves) and 283.1 mt of possible oil reserves (290.5 bcm) as of December 31, 2005.¹³ Besides, Pur is the only crude producer in the region and owns the whole production infrastructure. Its oil is of high

¹³ www.rosneft.ru.

quality with API of 35° and sulfur content of 0.2%. Its main fields¹⁴ are relatively young and have a high daily output of wells, while water cut is roughly 45%, much lower than the average figure of 70% for West Siberia.

From the very beginning, Purneftegas had an advanced and progressive management team and showed its willingness to improve transparency. Already in 1995, the company hired Price Waterhouse to audit its financial statements and OPC Ltd. to assess its oil and gas reserves (at that time its proven reserves were estimated at 1.4 bln barrels). Pur was also one of the pioneers in Russia to organize roadshows and presentations to Western investors in London and New York in the summer of 1995. Salomon Brothers' experts considered Purneftegas as "one of the most highly regarded Russian "blue chips" and... the industry leader in maximizing shareholder value and attracting investors. We regard Pur as open, reform oriented and one of the most "Western" in the Russian oil sector"¹⁵.

Even in the troubled mid-1990s, Purneftegas was successful in arranging significant international and domestic credits. At that time, the company received a \$ 158 million World Bank loan and a \$ 170 million loan from the EBRD under the oil and gas rehabilitation program¹⁶.

In contrast to other oil producers in Russia, Purneftegas had few social obligations (such as housing, schooling, healthcare, etc.) since some 67% of Purneftegas's employees worked on the basis of the "flight-in crews" thus permitting the company to reduce social infrastructure

¹⁴ Tarasovskoye, Barsukovskoye, Kharampurskoye, Komsomolskoye, Gubkinskoye, Meretoyakhinskoye, etc.

¹⁵ Salomon Brothers, Russian Oil. Vol 2, Oil Producing Companies, London, 1996, p. 175.

¹⁶ Under this program, EBRD and the World Bank fund specific projects and the purchase of Western equipment for the future enhancement of oil and gas production in West Siberia. Purneftegas also used \$ 15 million credit line from UNEXIMbank to finance development of the South-Kharampursk field and a separate \$ 15 million line to finance the hydro fracking program jointly undertaken with Schlumberger.

costs¹⁷. For the same reason, Pur was in a good position to rationalize its workforce without the cost and pain usually associated with such downsizing. In the mid-90s it undertook a restructuring program aimed at reducing its labor costs and optimizing its management structure. Having reached 19,600 in 1993, the number of employees decreased to 17,600 by 1995.

Sakhalinmorneftegas. Another key producing subsidiary of Rosneft, though quite minor by Russian standards (its crude output volume was 1.4 mt in 1996), is Sakhalinmorneftegas (SMNG), whose main upside potential lies in its participation in Sakhalin offshore projects (initially only Sakhalin-1)¹⁸. In Sakhalin, the possibility of oil exports is not linked to Transneft export capacity limitations and bottlenecks – one of the reasons why the projects were of such interest to international majors. Also, they open a window to the fast-growing markets in the Asia-Pacific region.

SMNG operates on the island of Sakhalin where crude has been produced from onshore fields since 1928. It holds licenses for 33 fields mainly concentrated in the northern part of the Sakhalin Island. Water cut at its fields is 83%; sulfur content of its crude is 0.28%, and API - 28°. The main consumer of SMNG's oil is the Komsomolsk refinery, also part of Rosneft. Sakhalinmorneftegas's production costs are the highest in the Russian oil industry because of the high amount of energy needed to inject steam into productive layers of viscous oil and expensive transportation of materials and equipment to its remote location.

The state subsidized oil and gas production in Sakhalin and provided considerable tax benefits and exemptions to SMNG throughout the 90s. This assistance was granted because of

¹⁷ Salomon Brothers, p. 231.

¹⁸ Sakhalin-1 was the second project to be signed under PSA terms after Sakhalin-2. Sakhalin-1 is based on oil, gas and condensate fields of Chaivo, Odoptu and Arkutun-Dagi. In 1993 the RF Ministry of Fuel and Energy, SODECO corporation, Exxon and Sakhalinmorneftegas-Shelf company, reached an agreement to pool their efforts in assessing the feasibility of developing the Odoptu, Chaivo and Arkutun-Dagi fields, as well as conducting negotiations on the terms of the Production Sharing Agreement. Initially there were only four shareholders in Sakhalin-1 project (Exxon, Rosneft, Sakhalinmorneftegas and SODECO), and in 2001 the Indian ONGC joined them (see 2.2.3).

the difficult recovery conditions, the region's vital role in supplying crude to the Far East of Russia, the lack of major pipelines, and also to help the company recover from a devastating earthquake that hit the island in 1995¹⁹. Another important objective was the desire to maintain the federal government's influence in the region. This territory of Rosneft's operations is particularly important for Russia's domestic policy. The Far East became a synonym for energy crisis that was, according to many experts, a carefully planned PR action serving concrete political objectives. Rosneft, as the state company, was commissioned to help resolve this crisis. So, Rosneft was more than a simple oil producer in the Far East of Russia: it acted as a pillar for the whole local economy.

Timan-Pechora was also a promising territory for Rosneft's operations since it is considered to be the second biggest (after West Siberia) petroleum province of Russia in terms of hydrocarbon reserves²⁰. Rosneft has 50% of the JV Polar Lights (with ConocoPhillips) there, and in 2003 it acquired Severnaya Neft that operated in the region (see the *Rebuilding the Empire* section).

The South of Russia accounted for 25% of oil and 30% of Rosneft's gas production during the 1990s. It is one of the oldest oil and gas producing provinces in the country where the average daily output of wells is about 0.6 tons, while lifting costs are one of the highest in Russia. However, its strategic advantage is the proximity to export ports located on the Black Sea and well-developed production and social infrastructure.

Thus, Rosneft's resource base was sufficiently diversified, and the company was protected against the inevitable decline of production in West Siberia. Additionally, nearly one

¹⁹ Rosneft-Sakhalinmorneftegas, Troika Dialog Research, July 1997, p. 12.

²⁰ Oil and Gas Eurasia, March 2004, p.62.

half of reserves lie in areas which have direct access to seas and oceans, i.e. it does not depend on the available pipeline system that may hold back output growth.

Therefore, despite all the losses that the company sustained in the early to mid 1990s, it was still a tempting acquisition target for its competitors that were particularly interested in Purneftegas, Timan-Pechora and offshore Sakhalin projects.

Privatization à la Gangster Capitalism

The saga of Rosneft's unsuccessful privatization during the 1990s is more than simply a case-study of corruption and inefficiency of the RF government. It is also a vivid illustration of the decision-making process in the oil sector at that time, when the fate of the state company was determined by the relative clout of various oligarchic groups

Misfortunes of Purneftegas. Privatization history of Rosneft is closely connected with the vicissitudes of Purneftegas, the jewel in its crown. In May 1994, the ordinance of the RF Government # 452 established SIDANCO that was comprised of five oil producing enterprises (all of them originally incorporated in Rosneft), including Purneftegas.

Suddenly, in early 1995 the top management of Purneftegas sent a letter to the government asking to return the enterprise to Rosneft in order not to break the established technological links between Purneftegas and Noyabrskneftegas (the latter was still in the state company's structure). On January 24, 1995, ordinance # 112-r signed by the Prime Minister Victor Chernomyrdin transferred the state stake in Pur to Rosneft. As a countermeasure, SIDANCO started litigation against the State Property Committee.

After SIDANCO was privatized in favor of Vladimir Potanin through loans-for-shares auctions, the fight for Purneftegas began in earnest. Actually it was not the war between Rosneft and SIDANCO, but between V.Potanin, who was a Vice-Premier for a short while, and

V.Chernomyrdin, who was the Prime-Minister. Chernomyrdin actively defended interests of Rosneft largely because his team which included bosses of Gazprom, LUKOIL and Rosneft, was not eager to let SIDANCO, which had the potential for becoming one of the biggest Russian oil companies, grow stronger.

In April 1997, Ziya Bazhayev, a young and energetic Chechen entrepreneur, became president of SIDANCO, and zealously joined the battle for Purneftegas with the authorities. Bazhayev's task was daunting. Plans for Rosneft privatization were being developed at that time, and the mightiest oligarch of the 1990s, Boris Berezovskiy, became interested in the state company, of course with Pur included in its structure. Various dirty tricks were used in the hostilities, including attempts to discredit Bazhayev because of his Chechen origins²¹.

After numerous arbitration court sessions and their controversial decisions, the tug-of-war ended quite unexpectedly. In late 1997, when judges recognized the validity of SIDANCO's claims, Vladimir Potanin voluntarily gave Purneftegas up. Observers saw the "invisible hand" of Boris Berezovskiy in such a "generous" gesture. Analysts also speculated that the government wanted to "sell Purneftegas twice". Playing the "Pur card" in the SIDANCO tender, whose auction price took into account ownership of Purneftegas, certainly served the government's objectives of replenishing its coffers. With similar interests at stake it might have been decided to legally duplicate the transaction by bequeathing Pur to Rosneft and finishing it off with another auction.²²

Rosneft's Resistance. However, Rosneft showed an admirable agility (or an exceptional luck) in avoiding privatization in the 1990s. It seemed that above all it was determined not to repeat the fate of other oil companies that had fallen under bank control as a result of the loans-

²¹ Izvestiya, April 16, 1997.

²² Capital Markets Russia, February 6, 1997, p. 2.

for-shares deals. According to Vladimir Tumarkin, Rosneft's PR Director at that time, "some people are hunting for Rosneft; we don't want to give the banks such a gift"²³.

During the previous decade, several attempts to privatize the state company were made. Initially, the sale was planned for summer 1996, but was put off due to a drawn-out court battle between Rosneft and SIDANCO over Purneftegas²⁴. Then, on September 4, 1997, Chernomyrdin signed ordinance # 1134 concerning the privatization of Rosneft. The personnel could have received 4% of shares, 51% were to be sold at investment tender, and the rest was to be disposed off at a commercial contest.

However, three weeks later, on September 25, the State Property Committee approved a new and radically different privatization plan. By the end of the year, 1.6% of Rosneft's shares were to be transferred to personnel, 63% were to be sold through cash auctions in early 1998, and 32.2% of shares were to be offered at a commercial tender.

Most experts were betting on Rosneft's takeover by Sibneft. SIDANCO was a likely contender as well. At that time, foreign majors were also considered eligible bidders for Rosneft, since Ordinance # 1134 eliminated the 15% limit on foreign participation in the state company. Even George Soros was interested in Rosneft and was prepared to pay \$ 1 billion for a stake in the state company²⁵.

Rosneft's president Alexander Putilov was fired because he resisted the privatization plan proposed by the State Property Committee and tried to retain his own influence in the company²⁶. He was made BoD Chairman and Yuri Besspalov, the ex-minister of industry, widely believed to be "the man of Berezovskiy", was appointed president in April 1997. The new boss

²³ John Webb, p. 6.

²⁴ Interfax Oil and Gas Report, February 28, 1997, p. 11.

²⁵ Kommersant-Daily, July 30, 1997.

²⁶ Oil and Capital, # 6, 1997, p. 7.

immediately started to get rid of the “old team”, and began to bring in his own people to Rosneft, probably preparing it through this infiltration for incorporation into Sibneft.

The infighting between BoD Chairman Putilov and President Bespalov was unprecedented in the oil sector of Russia where companies preferred not to wash their dirty linen in public. For example, the latter openly criticized the former for signing in July 1997 a Russian-Azeri agreement on the development of the Kyapaz field in the Caspian Sea that was allegedly poorly prepared in legal terms and violated the interests of Rosneft²⁷.

The plans to sell the company in 1997 dismally failed because certain influential players were interested in postponing the auctions for as long as possible. Boris Berezovskiy needed a delay because in November SIDANCO/BP and Gazprom /Royal Dutch Shell/LUKOIL alliances were formed, and the magnate was not confident that he would be able to triumph over these giants. The state was also not in a hurry since it was definitely not a seller’s market in Autumn 1997. Bespalov and his team were unhappy about the terms of privatization; particularly about the meager block of shares allocated for the personnel and management, and did their best to torpedo the process.

Adding Insult to Injury. In early 1998, the government of Chernomyrdin that ruled for 5 years was dismissed and, before resigning, approved yet another plan for Rosneft privatization. It was decided that 75% + 1 share of Rosneft would be sold for \$ 2.1 billion, which seemed then a fantastically huge amount of money, with additional \$ 400 million worth of investment conditions. The winner was to be declared in the end of May.

A fierce battle for Rosneft among the powerful players was anticipated. In the beginning, the newly created Yuksi (the first attempt at YUKOS-Sibneft alliance which lasted only for 6 months), SIDANCO/BP and Gazprom /Royal Dutch Shell/LUKOIL were prepared to fight to the

²⁷ Oil and Capital, # 7-8, 1997, p.28.

end. However, in late March Mikhail Khodorkovskiy announced that his company would not participate in the tender since the initial price was “ridiculously inflated”

Not surprisingly, the privatization attempt ended in a complete fiasco: in an ultimate humiliation, foreign investors shunned the auction. Some experts believed that it happened because at that time Rosneft was in danger of completely falling apart. Also, the company that was the traditional “raw material” for new VICs suffered additional losses. The President deprived it of the functions of the authorized company in PSA deals, of trust management of state shares in a number of enterprises, as well as the customer for R&D efforts²⁸.

After the May debacle, the tender was postponed till October. The new price for Rosneft was reduced to \$ 1.6 billion (and the investment conditions from \$ 400 million to \$ 65.5 million) in late May after the drop of the Russian stock market²⁹. Bespalov and Putilov were both fired since they were more interested in in-fighting than in ensuring the real privatization of the company.

The Turn-Around Artist. This time, the government decided to call in reinforcements and hire an outside organization to prepare Rosneft for the auction: it was the Alliance Group created by the former president of SIDANCO Ziya Bazhayev. On August 3, the Vice-Premier Boris Nemtsov presented Bazhayev as the General Manager of Rosneft.

When Bazhayev came to Rosneft the company was in a weakened state, burdened by huge debts and almost unmanageable. Assets of 40 enterprises were arrested, including Purneftegas; Krasnodarnefteorgsyntez was declared bankrupt³⁰. Within two weeks, Bazhayev’s team developed a program for enhancing efficiency and improving investment attractiveness of Rosneft aimed at carrying out the tender as scheduled on October 30. The Alliance Group

²⁸ Oil and Capital, # 4, 1998, p. 6.

²⁹ Oil and Capital, # 8, 1998, p. 12.

³⁰ Oil and Capital, # 9, 1998, p. 14.

reached an agreement with a number of major creditors about restructuring debts of Rosneft subsidiaries. A contract with Price Waterhouse about the audit was signed. Ziya Bazhayev managed to return the controlling interest of Purneftegas to Rosneft and increase it to 55% by buying 4% of shares at the secondary market³¹.

But even Bazhayev, with his undeniable crisis management talents, was powerless against corruption and inefficiency of the government officials. To continue transformation of Rosneft the Alliance Group needed to have its authority officially confirmed and documented. The Government Ordinance of August 11 ordered the BoD to sign within 3 days a contract with the crisis managers, but directors ignored this ordinance and did nothing for 2 weeks. During these two weeks the situation in the country changed drastically – the August 17 financial crisis struck - and the government was dismissed. Precious time was lost and on August 27 Ziya Bazhayev said that the Alliance Group could not continue to manage the company³². On August 28, Rosneft's BoD appointed Sergei Chizhov, its chairman and the first deputy minister of fuel and energy, to be acting president of the company.

Now we can only guess whether the sabotage of the contract with the Alliance Group was a malicious intrigue by somebody who wished to postpone the tender, or the officials were simply too busy in the crisis situation to worry about such nuances. In any case, the officials were forced to bow to the inevitable and to postpone indefinitely the sale of Rosneft.

Autumn of Our Discontent. To make things worse, in Autumn 1998 Rosneft lost Purneftegas again. The controlling interest in the subsidiary ridiculously valued at \$ 10 mln was

³¹ In 1997, a number of subsidiaries that reported net profit, including Purneftegas, made decisions not to pay dividends on preferred stock which, according to the RF legislation, turned into voting stock; as a result, the share of voting stock owned by the parent company was reduced.

³² Oil and Capital, # 9, 1998, p. 15. Ziya Bazhayev was killed in an airplane crash in 2000.

handed over to four creditors practically unknown in the oil community to cover Rosneft's debts (one of the creditors was MAPO-Bank allegedly connected with LUKOIL)³³.

In actuality, Purneftegas itself was interested in gaining independence from its "parent" since it had to support the greedy central administration of the company and act as a donor to other money-losing subsidiaries. The budget of the town Gubkinskiy where Pur is headquartered also suffered from the financial policy pursued by Rosneft that gobbled up cash generated by the subsidiary. On October 1, the tax inspection of the Yamal-Nenetsk Autonomous District started bankruptcy proceedings against Pur most likely to put pressure on its new owners³⁴.

However, after the default of August 1998, Evgeniy Primakov, an ardent supporter of the strong state and of the national oil company, became Prime Minister. He was instrumental in returning Purneftegas's controlling interest to Rosneft by a court decision in November 1998³⁵, using the resources of the General Prosecutor Office as a convincing argument.

To some extent, all failures of Rosneft in the 1990s might have been caused by the human factor. Its leaders (L. Tchurilov, A. Putilov and Yu. Bepalov) were no match for the new generation of oligarchs that acquired control over a large segment of the industry and bit big chunks off the state company, benefiting from the increasing weakness and corruption of the state authorities.

If a strong leader, such as Vagit Alekperov of LUKOIL, took the helm of Rosneft from the very beginning, the fate of the state company and the whole oil industry of Russia might have been completely different.

Very symbolically, while other oil companies were striving to become masters of their own destiny, Rosneft definitely preferred to remain under the patronage of the state. Was it a bad

³³ See NefteCompas, October 1, 1998, p. 1-2.

³⁴ Oil and Capital, # 10, 1998, p. 29.

³⁵ Oil and Capital, # 3, 2002, p. 23, Oil and Capital, # 10, 2004, p. 60.

case of the shortsightedness, or, on the contrary, the ability to see far into the future and guess that someday the state ownership of the company would be its key success factor in Russia? Still, if we analyze Rosneft's ordeal in the 90's and the negligible role it played in the economy as well as the domestic and foreign policy of Russia, it becomes clear that the fate of the company reflected the broader political and macroeconomic developments and the evolution of the role of the state in the country. During the previous decade, Rosneft (and largely the Ministry of Fuel and Energy) were victims of centrifugal and privatization processes in the Russian energy sector. The Ministry had been consistently losing its competencies, while Rosneft was a tempting target for domestic financial-industrial groups that had gained a rich experience in acquiring attractive oil assets.

THE WINNER TAKES IT ALL

Rewriting the Past

The Savior

The decade of failures and losses for Rosneft found its culmination in the 1998 financial crisis when control over core assets was lost, and the structure of the holding was threatened. However, after this nadir, a new era began for the state company.

In October 1998, the new Rosneft management team headed by Sergei Bogdanchikov, formerly the general director of Sakhalinmorneftegas, was appointed. He began to put together the company, which was completely falling apart.

When Sergei Bogdanchikov was appointed president of Rosneft few experts could bet on him staying in this position for a long time. He was neither a high profile figure, nor an envoy of oligarchs. He made a good career in the sphere of production having headed SMNG for five years and in the Communist Party having worked for three years in the mid-1980s in the

Sakhalin Region Party Committee. Bogdanchikov was promoted during the premiership of Evgeniy Primakov, largely to spite the representatives of Eltsin's "family" who were particularly interested in Rosneft.

The key danger for Bogdanchikov when he became president was Rosneft's acquisition by powerful oligarchic groups. To protect the company, Bogdanchikov busied himself with finding influential allies in the Establishment. Initially, Evgeniy Primakov became such an ally.

However, Rosneft passed its most important milestone in 2000, when Vladimir Putin was elected President of Russia. In the early 2000s, right after Putin's elections, there were two groups of influence in Russia: "family" and "piterskiye" (people from St.Petersburg). Bogdanchikov could not join the first group since he replaced Besspalov (the "family" man) in Rosneft. The rapprochement between the head of Rosneft and "piterskiye" was, therefore, inevitable and became evident in the high position Russian Establishment under V.Putin despite the modest place that Rosneft occupied in the domestic oil industry³⁶.

Putin had been consistently pursuing the policy of strengthening the state role in economy in general, and in the energy sector in particular. Apparently, the RF President needed a powerful state oil company that could be used to counterbalance the influence of private corporations and oligarchs. Subsequently, Rosneft has been gradually evolving into such an entity and this process has been recently growing like a snowball. In this light, it is clear that Rosneft's quick turnaround under Bogdanchikov's leadership does testify to his undeniable managerial talents, but also to the fact that he turned out to be the right man in the right place at the right time. He fit in quite well in the presidential team that apparently valued loyalty more than efficiency.

³⁶ Oil and Capital, # 10, 2004, p. 161.

Alexei Makarkin from the Center of Political Technologies believes that Putin approved of Bogdanchikov since he does not belong to any oligarchic group and does not demonstrate serious political ambitions. Both presidents are of the same generation and their careers really took off at the dusk of Eltsin's rule rather than during the initial redistribution of the state property³⁷.

Initially, Rosneft's boss was perceived as the integral element of the so-called "BMP Group" – Bogdanchikov-Miller-Pugachev³⁸. The "BMP factor" strongly affected the projects of Rosneft. Thus, Rosneft created Sevmorneftagas with Gazprom and Rusugol together with Mezhprombank³⁹. Mezhprombank also credits Rosneft's activities in Chechnya (see the *Efficient Market Instrument of the State Regulation* section).

Currently, experts include Bogdanchikov in the nomenclature and political group of "siloviki" that is headed by Igor Sechin, who became Rosneft's BoD Chairman in 2004.⁴⁰

With such a patron and partners, Bogdanchikov quickly got the chance to take revenge for the previous years when Rosneft was being torn to pieces. Now, the company possessed a

³⁷ Oil and Capital, # 10, 2002.

³⁸ Sergei Pugachev is an influential banker and senator from Tuva. In the early 1990s he got acquainted with V.Putin and I.Sechin. In 1992, he established Mezhprombank (International Industrial Bank) and was its BoD Chairman till 2001. It is rumored that the wife and daughters of Boris Eltsin kept their accounts in Mezhprombank. In the mid-1990s, Mezhprombank became the authorized bank for Northern deliveries and crediting of the gold mining industry. Mezhprombank is also the number one bank in Bashkiriya. There is information that Mezhprombank was involved in money laundering through the Bank of New York. Though associated with the "family", Sergei Pugachev did not lose his positions when "piterskiye" became the number one power group in Russia. In 2000-2001 Pugachev was directly involved in the conflict around the independent NTV. In 2000, he lobbied the appointment of Vladimir Ustinov as the General Prosecutor of Russia. In 2001, Pugachev acted as the key "maker of the president" during the elections in Yakutiya. In December 2001, Sergei Pugachev became the Senator from Tuva and officially resigned from the chairmanship of Mezhprombank, but it is assumed that he is still exercises full control over the bank. In Spring 2002, the "Mezhprombank team" was actively involved in the fight of oligarchic groups over Slavneft. Sergei Pugachev is close to Alexei Miller and Mezhprombank services the accounts of Gazprom. There are rumors that Pugachev was behind the idea of the merger between Gazprom and Rosneft (www.scandaly.ru).

³⁹ Rosneft was the only Russian oil VIC that tried to diversify into the coal industry. It signed framework agreements with the administrations of Sakhalin and Khabarovsk regions on participation in the development of their coal industry. In 2002, SMNG acquired a 55% stake in the Sakhalin Boshnakovsk Coal Mine. Rosneft also planned to mine coal in East Siberia, Kuzbass and the center of Russia in cooperation with Mezhprombank. To this end Rusugol (Russian Coal), a 50:50 JV between Rosneft and Mezhprombank, was established in 2001. However, in 2003 Rosneft quit the JV stating that it preferred to focus on its core business.

⁴⁰ Deloviye Lyudi, March 2006, p. 37.

formidable administrative and political clout, and it began to use it actively in order to consolidate its assets and acquire stakes in the enterprises it was interested in.

Taming of the Shrews

Under Bogdanchikov's leadership, Rosneft began to recapture its lost positions on all fronts. The first task that Bogdanchikov faced was to consolidate the company. The degree to which Rosneft really controlled its subsidiaries that were located from Kaliningrad to Sakhalin, many of them very independent-minded, was questionable during the 1990s. Moreover, Rosneft did not attempt at that time to make share swaps, which was done by its peer companies in order to strengthen the authority of the parent company over subsidiaries.

Rair Simonyan, its former First VP, said in 1996: "Rosneft is currently like a collection of different companies which up to now have been developing independently, without proper coordination. We must simply create an organism that is viable, normal and integrated"⁴¹. However, Rosneft was unable to achieve this objective during the 1990s.

But Sergei Bogdanchikov managed to quickly tighten his grip on some subsidiaries. Rosneft installed loyal executives and boards of directors in Purneftegas and Sakhalinmorneftegas and established very strict control over managers' activities. For example, they now had to get Bogdanchikov's approval on such issues as personnel structures, business plans, contracts and loans. His permission also had to be given before a general manager could use funds from subsidiary's profits, communicate with state and regional authorities, open accounts or start legal actions. Rosneft introduced a policy whereby all crude exports by the subsidiaries were to be channeled through the holding company⁴².

⁴¹ Proceedings of the International Conference "Trade and Investment Opportunities in the Russian Oil Industry", London, March 1996, p. 129.

⁴² NefteCompas, May 29, 1999, p. 6.

In March 2000, Rosneft got permission from the RF Anti-Monopoly Ministry to increase its stake in subsidiaries to 75% and began to buy their shares through affiliated companies. This process was accompanied by many scandals in the best Russian traditions. Experts commented that “Rosneft organized the process in such a way that shareholders had no right to demand buyout of shares by the issuer at market prices. Moreover, Rosneft deprived outside shareholders of the opportunity not only to influence the events, but even to assess the adequacy of asset valuation. The state company selected assets itself, priced them itself using unclear methodology and took them away”⁴³.

Krasnodarneftegas the Maverick. The most serious battles were fought over Krasnodarneftegas, a 1.5 million tons oil producer located in the South of Russia. Bogdanchikov’s efforts to restore control over it provide an interesting illustration of corporate governance in Russia.

In reality, Krasnodarneftegas was under the control of Alexander Putilov, the former Rosneft President, since 1997. The situation developed as follows. In 1997, the BoD of Krasnodarneftegas (KNG) proposed to the Annual General Meeting of shareholders not to pay dividends on preferred shares for 1996. Rosneft as a key shareholder agreed with this proposal. As a result, preferred shares of Krasnodarneftegas turned into voting shares, diluting Rosneft’s stake (it had 38% of voting shares of Krasnodarneftegas), and the holding actually lost control over its subsidiary. It could not enforce vital business decisions in KNG, such as the appointment of the loyal top management that would permit control of crude and cash flows. Without having even the simple majority at the meeting, Rosneft was able to put only four representatives in the nine-member BoD of Krasnodarneftegas. Other shareholders of KNG acted in a very coordinated fashion blocking all initiatives of Rosneft aimed at establishing control.

⁴³ Oil and Capital, # 3, 2002, p. 23.

Only in 2000 Rosneft could acquire another 13% of Krasnodarneftegas and ensured its majority in the BoD. In Putin's Russia, Bogdanchikov was dealt an important trump card in his efforts to make his "prodigal daughter" come to heel. Rosneft decided to use its new administrative clout and in July 2000 the session of the RF government was held where the issue of the controlling interest in KNG was discussed with the involvement of representatives of the General Prosecutor Office, the Ministry of Internal Affairs and the Federal Security Service. So, in the new political situation siloviki turned into a powerful instrument for resolving economic disputes that was available to certain "privileged" companies.

Another conflict with minority shareholders began after the decision was made by Rosneft to buy all produced oil at transfer prices, about one half of the previous export prices of Krasnodarneftegas. Revenues of the subsidiary dropped and shareholders could not expect generous dividends; also, taxes payable to the local budget decreased. Inevitably, a new round of lawsuits and letters to the federal authorities were arranged by the Association for Protection of Minority Shareholders of Rosneft that was organized by offshores affiliated with Sibneft.

Rosneft dismissed all lawsuits and letters to authorities as "greenmail" and an element of campaign organized by Sibneft with an aim of either forcing Rosneft to buy out shares of subsidiaries at inflated prices or arranging dismissal of the current top management of Rosneft and appointing their own people instead. In the first half of 2002, Rosneft lived through many troubles, even an armed invasion of Krasnodarneftegas's office by court bailiffs and a group of minority shareholders. However, by summer 2002 some compromise with minority shareholders was reached.

Pre-consolidation Battles. The saga of Krasnodarneftegas continued in 2005, when Rosneft was preparing for consolidation. Over the year, the state company practically doubled its

interest in KNG, from 50.7% to 95.46%. The press-service of Rosneft kept silent concerning the transaction and did not name the seller and the amount paid.

In general, investment analysts approve of Rosneft's policy that tried to buy shares of subsidiaries before consolidation, but, on the other hand, deplored its methods. Sergei Suverov from Gazprombank was worried that "it is unclear why shares of this very subsidiary were bought, who got money for this stake, and why they were bought out before the market value of the company was made public". Prosperity Capital commented that Rosneft did not inform investors about material facts, which constitutes a violation of the Federal Stock Market Service norms⁴⁴.

However, Rosneft was never famous for its transparency. In 2005, Standard & Poor's named it an outsider in terms of information disclosure among 11 Russian state companies. One of Rosneft's board members complained that the company places the stamp "Confidential Information" on nearly all its documents, even those that do not constitute commercial secret in other state companies.⁴⁵

Before IPO, Rosneft continued consolidation of its subsidiaries in order to sell its shares at higher prices, and the valuation methods it used upset both investment analysts and shareholders in these companies. Thus, Krasnodarneftegas was valued at \$ 706 million and Stavropolneftegas that was comparable to it in size and other parameters – at \$ 58.8 million. Experts were also surprised that Sakhalinmorneftegas' shares were significantly overvalued as compared to Purneftegas' shares and could find only one explanation to this distortion: Bogdanchikov (or companies associated with him) could be shareholder of the company,

⁴⁴ Vedomosti, 08.10.05.

⁴⁵ Vedomosti, 09.06.06.

though he vehemently denied it.⁴⁶ Finally, in October 2006, Rosneft completed consolidation of its subsidiaries.

The situation with corporate governance in Rosneft raises the traditional question of strategic management. Do managers work in the interests of shareholders (in this case of the state)? It is inevitable that state energy companies have their own narrower corporate interests that do not always coincide with state objectives.

Minority shareholders of Rosneft's subsidiaries, such as Purneftegaz, Sakhalinmorneftegas and Krasnodarneftegas, regularly accused the holding of infringing on their rights by systematically withdrawing assets, using transfer prices and attempting to dilute their stakes. It is the usual story in Russia - interests of minority shareholders were always violated when oil VICs were consolidated. However, while in the past "capitalist sharks" were the abusers, now it was the state company that behaved like a robber baron.

Rosneft was acting within the law, but the laws in Russia were such that they could not ensure protection of minority shareholders. And Rosneft (read the state) was taking advantage of this weakness of legislation. So, in reality, the national company was not acting in the national interests of Russia. This fact does not contribute to the improvement of the investment climate in Russia since Russian authorities could be interested in perpetuating provisions in legislation that do not protect ownership rights of investors.⁴⁷

Rebuilding the Empire

After helplessly watching its sphere of influence shrink in the 1990s, Rosneft began recapturing its niche in the Russian energy sector in the new millennium, strengthening its positions both in upstream and downstream.

⁴⁶ Vedomosti, 07.11.05.

⁴⁷ Oil and Capital, # 5, 2002.

In 2002, the BoD of Rosneft approved the new strategy of development: the corporation will be transformed into a “transnational energy company” dealing not only with hydrocarbons, but also with coal mining and power generation. It set the ambitious target of producing up to 40-45 mln tons per year by 2015 and about 45-50 bcm of gas to account for 15-20% of the total Russian oil production.

Continental Shelf. To implement this strategy, Rosneft began to turn into a formidable force on the Arctic shelf. In 2001, to develop 5 northern fields⁴⁸ Gazprom through its subsidiary Rosshelf⁴⁹ and Rosneft through Purneftegas established a 50:50 JV Sevmorneftegas. Initially, Gazprom did not want to let domestic companies join the development of Prirazlomnoye and Shtokmanovskoye fields, but did not achieve any progress on its own. Finally, it had to invite Rosneft since the latter had accumulated substantial experience in shelf projects through its subsidiary Sakhalinmorneftegas and enjoyed strong support of the state.

After long battles with the previous owners Gazprom and Rosneft re-registered licenses of Rosshelf (mainly for Prirazlomnoye and Shtokmanovsk fields) in favor of Sevmorneftegas in 2003. Rosneft’s involvement gave the stalling project a new start in life. In 2002, Rosneft bought abroad an old platform whose upper part was to be used for the construction of the platform for Prirazlomnoye. This solution allowed the company to save approximately \$ 300 million (however, some foreign oilmen believe that it might have been false economy since the field is very difficult to develop). Rosneft also created a transportation scheme for oil from

⁴⁸ Prirazlomnoye, Shtokmanovskoye, Kharampurskoye, Vyngayakhinskoye and Etypurovskoye.

⁴⁹ Initially, the closed JSC Rosshelf (its shareholders were major defense enterprises located in the North of Russia, R&D institutes and Severstal, a big metallurgical company) created in 1992 was to develop Prirazlomnoye field located in the Pechora Sea. Rosshelf was supposed to operate the shelf fields by using the potential of the domestic defense sector. In 1994, Gazprom joined the project by acquiring a 51% stake in Rosshelf; AGD had 13.6%, and Sevmashpredpriyatiye and Severstal - 12.5% each. It started to search for foreign partners but without any visible success, and invested some minimal funds into the project to keep it afloat.

Prirazlomnoye through a tanker Belokamenka that the company freighted and anchored in the region of Murmansk.⁵⁰

By 2002, the amounts that Gazprom and Rosneft invested in Sevmorneftegas became equal. After having swapped assets with LUKOIL, Rosneft consolidated a blocking interest in Rosshelf, and *de jure* became leader of Sevmorneftegas's projects. In 2003 some experts predicted that Rosneft's leadership in Prirazlomnoy might well evolve into its leadership on the whole northern shelf.⁵¹ However, in 2005 Rosneft sold its share in the JV to Gazprom to get funds to pay for Yuganskneftegas. Therefore, when assessing the long-term implications of Yugansk acquisition for Rosneft it is necessary to analyze what it really got and what it lost.

Rosneft began to establish its control over other offshore petroleum projects. In 2003, it got the 5-year license for geological studies of the Veninsk block within Sakhalin-3 project, and in 2005, Rosneft signed an agreement with Chinese Sinopec to conduct geological exploration and prospecting of the licensing area⁵². In 2002-2003, Rosneft got licenses for geological studies in Sakhalin-4 and Sakhalin-5 - and invited BP as junior partner.⁵³ Therefore, Rosneft gained control of all Sakhalin projects of the "second wave".

In addition to the virtually untapped Far East and the Extreme North of Russia, Rosneft has been active since 2002 in the Azov Sea and the Black Sea, the very mature petroleum province of Russia, where its positions are quite strong. In the autumn of 2002, the company Priazovneft was established (15% of shares held by the Krasnodar region administration, the rest were divided between Rosneft and LUKOIL) to assess and develop reserves of the Azov

⁵⁰ Oil and Capital, # 10, 2004, p. 31.

⁵¹ Oil and Capital, # 12, 2003.

⁵² Currently, shareholders of the Veninsk block are as follows: Rosneft (49.8%), Sakhalin Oil Company (25.1%) and Sinopec (25.1%).

⁵³ Rosneft and BP have 51%:49% stakes in both projects. Within Sakhalin-4, they develop Zapadno-Shmidtovskiy plot, and within Sakhalin-5 – Kaigansko-Vasyukanskiy and Vostochno-Shmidtovskiy plots.

Sea. Besides, in Spring 2003, Rosneft and TotalFinaElf signed an agreement on the joint studies of the Black Sea shelf.

East Siberia. In addition to the shelf projects, Rosneft is conquering the East-Siberian petroleum province, which it considers to be its zone of strategic interest.

Rosneft got the Vankor group of fields (see the *Kremlin's Trouble Shooter* section) and bought 25.9% of Verkhnechonskneftegas from Interros⁵⁴ in 2005, becoming partners with TNK-BP, which has 62.7% of Verkhnechonskneftegas. So, TNK-BP is trying to ally itself with the now-mighty Rosneft in many spheres hoping that such partnership would facilitate project implementation. There are certain contradictions between TNK-BP and Rosneft concerning their activities in the Irkutsk region. However, it appears that both companies decided to temporarily cease their rivalry. Currently it is more important for them to speed up the development of the Verkhnechonsk field to ensure oil deliveries to East Siberia – Pacific Ocean Pipeline (ESPO) which after its re-routing will pass much closer to the field.

Rosneft continues to build up its resource base in East Siberia, aggressively acquiring assets (largely heedless of their price) in the auctions that have recently been held.⁵⁵ It is particularly interested in the fields that are located in the Irkutsk region which have the potential to serve as a resource base for ESPO.

An important initiative aimed at strengthening the positions of Rosneft in the largely untapped East Siberia was taken by Alexei Miller, head of Gazprom, and Sergei Bogdanchikov,

⁵⁴ In 2002, Verkhnechonskneftegas was spun off from RUSIA Petroleum, the license holder for Kovykta field. The company owns license for the Verkhnechonsk field located in the Irkutsk region with reserves of 159 mln tons of oil and 129 bcm of gas. (Vedomosti, 07.11.05).

⁵⁵ Thus, in 2005, Rosneft won the auction for Vostochno-Sugdinsk plot located in Irkutsk region with forecast oil reserves in C3 category of 60 million tons, D2 resources of 150 million tons, and gas reserves in C3 categories of 42 bcm. In Summer 2006, it bought the Danilovsk plot in Irkutsk region with D1 resources of 38.7 mt of oil and 51 bcm of gas, as well as the Sanarsk plot with D1 resources of 70.5 mt of oil and 73.8 bcm of gas, and Mogdinsk plot that is adjacent to the Vostochno-Sugdinsk plot that Rosneft already owns. The Mogdinsk plot has C3 reserves of 30 mt of oil and 16 bcm of gas, as well as D1 resources of 54.2 mt of oil and 40.1 bcm of gas. In February 2006, it bought Vadinsk and Tukolands plots in Evenkiya thousand, and in Autumn 2006, Kulindinsk plot with D1 resources of 200 mt of oil equivalent.

who sent a letter to President Putin in February 2003 with a proposal to unite several East Siberian and Yakutiya fields into a joint complex with a single production and social infrastructure. The two CEOs also wanted to develop oil and gas resources simultaneously, giving priority to the gas industry to provide for the needs of the region and ensure deliveries to APR countries.

Later, Surgutneftegas joined them and added its substantial financial power to the tripartite consortium. The union of these three companies turned into a formidable force in this part of the country where they planned to bid for attractive oil and gas fields. Interestingly, some experts consider Sergei Bogdanchikov to be the main driving force of this alliance.⁵⁶ Apparently, the state intended to use this consortium to establish its dominance in this promising petroleum frontier and to counterbalance the influence of private companies in the region. Before its destruction, YUKOS reigned supreme in East Siberia.

However, the much-publicized consortium did not really work, and ceased to exist quite soon, probably because of the irreconcilable contradictions between its members. Also, after the significant strengthening of Rosneft's positions following its acquisition of Yugansk, the balance of power within the consortium was disrupted. In any event, the former allies turned into rivals who aggressively compete for East Siberian resources.

Yamal-Nenetsk Autonomous District. However, despite the success Rosneft enjoyed in its turnaround, it failed to realize the full potential of its “jewel in the crown” – Purneftegas for which it fought so hard during the 1990s. Purneftegas was unable to intensify oil production on its relatively young but complex fields and this debacle was particularly visible against rapid output growth of YUKOS, Sibneft and TNK. Hence, Pur decided to follow the way of extensive growth and began acquiring small companies located in close proximity to its production

⁵⁶ Finansovye Izvestia, 30.12.03.

infrastructure. First, it purchased Selkupneftegas,⁵⁷ the owner of licenses for six fields of Kynsko-Chasselsk group with 13.5 mt of proven oil reserves and 50.1 bcm of proven gas reserves, and then Pur Oil Company⁵⁸ that had the licenses for Udmurt-Chatylinsk group of fields.

Rosneft's inability to ensure organic growth in the Yamal-Nenetsk region is rather bewildering since Purneftegas is the youngest and the most promising producer in West Siberia. However, its crude production shrank from 9.9 mln tons in 2002 to 9.4 mln tons in 2005. Rosneft claimed that this decline occurred because the new wells in the region had a lower daily output than the best performing wells of Severnaya Neft (see below) and Yuganskneftegas. However, the average daily output of Pur's wells amounted to 84.9 barrels in 2005, i.e. was some 13% higher than the industry-wide indicator.⁵⁹

The problems of Purneftegas are particularly visible with respect to such fields as Komsomolsk and Kharampur. The Komsomolsk field that has very complex mining and geological conditions and multiple productive layers, containing viscous sour oil, was discovered in 1966 and its commercial development began only in 1988. But it was definitely not a success story.

By 2000, almost all 195 wells of the field were in an accident-fraught state and further drilling was stopped. According to Rosneft, Komsomolsk was in such a bad situation because the effective system of taxation made the application of special technologies unprofitable there. At the insistence of Rosneft, a PSA was approved for three fields of Purneftegas (Komsomolsk,

⁵⁷ Selkupneftegas was founded in 2000 by SENECO, Pur Investment Company and Purneftegasgeologiya. In 2002, Purneftegas bought 66% of Selkupneftegas's shares and in 2003 sold them to Rosneft. NOVATEK, parent company of Purneftegasgeologiya has 34% of shares. (Oil and Capital, # 9, 2004).

⁵⁸ The company was established in 1998 with direct involvement of Purneftegasgeologiya. NOVATEK, the parent company of Purneftegasgeologiya decided to sell the Pur Oil Company because its fields were located too far away from the core fields of NOVATEK and its geological exploration licenses were to expire in 2003.

⁵⁹ www.rosneft.ru.

Severo-Komsomolsk and Kharampur) in Autumn 2000 and serious hopes for revitalization of the field were connected with it.

However, the PSA for the field was abolished in 2003, and currently the field is being developed under a standard taxation scheme. So, the same year Rosneft changed its strategy vis-à-vis Komsomolsk, drilling just 36 wells versus 90 in 2002 and giving up its cooperation with Halliburton. The company downgraded its reserves and said that the project was no longer its top priority.⁶⁰ While waiting for the much needed investments and technologies, Purneftegas can barely maintain production at the Komsomolsk field.

The Kharampur field that holds 106 mln tons of recoverable oil reserves is considered unique in terms of its natural gas reserves (836 bcm) and its maximum yield could be up to 10-12 bcm/yr. Annually, some 600-800 mln cubic meters of associated gas are flared at Kharampur. If associated gas of Kharampur is utilized, oil production could increase to the maximum of 2.1 mln tons per year but it is unfeasible to build a gas pipeline to pump just associated gas to the nearest gas processing plant. It is necessary to begin production of natural gas together with associated gas – in this case Kharampur would operate at full capacity. The Catch-22 is Gazprom, the undisputed master of the Yamal-Nenetsk Region and owner of gas pipelines. Pur could not reach an agreement with the gas monopoly concerning access to the Urengoi-Chelyabinsk trunk gas pipeline.

Purneftegas reduced drilling on other fields of the Yamal-Nenetsk region as well. It appears that now Rosneft was using Purneftegas as a source of funds essential for entering new petroleum provinces. As a state company, it did not have to fear that its licenses for Purneftegas's fields would be revoked, and it might renew their active development when the

⁶⁰ Oil and Capital, # 3, 2004.

situation improves, e.g. when it reaches some working agreement with Gazprom on gas utilization.

However, an intriguing question remains. Would a private company be able to more efficiently utilize the potential of Purneftegas?

Timan-Pechora. An important milestone in Rosneft's comeback was passed in 2003 when the company acquired Severnaya Neft from Senator Andrei Vavilov.⁶¹ Following its acquisition, Rosneft started to create its own export scheme for Timan-Pechora oil through an export terminal in the Archangelsk sea port because it did not want to rely on Transneft's facilities for export.

Bogdanchikov admitted at that time that Severnaya Neft with 62.0 mt of proven reserves, 29.9 mt of probable reserves and 38.1 mt of possible oil reserves was Rosneft's most interesting project.⁶² It is demonstrating double-digit production growth rates and in 2005, it produced some 4.8 mt of oil, while its average daily output of wells was 603 barrels, i.e. was 8 times higher than the average Russian indicator.⁶³

Downstream. Rosneft was also making resolute efforts to recapture and expand its lost downstream positions. One of Rosneft's major investment projects in the downstream was the upgrading of its Komsomolsk refinery⁶⁴ that was in very poor shape throughout the 1990's. After

⁶¹ Severnaya Neft was established in Usinsk in 1994 and held 15 licenses for fields in Timan-Pechora. It was dynamically increasing its oil production even during the troubled 1990s: from 206 thousand tons in 1995 to 2.2 mln tons in 2003. Severnaya Neft became scandalously famous in 2001 when it won the license for the Val Gamburtseva fields in Timan-Pechora in an investment contest outplaying such grandees of the Russian oil business as LUKOIL and Surgutneftegas. The losers (mainly LUKOIL) accused the company of colluding with the governor of Nenetsk Autonomous District, requested the government to check the validity of the contest results and initiated numerous court investigations. These attempts to restore justice stopped after Rosneft acquired Severnaya Neft and the state company swapped assets with LUKOIL.

⁶² Oil and Gas Eurasia, March 2004, p. 60.

⁶³ www.rosneft.ru.

⁶⁴ Komsomolsk refinery was built in 1942 and was geared to refining of the Sakhalin and West Siberian oil. Rosneft received the refinery during privatization of 1995 and up to the August 1998 crisis could not take full advantage of the enterprise. First, excluding Sakhalin, all consumers in its traditional markets (Khabarovsk, Primorsk, Amursk regions, Magadan and Kamchatka) were insolvent, and the refinery was limited by contracts with the authorities of the Far Eastern regions and volumes it had to supply within the framework of the so-called "Northern deliveries". Second, SIDANCO had clear competitive advantages in this region because it controlled all petroleum product suppliers and had two own refineries, Angarsk and Khabarovsk. Komsomolsk

changes in Rosneft's leadership the situation in the refinery radically improved. The new management began to pay special attention to its far-eastern assets in connection with the development of its Sakhalin ventures. The company changed the transportation scheme of oil deliveries to it by obtaining for SMNG the right to provide the "budget" deliveries of fuel to the island of Sakhalin. By doing so, it undermined the positions of Sakhalinnefteproduct that belonged to SIDANCO.

Rosneft increased the loading of the Komsomolsk refinery by using oil produced by Purneftegas and by cutting prices the company was able to capture the market of Sakhalin. Then it started the upgrading of refinery that produced 36% of fuel oil, 40% of diesel, 6% of kerosene and 18% of gasoline.⁶⁵ Rosneft aimed to establish new facilities that could improve quality and enhance the yield of light products, particularly of aviation kerosene and diesel fuel since these petroleum products were in great demand in the Far East and in the Pacific Rim countries. As a result of the upgrade, production volume will amount to 7 million tons of petroleum products per year; the total investments in the upgrading will come roughly to \$ 700 million.

Rosneft also plans to build a 20-mt/yr refinery at the final point of the ESPO since strengthening its downstream positions became a top priority for the company after its acquisition of Yugansk.

Rosneft further consolidated its stronghold in the Far East by ensuring export outlets for its crude. The company now has 3 ports in the Far East: De Castri with a capacity of 1.5 mln tons/year through which it exports Sakhalin oil; Nakhodka, where its subsidiary,

refinery was connected by pipelines only with SMNG that produced some 1.5 mln tons of crude per year, and the remaining oil was transported to the enterprise by railway. Up to mid-1998, the price situation was such that it was more profitable for Rosneft to export crude than to compete for Russian markets of petroleum products. So, for a long time the refinery operated with the minimal possible loading.

⁶⁵ See Oil and Capital, # 3, 2000.

Nakhodkanefteproduct, transships petroleum products with throughput capacity of 6 mln tons/year, and the Eastern Oil Loading Terminal.

Right now, Rosneft also intends to capture the market of Moscow. First, it plans to create a company jointly with the Moscow government to supply the capital with gas.⁶⁶ While back in 1995 Moscow's Mayor Yuri Luzhkov was against Rosneft's domination in the fuel market of the capital fearing that it would become a monopoly and dictate price terms, apparently he did not consider this idea so unpalatable a decade later.

Until recently, Rosneft did not have a single fuel station in Moscow and the Moscow region. In 2005, it opened its first retail outlet that used to bear YUKOS brand name.⁶⁷ In the nearest future another five fuel stations with Rosneft's logo will open in Moscow under franchising conditions. Rosneft needs retail sites in Moscow both for image purposes and for the development of its business: following its acquisition of Yuganskneftegas, the company faces a shortage of refining capacity and sales network.

A Very Special Company

On His Majesty's Social Service

Rosneft is the "national company", i.e. the company that performs some of the state's functions and gets additional privileges in return. Though in the past its official burden and benefits did not seem very significant, Rosneft is increasingly playing a certain unofficial role.

The former website of Rosneft (www.rosneft.ru) positioned the company as a vehicle for pursuing the strategic interests of Russia in the oil and gas sector, and in the whole fuel and energy complex (or as the efficient market instrument for state regulation of the fuel and energy complex), i.e. as the national oil company *de facto*. It is particularly noteworthy that the new

⁶⁶ Vedomosti, 02.05.05.

⁶⁷ Vedomosti, 08.09.05.

jazzed up website which was created for the IPO of Rosneft does not contain any information about any special functions the company performs. The new image of Rosneft as a future global supermajor probably does not permit it to admit that it undertakes additional activities on behalf of the state, and, therefore, Rosneft prefers to advertise its purely commercial and business successes. But, nevertheless, Rosneft still enjoys special privileges and performs certain duties.

Sergei Bogdanchikov was always regarded as one of the key supporters of the national oil company in Russia. In an interview given in 1999 he explained his vision: "... if the state does not aim to "strangle" other companies and displace them from the market the national company would not do it. It is unclear if private companies are ready to solve difficult problems with vague prospects in terms of profit. A typical example here is the supply of the northern regions with crude. On the one hand, such supply is an apparent state duty. On the other hand, everybody knows that there is a shortage of money in this sphere. If the government needs a rescue team that can be relied on even under conditions of financial shortage that it will cope with supplies and won't permit people to freeze in winter than it is logical to commission the state company to do it. It is difficult to order private companies to do something to their own detriment, but it is possible to order such a company".⁶⁸

However, Bogdanchikov's actual deeds sometimes contradicted his publicly expressed sentiments, as the situation with fuel supply to Kamchatka definitely showed.

Kamchatka. In early 2001, Rosneft, the sole supplier of fuel to Kamchatka, notified the governor that it would stop deliveries of mazut to the peninsula starting April 1 because of Kamchatskenergo's non-payments. This local power generating subsidiary of RAO UES Russia,

⁶⁸ Oil and Capital, # 1, 1999, p. 45.

was not paid by its customers.⁶⁹ In April, the governor announced that the region was on the verge of a complete energy disaster. To “persuade” the debtors, Kamchatskenergo started to disconnect consumers, even such “untouchables” as schools and hospitals. In April, there was enough fuel oil for only several days in the storage houses of two power stations of Petropavlovsk-Kamchatskiy. Meanwhile, the tanker with 15 thousand tons of Rosneft’s fuel oil on board was anchored in the port; Rosneft did not permit to unload it until Kamchatskenergo started repaying its debt. Vice-Premier Victor Khristenko had to interfere and developed a schedule for Kamchatskenergo’s debt repayment.

Furthermore, in 2001 Rosneft was charged with gasification of Kamchatka by a special ordinance of the government and as a result, it had to build a pipeline to Petropavlovsk-Kamchatskiy. This gas pipeline could have eliminated the need to deliver huge quantities of fuel oil to the peninsula, and thus resolve energy problems of the region.⁷⁰ Rosneft was supposed to receive 51% of shares in the pipeline and finance its construction, and also get the controlling interest in Kamchatgazprom, a company established by the local administration to develop the gas fields and supply gas to local consumers.

There is information that Sergei Bogdanchikov got involved in the project only under pressure of the authorized representative of the RF President in the Far-Eastern Federal District, Konstantin Pulikovskiy. Later, in spring 2003, analysts of Rosneft submitted a paper to the RF Government where they questioned the profitability of the project of gas supplies to Petropavlovsk-Kamchatskiy. Rosneft believed that its participation in gasification would undermine its financial stability and attractiveness for investors.⁷¹ The company regarded this \$

⁶⁹ Energy in Kamchatka is the most expensive in Russia because fuel is delivered to the peninsula. The economic situation in this isolated region is such that neither enterprises, nor population can pay their bills fully. Numerous defense entities located there were insolvent because funds were not transferred in the necessary amount from Moscow.

⁷⁰ Oil and Capital, # 7-8, 2001.

⁷¹ Oil and Capital, # 11, 2003.

600 million project as a social, rather than commercial, endeavor and negotiated with the Ministry of Economic Development reimbursement of its expenses, either through direct compensation, or through letting Rosneft into another, more profitable venture.

So, the right for the exploration of the Western Kamchatka shelf⁷² might have been such a consolation prize. Forecast resources of the West-Kamchatka shelf are estimated at 900 mln tons of oil equivalent, making it comparable with Sakhalin-1 and Sakhalin-2 projects. YUKOS competed with Rosneft for the 5-year license for geological studies of the West Kamchatka shelf; however, in August 2003, Rosneft was declared the winner, partly because it was the state company, and partly because of its status as the sole fuel supplier to Kamchatka.

This status also helped Rosneft to win a victory over the local “green” organizations. In December 2004, the public of Kamchatka organized protests against the development of the shelf which they believed would result in an environmental disaster, since the areas of oil exploration are unique in terms of biological resources – one of the biggest crab populations in the world is located there. The local scientists believe that the shelf plays an important role in ensuring food safety of Russia. However, for the Russian government the oil industry is more important, and not only in terms of its export revenues: fishery is much less transparent and law-abiding than the fuel and energy complex. In this conflict of interests Putin publicly took the side Rosneft.⁷³

Given that the Kamchatka project was risky and expensive, Rosneft quickly found a foreign partner. In September 2004, it signed a memorandum of understanding with the Korean National Oil Corporation (KNOC) and transferred geological and geophysical data to

⁷² Systematic geological and geophysics works began in the Okhotsk Sea back in 1957. In the early 1990s state financing of exploration ceased and studies of the West-Kamchatka shelf were frozen.

⁷³ Oil of Russia, # 6, 2005, p. 59.

the Korean party. The Korean party will incur almost all expenses connected with the geological exploration of the shelf, as well as a significant proportion of these expenses at the stage of project implementation. In return, KNOC received 40%, and Rosneft acquired 60% in the managing company West Kamchatka Holding BV.

Gasification of the Far East. Another example of the state company's attitude to the local needs is its involvement in the Program of the Far East gasification that was approved by the RF government ordinance in July 1999. Gas was to be delivered to consumers through the existing pipeline from Okha to Komsomolsk-on-Amur and the new \$ 4 billion 1578 km long trunk pipeline Sakhalin-Khabarovsk-Vladivostok was to be built.

To implement the program, the administrations of the Far Eastern regions and Rosneft established a JV Daltransgaz in 2000. The Khabarovsk regional administration became the leader of the project since it was vitally interested in its success. With a transition to gas, the local power generation sector could have saved remarkably on fuel, thus alleviating social tension in the region and reducing the burden on the budget. However, Rosneft and Sakhalinmorneftegas quickly lost their enthusiasm concerning gasification of the Far East. As a result, the share of Rosneft in the project dropped from 64% to 25%.

In 2002, a 20% share in Daltransgas was transferred to the state and financing from the federal budget was provided. By January 2005, approximately 250 km of the pipeline were laid. However, in February 2005, Rosneft decided to quit the project and offer its share to Gazprom, allegedly in order to optimize its portfolio of assets, but more likely, because of the shortage of funds as the result of Yuganskneftegas's acquisition.

Later in 2005 Rosneft reversed its decision to sell to Gazprom its share in Daltransgas. This *volte-face* might be explained by Rosneft's plans to expand its gas business and increase

gas production in the future from its current 17 bcm to 70 bcm in 2015. In this case it would have faced the problem common to all independent producers – limited access to trunk pipelines. So, it might have seemed better for the company to complete the construction of its own pipeline, rather than be dependent on Gazprom.⁷⁴ Negotiations between Rosneft and Gazprom concerning Daltransgas and their relative role in the gasification of the Far East still continue, and their results will probably depend on the general relations of the two powerful companies, which now can only be described as aggressive rivalry (see the *Ugly Duckling Turned Falcon* section).

Consolidation in the South. In addition to the social function, Rosneft is turning into an instrument of the domestic policy, which the federal authorities unofficially use for strengthening the influence of the federal center, particularly in the “troubled regions”. In February 2004, Bogdanchikov said in an interview that Rosneft would consist of four major regional divisions (the Far East, Siberian, North-Western and Southern). Soon after that, in May 2004, Rosneft made an announcement about joining together its producing assets in Krasnodar (Krasnodarneftegas, Yugneftegas and Termneft) in order to cut administrative and operating costs. In the future Krasnodarneftegas could turn into a center of the major production complex, which would include enterprises of the neighboring regions.

The activity of Rosneft in the south of Russia with its old and depleted reserves is hardly connected with any serious economic benefits. However, the Southern region is strategically important for Russia and therefore, the state company might be putting its house in order there to meet the state objectives. Given the instability in the Caucasus region it appears that the consolidation of Rosneft’s southern assets is largely a political process.

⁷⁴ Vedomosti, 28.10.05.

“Efficient Market Instrument of the State Regulation”

Under Bogdanchikov, Rosneft not only reestablished control over its prodigal subsidiaries, but also returned the special functions that it had been deprived of.

Production-Sharing Agreements. First, together with Zarubezhneft, the company was reappointed as an authorized organization in preparing and implementing PSAs. A relevant agreement was signed in August 2001 with the RF Ministry of Economic Development and Trade. The authorized companies were supposed to provide scientific, technical and advisory support to the Ministry in preparing and implementing PSAs, to help to speed up the process of developing the agreements, and to strengthen the state’s position in contests and negotiations.⁷⁵ This role created a certain controversy between Rosneft and its peers because the former simultaneously acted as a commercial entity in these agreements and also got additional privileges that conveyed competitive advantages to it.

However, the new status did not immediately ensure the victory of Rosneft over its rivals. In the sphere of PSAs, Rosneft suffered a crushing defeat from YUKOS. Production-sharing agreements constituted an area where Rosneft, as the authorized company of the state, and Bogdanchikov, as its boss, could have drastically improved their status and authority. Vladimir Putin was always publicly proclaiming his commitment to the idea of PSAs, and Bogdanchikov was supposed to translate this idea into practical implementation. But in reality, the president did not provide the necessary support to Rosneft.

As a result, Bogdanchikov lost his struggle with Mikhail Khodorkovskiy who was a vehement opponent of PSAs and conducted a very effective PR campaign against it. The leader

⁷⁵ Oil and Gas Vertical, # 02, 2002, p. 84.

of YUKOS was saying that PSAs damaged the state budget, created preferences to certain companies, promoted corruption and limited the upside potential of Russian corporations.

Rosneft had purely economic interests in supporting PSAs, since the development of the Arctic shelf projects, particularly the Shtokman and Prirazlomnoye fields, was unfeasible under the effective taxation regime. In this respect, Mikhail Subbotin, a leading Russian expert on PSAs, speculates that YUKOS's victory "cut off oxygen supply" for the companies such as Rosneft that tried to launch major new investment projects.⁷⁶

His view is confirmed by the unambiguous statement of Sergei Bogdanchikov who said, "Let's have a look at who is interested in burying PSAs in Russia. These are two companies [YUKOS and Sibneft] that got the most productive fields in the period when the oil pie was divided. Hence, they have the lowest lifting costs; they secured competitive advantages for themselves at that stage, and want to maintain them for the next 15-20 years. It is clear that the expenditures for the development of a new region that entails construction of roads, pipelines and electricity transmission lines will always be uncompetitive versus operations in the already developed areas...".⁷⁷

However, strategic visions do change. Today Rosneft itself is claiming that the practice of transferring subsurface plots to non-residents under PSA terms damaged the interests of the country. Developing Khodorkovskiy's arguments, but with somewhat of a different twist, Rosneft together with Gazprom managed to convince V.Putin and M.Fradkov, the RF Prime Minister, that "now the state companies should be in charge of distributing entry tickets for the

⁷⁶ Mikhail Subbotin, Yabloko and PSA, Moscow, 2004.

⁷⁷ Vedomosti, 20.03.2003.

best fields”.⁷⁸ It is clear that both companies regard international majors only as their technical and financial partners.

Chechnya. The second task that the state entrusted it with is the restoration of the oil industry of Chechnya that was destroyed by the war. To this end, Rosneft established in the late 2000 a subsidiary - Grozneftegas. Grozneftegas produced oil from 14 fields in Chechnya. Rosneft, the license owner, holds a 51% stake in the company, while the government of Chechnya holds the remaining 49%. Over the early 2000's, Rosneft managed to restore more than 250 facilities destroyed by the war and significantly increased oil production: from 0.7 mt in 2001 to 2.2 mt of oil in 2005. Rosneft is to export Chechen oil, and profits from sales are to be transferred to the special account of the RF Ministry of Industry and Energy to be used for restoration of Chechnya.

The Chechen government tried to get the controlling interest in Grozneftegas saying that the activities of the company had no positive impact on the republican budget since the bulk of taxes from oil sales go to Moscow. Politically, Moscow was more interested in demonstrating that the territory was involved in a normal economic process rather than in getting revenues from Chechen oil, while the regional elite needed maximum revenues. So both parties are now looking for a compromise between the “image” and “financial” goals.

Supplier of Petroleum Products. Third, Rosneft supplies petroleum products for the state needs, mainly to the subsidiaries of RAO UES Russia. It also delivers fuel and lubricants to the agricultural sector of Russia, the RF Ministry of Defense and the Ministry of Transportation. Rosneft's representatives claim that the fulfillment of the state tasks do not bring it any commercial benefits, since only its work is remunerated and incurred expenses are reimbursed.

⁷⁸ Vedomosti, 25.05.06.

However, as the situation with Kamchatka demonstrated, the state will always find ways to award a faithful vassal for additional efforts.

Extraordinary and Petropotentiary

Powerful oil companies in Russia, as elsewhere in the world, often serve as an instrument of national foreign policy, establishing or consolidating Russia's influence in other countries or helping to achieve other geopolitical objectives. For example, LUKOIL acted as the "petroleum ambassador" of Russia in the Caspian Sea,⁷⁹ Eastern Europe and even the U.S.

Rosneft, which should have logically been such an instrument because it was the state-owned company, until recently was not strong or influential enough to perform this function. However, now the situation is changing and it is gradually evolving into a state agent in the foreign policy realm.

First, Rosneft is taking part in petroleum projects with political undertones in the former Soviet republics and other countries.

Kazakhstan. Since July 2001, Rosneft has been involved in the development of a promising Adaisk zone with recoverable oil reserves estimated at 75-100 mln tons of crude in Western Kazakhstan (another participant is the Chinese Sinopec also with a 50% stake).

Besides, Rosneft takes part in the development of Kurmangazy structure with total oil reserves of around 1.8 bln tons located in the northern part of the Caspian Sea together with KazMunaiGas. The subsidiary of Rosneft, RN-Kazakhstan, was authorized by the RF government in 2003 to participate in the Kurmangazy project and finance the Russian share of expenses. On July 6, 2005, a relevant PSA and Agreement on Joint Activities were signed in Astana in the presence of Russian and Kazakh Presidents. According to the president of

⁷⁹ See "Petroleum Ambassadors of Russia: State versus Corporate Policy in the Caspian" by I.Gorst and N.Poussenkova, Rice University Publications, 1996.

KazMunaiGas, Kurmangazy is the example of practical implementation of the Interstate Agreement on Delimitation of the Caspian Sea so it also has political undertones.⁸⁰

It is noteworthy to mention that Kurmangazy was one of the many spheres where Rosneft crossed swords with YUKOS. The Caspian Oil Company that was founded by YUKOS, LUKOIL and Gazprom also hoped to become the Russian envoy in the project. However, Rosneft was chosen for this role and YUKOS complained that Rosneft took unfair advantage of its special status.

Algiers. Overseas efforts of Rosneft are now mainly focused on Algiers, after the company wound down its activities in Columbia.⁸¹ Rosneft and Stroitransgas established a joint operating company on a 50:50 basis. In March 2001, the operating company signed a contract for exploration with Sonatrach that concerned the development and production of hydrocarbons in block 245-South. In 2002, the operator began geological and exploration activities. In 2004, the company discovered two fields of hydrocarbons in the Illizi basin and successfully implemented a turnkey project on drilling exploratory wells with Schlumberger. Analysts predict that if exploration efforts are successful, the companies could start development activities in 2007.

Rosneft, similar to any other oil company, is interested in expanding its resource base in Algiers. Bogdanchikov was saying that he was driven by purely economic considerations, since it is profitable to invest in oil production in North Africa. However, experts believe that Rosneft pursues broader interests of Russia in its overseas projects that go far beyond the framework of oil production. It is noteworthy to mention that the date of Rosneft's arrival in Algiers coincided with the intensification of the Russia-Algiers political dialogue (Spring

⁸⁰ Oil and Gas Vertical, # 15, 2005, p. 53.

⁸¹ In 2001, a consortium of Rosneft (45%), Petrotesting Columbia S.A. and Holsan Chemicals Ltd. won a tender for the development of the Surorient field. Rosneft America Inc. was established for implementation of the project.

2001). By the end of the 1990's, Russia lost its former influence in North Africa, but this region is still of vital geopolitical importance for the country. Algiers is particularly significant, since it has large hydrocarbon reserves, and is the second biggest (after Russia) non-European supplier of gas to Europe. Also, Algiers owes Russia since the U.S.S.R. times roughly \$ 4 billion and is an important buyer of Russian weapons.⁸² Therefore, participation of Russian companies in Algiers' petroleum projects will contribute to the development of political and economic cooperation between the countries.

Caspian Pipeline Consortium. Rosneft is also a long-standing member of the international Caspian Pipeline Consortium that deals with transporting crude oil from Russia and Western Kazakhstan and its subsequent export through a terminal on the North-Eastern coast of the Black Sea. Therefore, CPC is not only about oil transportation, but also about geopolitics. Crude is to be pumped through a 1,500-km pipeline with initial throughput of 28 mln tons per year that would be increased to 67 mln tons. Rosneft is involved in the project through a JV Rosneft/Shell Ventures Ltd (51%:49%) that has a 7.5% stake in the consortium.

Recently, the political weight of Rosneft seriously grew in the Far East of Russia. Probably, this trend reflects the new vector of Russia's foreign policy, i.e. greater focus on the Eastern direction. The state company now plays an important role in relations between Russia and China, Japan, and India through the projects it is undertaking in the Far East of the country.

China. Special relations exist between Rosneft and China. Rosneft cooperates with Chinese oil companies in many spheres, including in Kazakhstan (see above) and in the Sakhalin-3 project (see the *Rebuilding the Empire* section).

⁸² Oil and Capital, # 6, 2003.

During the latest visit of V.Putin to Beijing, an agreement was signed between Rosneft and CNPC on establishing a JV and on cooperation both in Russia and in China. Thus, by mid-2006, Vostok Energy JV was established between Rosneft (51%) and CNPC (49%) to deal with hydrocarbon production and exploration in Russia. Another JV will be established in China to deal with refining and marketing and a 10-mt refinery might be built, as well as a network of 300-400 fuel stations, within its framework.

But, most importantly, in the summer of 2006, Sinopec bought from TNK-BP a 96.86% stake of its subsidiary Udmurtneft (which produced 5.9 mt of oil in 2005), and Rosneft exercised an option to buy 51% of Udmurtneft from the Chinese.

In reality this deal, which permitted the Chinese access to the Russian oil and gas sector,⁸³ demonstrated the new attitude of the Russian companies with regards to foreign involvement in the oil sector – “our assets for your money but under our control”.⁸⁴

With its high debt burden and ambitious plans, Rosneft faced a shortage of funds for the development of fields and future expansion. Rosneft intended to compete for fields located in the Nenetsk autonomous region (fields named after Trebs and Titov, Val Sorokina, Central-Khoreiver elevation), the Lodochnoye field in Krasnoyarsk krai, subsurface plots on the continental shelves of the Kara, Chukotka, Barents and Laptev seas, and the Kirinsk block within Sakhalin-3. And the Chinese companies could help finance its bidding in future auctions in exchange for getting access to the Russian oil sector. Rosneft could have reached an agreement on such cooperation with the Chinese companies in early 2005 when it urgently

⁸³ In the past, they unsuccessfully tried to participate in Slavneft privatization. Then, CNPC wanted to acquire the Orenburg oil and gas producing company Stimul, but did not obtain the permission of the RF Anti-Monopoly Service. Finally, the officials advised the Chinese companies not to participate in the auction on Yuganskneftegas.

⁸⁴ Vedomosti, 21.06.06.

needed money after its purchase of Yuganskneftegas (see the *Ugly Duckling Turned Falcon* section).

It can also be assumed that the decision on the route of the East Siberia – Pacific Ocean pipeline that for a long time was a matter of bitter disputes between China and Japan was also influenced by the role the Chinese companies and banks played in the Yugansk affair.

The irony of fate is actually such that YUKOS was the first Russian oil company to reveal its strategic interest in China and try to enter the Chinese market. Therefore, Rosneft inherited not only its key asset, but also borrowed its vision connected with the necessity of establishing the long-term business relations with the Chinese companies.

Japan. The Russian-Japanese summit held in November 2005 confirmed the role Rosneft will play in Russian-Japanese relations. Sergei Bogdanchikov admitted in Tokyo that he was discussing with JNOC the establishment of a JV dealing with the development of fields in East Siberia not only to resolve financial problems, but also because Rosneft needed a partner that would be closely connected with the future market.⁸⁶

India. In February 2001, Rosneft and the Indian Oil & Natural Gas Corporation Videsh Ltd. signed a deal concerning the Sakhalin-1 project whereby Rosneft sold half of its share (20%) to India and also got reimbursement of past expenditures and exemption from further investments up to the beginning of commercial production. This deal facilitated a big contract with India for deliveries of weapons, starting with 310 T-90C tanks.

The idea about selling a part of Russian share in Sakhalin-1 emerged after the 1998 crisis. Depressed world oil prices and the August default forced Rosneft to rethink its ambitions about Sakhalin projects where it initially demanded a minimum 30% interest. In

⁸⁵ Vedomosti, 21.11.05.

⁸⁶ Vedomosti, 22.11.05

November 1998, Sergei Bogdanchikov was saying: “Rosneft is not the world’s largest company. Twenty percent would suffice for us”.⁸⁷ However, at that time no buyers were found, probably because of unclear prospects of the Russian economy and risks inherent in Sakhalin-1. In 2000, Bogdanchikov repeatedly stated that Rosneft faced difficulties with raising credits to finance participation in Sakhalin projects, and was short of its own funds,⁸⁸ and this time his voice was heard at the very top. It is unclear what was more important for Russia, to sell products of the defense industry or to save Rosneft’s money, but, apparently, this deal helped to kill two birds with one stone.

Kremlin’s Trouble-Shooter

Recently, the Russian government has been revising its attitude towards the involvement of foreign companies in the domestic oil and gas sector. This trend is further manifested in the new draft of the Law on the Subsurface, which unambiguously limits the contribution of foreign majors to the development of strategic reserves permitting them to act only as junior partners to Russian companies.

Actually, Sergei Bogdanchikov holds fairly strong views about the role of foreign majors in the Russian oil sector. He said in February 2004, “I believe we should give an even more careful consideration to the issue of foreign involvement in our oil industry. It might even make sense to think about limiting the acquisition of major stakes in Russian companies by foreigners. Let them invest in the production sphere rather than in the stock market: let them win a license under general terms and work”.⁸⁹

Not surprisingly, his tough stance reflected the general sentiment of “oil and gas patriotism” that is increasingly gaining resonance in Russia. The usual Russian xenophobia is

⁸⁷ Russian Petroleum Investor, December 1998/January 1999, p. 52.

⁸⁸ Oil and Capital, # 3, 2001, p. 48.

⁸⁹ Oil and Gas Vertical, # 16, 2004, p. 21.

particularly visible in the case of the oil and gas sector. According to the latest public opinion polls by Levada-center, 67% of the population believes that foreigners should not be allowed any form of control in the oil sector of Russia versus only 2% that accepts foreign involvement without any limitations (see Appendix 6, Table B)⁹⁰

Furthermore, the activities of Rosneft clearly reflect the position of its leader concerning foreign involvement in the oil industry, as its fight for Vankor clearly shows.

Vankor Field. In 2003, Rosneft successfully limited foreign presence in the course of a prolonged battle for the Vankor field in the Krasnoyarsk Krai when it defeated both the French TOTAL and YUKOS. Vankor field holds an estimated 135.4 mt of proven reserves, 133.4 mt of probable reserves and 54.9 mt of possible reserves.⁹¹

Eniseineft created in 1992 won a license for Vankor in a tender held in 1993.⁹² In early 2000, a PSA for Vankor was signed by Vladimir Putin.⁹³ Also in 2000, YUKOS joined the game by acquiring the controlling interest of East-Siberian Oil Company, a parent company of Eniseineftgasgeologiya and Eniseigeophysica.

The initial structure of Eniseineft's shareholders did not last long. Soon, a series of reallocations began with YUKOS as their key driver. At first, East-Siberian Oil Company obtained stakes in Eniseineftgasgeologiya and Eniseigeophysica. Subsequently, YUKOS acquired 20% of Eniseineft. Then, top executives of Eniseineft sold 21% of Eniseineftgasgeologiya shares and 14% of Eniseigeophysica shares to Soyuzneftegaz, a firm owned by the former Fuel and Energy Minister, Yuri Shafranik.

⁹⁰ Vedomosti, 29.08.05.

⁹¹ www.rosneft.ru.

⁹² Eniseineft's Russian founders were state enterprises Eniseineftgasgeologiya (22%) and Eniseigeophysica (15%), as well as the administration of the Turukhansk region (4%). The foreign investor of Eniseineft was Anglo-Siberian Oil Company, founded, among others, by two sheikhs from the United Arab Emirates.

⁹³ Oil and Capital, # 3, 2002.

In April 2003 Shafranik disclosed that he owned 35% of Eniseineft shares. YUKOS immediately began to dispute the actions of Eniseineft's Director General in the Arbitration Court of the Krasnoyarsk Region, accusing him of closing the deal without the Board of Directors' permission.

It was then that two new investors appeared on the stage, both having claims on the controlling interest in Eniseineft: TOTAL and Rosneft.

In early 2002, the French major conducted negotiations with the administration of the Krasnoyarsk region, Eniseineft and Anglo-Siberian Oil Company (ASOC) about its possible participation in the development of the field. A year later, it reached an agreement on buying 52% out of 59% of Eniseineft owned by ASOC. In February 2003, TOTAL held a presentation in Krasnoyarsk on the development of the field and said that it was ready to invest \$ 2.5-3 bln in the development of Vankor over the next two years. However, its plans were torpedoed by Rosneft that obtained a 13% stake in Eniseineft and wanted to have 60%.

Rosneft offered ASOC shareholders a deal to buy their shares at LSE. However, the Anglo-Siberian Oil Company founders were hesitant to sell to Rosneft. But Shafranik backed Rosneft's efforts and in 2003 the state company bought ASOC for \$ 80 million and became the owner of a 59% stake in Eniseineft.⁹⁴

Interestingly, wishing to secure its control over the Vankor field TOTAL tried to use "the administrative resource", i.e. its friendly relations with the Krasnoyarsk Region administration. However, it discovered to its chagrin that Rosneft possessed "administrative resource" on the federal level.⁹⁵ Some experts believe that the lengthy negotiations between Rosneft and TOTAL about the possibility of undertaking joint projects were unsuccessful mainly because the French

⁹⁴ Oil and Gas Vertical, # 16, 2004, p. 42.

⁹⁵See in greater detail N.Simonia, Russian Energy Policy in East Siberia and the Far East. Baker Institute Publications, 2004.

were insisting on a 50% shareholding. Also, much to Rosneft's irritation, the major tried to put pressure on the Russian company by sending letters to the RF Government, including to the Ministry of Foreign Affairs,⁹⁶ which may have not been the most appropriate method to deal with the state company that had good connections in the federal authorities.

Rosneft also won subsequent lawsuits with YUKOS. It accused YUKOS of stealing a 19% stake in Eniseineftegasgeologiya by transferring it to YUKOS's offshore and the court made decision in the state company's favor on December 15, 2003.

Having gotten rid of the rivals, Rosneft started drilling at Vankor field in March 2004. Rosneft recently commented that it would not exclude in the future the option of inviting Western investors, albeit with limited participation, to develop Vankor.

Rosneft fought so hard for Vankor not only to expand its reserve base, but also to fulfill one of its functions as the state company, that is of limiting foreign involvement in the oil sector. By buying ASOC it did not permit Vankor (and probably its neighbors, Suzunskoye, Lodochnoye and Tagulskoye fields) to pass under the ownership of TOTAL. If it happened, a new channel of oil export not controlled by Transneft (read - the state) could have emerged.

Vankor, in contrast to other oil and gas projects of East Siberia, is not irreversibly linked to the Pacific Rim markets. Liquid hydrocarbons of the Krasnoyarsk region could be shipped along the Northern Sea Route, which would diversify markets for Vankor crude: it could be delivered to Europe, America, and Asia.

Rosneft could not decide for a long time where to transport oil from Vankor. A couple of years prior Bogdanchikov wanted to build his own \$ 1.5 billion 800-km pipeline through Dudinka to the port Dixon on the Arctic Ocean, and from there to deliver oil to the Belokamenka tanker in the Kola Straits. The second possibility for Rosneft was to build a 550-km pipeline to

⁹⁶ NefteCompas, April 24, 2003, p.4.

Purpe in the Yamal-Nenetsk Autonomous District to pump crude into Transneft's trunk pipelines. Rosneft did not particularly like the latter option because of losses connected with blending the light and sweet Vankor oil with a sulfur content of 0.08-0.11% with Urals in Transneft's system, and also because the pipeline monopoly's export capacities were limited. Initially, the "northern route" looked much better than the "southern" by all parameters.⁹⁷

However, Bogdanchikov suddenly noticed many disadvantages with the northern option: seven sites where anthrax is buried were discovered along the route, therefore the pipeline should have been extended by several dozens kilometers. In addition, cowfishes live on the island close to Dixon. Besides, Rosneft's CEO indicated that the port of Dixon is covered with ice in the winter, and icebreakers will be needed to implement the project.

These unexpected reservations about the Northern route showed that Rosneft, most likely, had to take into account political considerations – after the government decided to build the Eastern Oil Pipeline to export crude to China which Bogdanchikov lobbied for. In early August 2005, he pleaded with the president "to ask the government and regional authorities to pay more attention to this pipeline, otherwise many billion dollars of ours will be frozen", he complained.⁹⁸

Bogdanchikov proposed an idea to deliver Vankor oil to Nakhodka. This unprecedented mega-project would entail pumping oil for a distance of more than 5 thousand kilometers. It appears that the political factor of this venture is more important than its economic considerations: the strategic decision about building the Eastern Oil Pipeline was made, but there was not enough oil to ensure its economically feasible operations (50-80 mln tons). Without Vankor it will be impossible to fill it. Since Vankor is located too far away from the ESPO route,

⁹⁷ Oil and Gas Vertical, # 14, 2005, p. 63.

⁹⁸ Vedomosti, 31.08.05.

it will not be connected to the export pipeline directly, but oil will be pumped to it through the existing pipelines of Transneft that connect West Siberia with the East of the country. To deliver Vankor oil to the Transneft's system, a pipeline will be built to Purpe settlement.

So, Bogdanchikov might have been forced to do a favor for Russia. In some sense, the patronage of the federal authorities turned out to be a mixed blessing for the company since it sometimes requires Rosneft to sacrifice profitability for political objectives.

Sakhalin-3. An even more convincing proof of Rosneft's role in restricting the activities of foreign investors came in 2004 with respect to the Kirinskiy block of the Sakhalin-3 project. In 1993 Mobil and Texaco won the tender to conduct oil and gas prospecting, exploration and development at the Kirinsky block under PSA terms. The block is the biggest and most promising structure of Sakhalin-3, with 700 bcm of gas and 70 mt of gas condensate.

In May 1996, both Exxon and Mobil-Texaco encountered demands from the Sakhalin administration and SMNG to bring a Russian partner into the project. The new demands violated the terms of the tender, which had awarded western companies the right to implement the project independently. However, the U.S. companies' resistance made the project vulnerable to intrigues by the local authorities.

As a result, in November 1997 Mobil and Texaco agreed to concede a third of their stake in the project to Rosneft and SMNG. Ultimately, ExxonMobil, ChevronTexaco and Rosneft/SMNG each owned 1/3 of the project.

In late January of 2004, the government denied ExxonMobil and ChevronTexaco the right to work on the Kirinskiy block not only under PSA terms, but under the ordinary licensing terms as well. It used a formal pretext that investors did not have documented rights for the relevant plot of the shelf. Different versions were put forward to explain this harsh decision, but,

the most plausible reason might have been that the now empowered Rosneft no longer wanted to play second fiddle to foreign partners, and the state was not satisfied with the role that companies under its control had in the most significant petroleum projects.

In 2004, Rosneft stated that it was investigating opportunities to participate in the new contest for the Kirinskiy block of Sakhalin-3. It might have to compete for it with Gazprom, which was vitally interested in expanding its presence in the gas sector of the Russian Far East.

The events connected with the Vankor and Kirinskiy block indicate the current situation in the oil sector of Russia. On the one hand, the state demonstrated that it would never permit foreign companies to gain substantial control over the industry that generates the lion's share of budget revenues and can be used as a foreign policy lever. Additionally, the state distinctly differentiates between Russian oil companies, vehemently suppressing some of them, while actively supporting other companies that are "closer to it in spirit".

Conquering the Future

Ugly Duckling Turned Falcon

Under Sergei Bogdanchikov, Rosneft, that used to be the prey of the Russian oil sector predators, now turned into a predator itself and began to establish its own rules of the game. It was transformed into the state tool that restricted foreign involvement in the industry; the company also became a weapon to be used against the previously mighty oligarchs.

Severnaya Neft. The loud signal about the current balance of power between the state and private oil companies and the new role of Rosneft was given at the meeting between V.Putin and representatives of the Russian Union of Industrialists and Entrepreneurs held in February 2003. Then, Mikhail Khodorkovskiy complained about Rosneft's acquisition of Severnaya Neft

for \$ 622.6 million, at least twice its fair value, as most experts believed.⁹⁹ Khodorkovskiy cited this deal as an example of the magnitude of corruption in the state authorities.¹⁰⁰

Putin's reaction was tough: "It is a state company that needs to increase its insufficient reserves", he said, and added that "other oil companies" have excessive reserves, while "we still have to investigate" how they obtained them.¹⁰¹

Soon after that conversation, the YUKOS case started: first Platon Lebedev, then Mikhail Khodorkovskiy were arrested. Consequently, the destruction of the previous mighty company began, largely aided and abetted by Rosneft.

Rosneft is definitely enjoying preferential treatment by the state as evidenced by the further development of the situation with Severnaya Neft. After Rosneft bought Severnaya Neft, conflicts around it continued; but now, instead of LUKOIL (see the *Fading Glory* section), Rosneft had to fight with the local authorities. In April 2004, the administration of the Nenetsk Autonomous District filed a lawsuit against Severnaya Neft in Moscow arbitration court wishing to recover \$ 19 million of principal debt and \$ 12 million of penalties for unpaid social obligations envisaged by the license for Val Gamburtseva fields in 2001-2002. This sum equals almost one third of the district budget revenues in 2003.

In August 2004, the Moscow arbitration court decided that Rosneft should repay debts of its subsidiary and transfer about \$ 20 million to the budget of the Nenetsk Autonomous District.¹⁰² However, in early 2005 Rosneft proved in court that Severnaya Neft is not obliged to pay the Nenetsk autonomous region social taxes for the Val Gamburtseva fields. Experts

⁹⁹ When Andrei Vavilov, the previous owner of Severnaya Neft, was searching for a buyer, he hinted to the press that he found a big oil company that both LUKOIL and the authorities of the Nenetsk Autonomous District would not be willing to take to court (Vedomosti, 04.02.03).

¹⁰⁰ Oil and Capital, # 10, 2004, p.131.

¹⁰¹ See N.Simonia, op.cit.

¹⁰² Oil and Capital, # 9, 2004.

commented that judges may have been too lenient to Rosneft that takes advantage of its “privileged position of the state company”.¹⁰³

Yuganskneftegas. The warning signal about Rosneft’s new position sounded really fortissimo on July 27, 2004 when the Deputy Chief of the Presidential Administration, Igor Sechin, was appointed Chairman of Rosneft’s Board of Directors. As Rosneft headquarters were located on the Sofiiskaya Embankment facing the Kremlin, employees of the companies began to joke that all strategic decisions are made “right across the river”.¹⁰⁴

This appointment presented concern for the global investment community since it pointed to the drastic increase of the state interference in the domestic oil sector.¹⁰⁵ There are different opinions about the role Sechin currently plays in Russia, but many experts agree that he is the *eminence grise*. Thus, Renaissance Capital believes that “Sechin is the second most powerful person in Russia”, one of the most influential people not only in politics, but in the country’s economy as well.¹⁰⁶ In any case, his political clout strengthens the position of the company and his ambitions might have determined the later aggressive actions of Rosneft – Sechin is generally believed to be the initiator of the YUKOS case.¹⁰⁷

The saga of Yugansk developed as follows. In the autumn of 2004, two interrelated events transpired. In mid-September, Vladimir Putin approved the proposal of the government to fully incorporate Rosneft in Gazprom in exchange for 10.74% in the gas monopoly that was held by its subsidiaries. This swap would have permitted the state to increase its stake in the gas monopoly from 38.4% to the controlling interest and after that to liberalize the market of Gazprom’s shares. With regard to this plan, Vladimir Milov, the leading energy expert,

¹⁰³ Vedomosti, 16.02.05.

¹⁰⁴ Personal conversations with Rosneft’s employees.

¹⁰⁵ See, for example, gazeta.ru, 28.07.04.

¹⁰⁶ Vedomosti, 24.12.04.

¹⁰⁷ The Moscow Times, 05.08.05.

commented that “the state intends to get rid of the oil company that is worth several billion dollars, in exchange for the legal confirmation of the status quo”.¹⁰⁸

Then in November 2004, Deutsche Bank, Gazprom’s advisor, recommended the company to purchase Yuganskneftegas, Surgutneftegas and Sibneft,¹⁰⁹ and this idea was wholeheartedly approved by Gazprom’s management and Sergei Bogdanchikov (who was expected to head the new oil division within the gas giant).

There were no doubts at that time that Gazprom would acquire Yugansk, whose parent company was in a disastrous state. By late 2004, YUKOS faced tax bills of \$ 28 billion. Its market capitalization plunged from the peak of \$ 36.9 billion in March 2004 to \$ 3.6 billion in early December 2004.

However, YUKOS’s management team under Steven Theede put up a fight to save the company from being acquired by Gazprom. It made a defensive move, which was unprecedented in the history of the world business by applying to the Houston court to seek protection under chapter 11 of the U.S. law on bankruptcy. Initially, the court satisfied the request to temporarily forbid the auction for Yugansk, and warned Gazprom, and six foreign banks¹¹⁰ that were to credit the acquisition of Yugansk by Gazprom not to participate in the auction scheduled for December 19. The banks obeyed and Gazprom lost the chance to get the much needed foreign credit; it also risked economic sanctions and problems in relations with foreign partners had it proceeded with the purchase.

¹⁰⁸ Vedomosti, 24.03.05.

¹⁰⁹ Oil and Gas Vertical, # 2, 2005, p. 4.

¹¹⁰ J.P.Morgan, Deutsche Bank, Calyon, BNP Paribas, Dresdner Kleinwort Wasserstein and ABN AMRO.

Still, despite this unexpected setback, the auction took place as scheduled – to cancel it would have meant for the Kremlin “dancing to the tune of foreigners”.¹¹¹

On December 19, a 77% stake in Yuganskneftegas (representing 100% of its voting shares) was sold for \$ 9.35 billion, allegedly to cover the company’s tax debts. This transaction looked like a remake of the “loans-for-shares” auctions of the mid-90s: the buyer was a dummy corporation BaikailFinanceGroup that was registered in the town of Tver literally on the eve of the auction. To lend legitimacy to this transaction, Vladimir Putin said that it was carried out in accordance with market principles and Russian law: “As far as I know, the shareholders of BFG are individuals who have been working in the energy sector for years”.¹¹²

Three days after the auction, Rosneft bought BaikailFinanceGroup for 10,000 rubles (a price of a mid-class refrigerator). BaikailFinanceGroup transferred the budget money for the Yugansk shares on December 30, 2004.

The leadership of Rosneft was in no hurry to reveal the origins of the \$9.35 billion that it spent in 2004 to purchase Yugansk claiming that it was a “commercial secret”. However, it was clear to analysts that the company had no funds for such lofty expenses.

Only in June 2005 did Rosneft admit in its annual report under the U.S. GAAP standards that it raised \$ 6.1 billion through the sale of short-term notes and got a credit from Sberbank for \$ 1.8 billion. Rosneft received interest-free credits from its subsidiaries for \$ 5.3 billion. The subsidiaries did not have this money but they got them from an unknown company called Trade-Express in exchange for notes that they issued. Rosneft did not admit who was behind Trade-Express but notes worth this amount were discovered in the balance sheet of Vnesheconombank. Vnesheconombank bought notes of the subsidiaries not for its own money, but for the money of

¹¹¹ Oil and Gas Vertical, # 1, 2005, p. 5.

¹¹² See, for example, Moscow Times, December 22, 2004.

the Ministry of Finance that were to be used to repay Russia's foreign debt. Rosneft repurchased these notes from Vnesheconombank on January 17, 2005 and redeemed its debts to its subsidiaries by using these notes.

In early 2005, Vnesheconombank got for Rosneft \$ 6 billion from the Chinese banks as a prepayment for oil deliveries. Rosneft promised to supply 48.4 mt of oil up to 2010 to CNPC, though it vehemently denies that the Chinese funds were used to buy Yugansk, and claims that they were intended for the operating needs of the company.¹¹³

Thus, budget funds were used in the transaction to acquire Yugansk in the best traditions of the "loans-for-shares" auctions. Andrei Illarionov, the former economic advisor to the RF President, nominated the acquisition as "the shady deal of 2004".

Though huge efforts were taken by the authorities to present the acquisition of Yugansk as a fair deal executed under market conditions, in spring 2005, two valuers – 2K Audit and Morgan Stanley – valued Rosneft at \$20-28 billion. Interestingly, just 6 months ago the same experts had estimated that the company was worth \$ 7-8.5 billion. The government officials explained that Rosneft had become more expensive by a factor of 4 because it acquired a major asset, i.e. Yuganskneftegas. In actuality, the authorities admitted that Yugansk was sold with a huge discount.¹¹⁴

Having acquired Yuganskneftegas which was the biggest oil producing subsidiary of YUKOS, Rosneft was transformed overnight from a modest player (21 mt of oil production) into a 75-mt/yr giant. It increased its hydrocarbon reserves to 2.05 billion tons of proven oil reserves, and 691 bcm of proven gas reserves. Currently, the company also has 1.143 billion tons of

¹¹³ Rosneft 2004 Annual Report.

¹¹⁴ Vedomosti, 27.05.05.

probable oil reserves, 444 bcm of probable gas reserves and 0.987 billion tons of possible oil reserves, and 435 bcm of possible gas reserves.¹¹⁵

This unprecedented situation, where a much smaller company acquires a bigger rival, raises really intriguing questions concerning management and the corporate culture of a new entity. Only time will show whether Rosneft will be able to fully realize the potential of Yugansk which used to be the most efficient, dynamic, transparent and Westernized Russian oil company. Will other subsidiaries of Rosneft improve their performance to reach its standards, or will Yugansk deteriorate to the level of the other subsidiaries?

The acquisition of Yugansk cost Rosneft a lot in many aspects. Not only did the company suffer serious negative publicity, but also incurred some tangible losses. For example, it had to sell its share in Sevmorneftegas to Gazprom (see the *Rebuilding the Empire* section) and simultaneously the company had to give up its plan to build a refinery in the Leningrad region. By buying Yugansk, Rosneft became the second biggest borrower in Russia after Gazprom. As of early 2005, its debt totaled nearly \$ 22.5 billion, and its financial position lacked stability. In other words, the company bit off more than it could chew, and symptoms of this indigestion were rather obvious.¹¹⁶

The attitude of Rosneft to its new subsidiary is quite noteworthy to mention. On the one hand, though Sergei Bogdanchikov severely criticized Mikhail Khodorkovskiy and his management team for aggressive oil production methods, Rosneft now actively uses hydrofracking in Yuganskneftegas and cooperates with Schlumberger, which performed frac jobs for Yugansk under the previous management.

¹¹⁵ www.rosneft.ru.

¹¹⁶ Oil and Gas Vertical, # 6, 2005, p. 29.

Additionally, analysts are convinced that Rosneft is buying oil from Yugansk at transfer prices, which worsens the financial performance of the subsidiary. At the same time, Rosneft is initiating lawsuits on behalf of Yuganskneftegas against YUKOS demanding compensation of losses incurred because YUKOS used transfer pricing in relations with Yugansk.¹¹⁷

However, Rosneft turned out to be a blessing in disguise for Yugansk in another respect. It managed to reduce Yuganskneftegas' tax debts by a factor of 6. In its report for 2005, the company indicated that now the subsidiary owes only \$760 million to the budget instead of \$4.7 billion, while Yugansk was losing all court cases when it was in the structure of YUKOS.

In general, Rosneft is playing a pivotal role in the destruction of YUKOS.

Thus, the practically insolvent YUKOS stopped repaying its credits to Western banks by December 2004.¹¹⁸ In January 2005, the banks demanded that Rosneft, the new owner of Yugansk, should redeem the remaining part of the \$1 billion debt. Initially, Rosneft refused to pay and advised the banks to address their demand to YUKOS. The bankers threatened with lawsuits and cross-default on credits of the state company itself (Rosneft violated the terms of its own previous loan agreements by incurring huge debts), since some of the banks that lent money to YUKOS credited Rosneft as well.

Finally, Rosneft agreed to redeem the remaining debts of YUKOS, because it was important for the company to maintain good relations with the banking community. Actually, it could later include the money that it pays to the banks in the claims of Yugansk against its former parent company.

¹¹⁷ Vedomosti, 17.11.05.

¹¹⁸ In September 2003, YUKOS got a \$ 1 billion credit from Citibank, Commerzbank, Credit Lyonnais, Deutsche Bank, HSBC, ING and Societe General. Societe General provided another \$ 1.6 billion to YUKOS. Subsidiaries of YUKOS, including Yugansk, were guarantors of both credits.

At some point it became clear that it was not easy to completely destroy YUKOS. It repaid \$21.5 billion of its tax debt and could have repaid the remaining \$10 billion, given the extremely favorable oil pricing situation. It was impossible to bankrupt YUKOS directly, because Vladimir Putin publicly stated that the government was not interested in its bankruptcy¹¹⁹.

However, Western banks indirectly helped the RF government. They insisted on YUKOS's bankruptcy, and sold YUKOS's debts worth \$ 455 million + interest to Rosneft in March 2006. Therefore, the state company could save the face of the president and bankrupt YUKOS. Now, the RF fiscal authorities and Rosneft were the largest debt holders of the beleaguered oil company.

Currently, Rosneft is aiming to gain access to the remaining assets of YUKOS. It is particularly interested in YUKOS's refineries, since it currently faces a serious shortage of refining capacities. It already introduced its own people to the Angarsk Petrochemical Company and delivers oil from Yuganskneftgas there for processing. It intends to acquire East Siberian Oil Company that operates in Yurubcheno-Tokhomsk zone in Evenkiya (Krasnoyarsk Krai) close to its Vankor field. Should this happen, Rosneft will become the undisputed king of the "big oil" in East Siberia. Of course, it will have to compete with a formidable rival for these assets – Gazprom is also interested in them.

Rivalry with Gazprom. Just a few years ago, a situation where Rosneft could contemplate opposing the all-powerful gas giant would have seemed a story directly from the science fiction. However, now two state companies are crossing swords on many fronts, and the new status of Rosneft is reflected in the fact that it is often winning.

¹¹⁹ Vedomosti, 16.03.06.

The planned merger between Gazprom and Rosneft became much more complicated after Rosneft acquired Yugansk – this transaction drastically changed the value of Rosneft and augmented risks connected with the company.

The saga of the failed merger between Rosneft and Gazprom sometimes took quite comical turns.

Thus, journalists had a field day on March 2005, when Sergei Bogdanchikov and Alexei Miller met in the studio of the NTV television channel and made a joint declaration about the scheme of Rosneft's acquisition by Gazprom in exchange for 10.74% shares of the monopoly. Miller said that Gazprom would acquire Rosneft, and Yuganskneftegas would be a separate state company headed by Bogdanchikov. The next day, Bogdanchikov refuted the statement of Gazprom's CEO that was made in his presence; after that the press-service of Rosneft declared the words of Bogdanchikov a "technical mistake".¹²⁰

But in spring 2005, after all the scandals Gazprom realized that the risks connected with Rosneft were too high. As a result, the government decided to change the algorithm of the deal. Now, the state transferred 100% of Rosneft valued at \$26 billion to the specially created state company Rosneftegas, that was to raise credits and purchase from Gazprom's subsidiaries 10.74% of shares that were necessary to assure the controlling interest of the state. After that, Rosneftegas was to sell off a block of Rosneft's shares through an IPO to repay credits of international financial institutions, and then was to be liquidated. Actually, Gazprom preferred to get cash for its shares because it was planning to buy new assets, i.e. Sibneft.

As legal experts admit, Bogdanchikov achieved his goal. He did everything possible to ensure that Gazprom would not want to have Rosneft. He created debts through the use of the notes schemes, initiated court actions of Yugansk against YUKOS, refused to repay debts of

¹²⁰ Vedomosti, 03.05.05.

Yugansk to foreign banks, and bought oil from Yugansk at transfer prices. According to Anatoliy Yushin, the director of the A.S.T. Legal law firm, this was an example of an anti-takeover defense that is worthy of being included in textbooks.¹²¹

Dresdner Kleinwort Wasserstein (DrKW), the advisor of Gazprom, admitted that the company had underestimated the top management of Rosneft which managed to convince the government that it was necessary to leave an “independent national oil company” and which would be able to control 10.7% of Gazprom – Rosneftgas was actually managed by the leadership of Rosneft, and was poised to be the second biggest shareholder of Gazprom. “It looks like the “golden fish” (the only state company in the strategic sector of the economy) can start devouring the “whale” (the biggest gas company in the world)”, wrote analysts of DrKW.¹²²

The failed merger and the scandals connected with it raise many questions concerning the specifics of the strategic decision-making at the very top in Russia. The conflict between Rosneft and Gazprom revealed profound contradictions between different factions in the presidential administration, more precisely between Dmitriy Medvedev, the BoD Chairman of Gazprom, the “civilian” and Igor Sechin, the BoD Chairman of Rosneft, and the leader of the “siloviki” group that competed with the “civilians”. Medvedev was insisting on a complete acquisition of Rosneft by Gazprom and also emphasized the need for Yugansk to remain an independent state company, while Sechin was lobbying independent Rosneft that would own Yugansk.

At that point in time, Rosneft, which was connected with the siloviki group, won. But the general forecast was that political figures who were close to Gazprom, the company that was supposed to be the support of the “civilian” faction in the Establishment, expected to retain and

¹²¹ Vedomosti, 17.05.05.

¹²² Vedomosti, 20.05.05.

even strengthen their positions after the 2008 elections, since Dmitriy Medvedev was included in the unofficial short-list of Putin's successors.¹²³

Having defended its independence from Gazprom, Rosneft continued to fight with the gas monopoly. To strengthen its positions, it was joining forces with TNK-BP, that was also a rival of Gazprom, on many fronts, and this combination was beneficial for both companies that could act together in acquiring new licenses TNK-BP received a partner with formidable political clout, while Rosneft needed a cash-rich ally.

Rosneft outplayed Gazprom when it acquired (through the Chinese Sinopec) Udmurtneft from TNK-BP which Gazpromneft was interested in (see the *Extraordinary and Petropotentiary* section). Other contenders were MOL (Hungary), and a consortium of Itera and ONGC. Sinopec was recognized as an optimal buyer, though other contenders were prepared to pay more. Gazprom was disappointed and its representatives complained that it was “a political decision”.¹²⁴

In addition, there are contradictions between Rosneft and Gazprom with regard to Sakhalin-1, where Rosneft is one of the project participants. Gazprom was very eager to get into the Sakhalin projects that were already underway since it intended to enter the gas markets of the Pacific Rim countries and the U.S. using gas from Sakhalin.

Gazprom wanted to get Rosneft's share in Sakhalin-1 and buy gas that was produced within the framework of the project (the monopoly already made such a proposal to ExxonMobil). However, Rosneft was not willing to let Gazprom join Sakhalin-1.

Hostilities began as Gazprom was trying to make life difficult for project participants. On October 19, 2006, Exxon Neftegas signed a preliminary agreement with CNPC to build a 900-

¹²³ Oil and Capital, # 10, 2006, p. 8.

¹²⁴ Vedomosti, 21.06.06.

km pipeline from Sakhalin to North-East China with a throughput capacity of some 8 bcm/yr. But Gazprom was actively resisting these plans because company officials did not want this pipeline to compete with its gas exports.

Actually, the competition between Gazprom and Rosneft was particularly fierce in East Siberia and the Far East. Despite being a coordinator of all gas activities in the East of Russia, Gazprom had few valuable assets there. By contrast, the Eastern positions of Rosneft were traditionally strong, and it declared this region an area of its strategic interests. It is not surprising therefore that Gazprom and Rosneft had been competing for many subsurface plots in the Irkutsk region and in Krasnoyarsk krai that were recently auctioned off, and in many cases Rosneft snatched the victory from the gas giant (though overpaying for the subsurface plots). So, will the East of Russia be too small for these two adversaries?

Their relations might be complicated further by Rosneft's desire to become a major gas company that would produce some 60-70 bcm of gas by 2015. To this end, it needs to get access to trunk pipelines of Gazprom. Analysts believe that this company has better chances than other independent gas producers to achieve this goal.

Consequently, Rosneft and Gazprom signed an agreement on November 28, 2006, consolidating a strategic partnership that would be valid up to 2015. As part of this agreement, they are ready to jointly develop fields, produce, transport and process hydrocarbons, generate power, manufacture equipment, and cooperate in the petrochemical and gaschemical industry, etc. However, it is reasonable to predict that their cooperation will be limited by Gazprom providing access for Rosneft to its gas transportation system. Since Gazprom is insisting on maintaining its monopoly on gas exports, it might gradually cede the domestic gas market to

independent gas producers (including Rosneft) – they will be called upon to compensate the declining gas production of the gas monopoly and cover the potential domestic shortage of gas.

There is an opinion among analysts that this temporary truce is a political decision. Vladimir Putin needs to mitigate at least the economic rivalry of the groups surrounding him on the eve of the 2008 elections, since it is hardly possible to make a complete peace between the opponents in the foreseeable future. Apparently, the president himself insisted on this compromise between the competing political groups.¹²⁵

The relations between the two mighty companies were never exactly amicable. However, in the future, the rivalry between the adversaries will most likely intensify: they will have some really tempting assets to fight over.

Rosneft could conceivably compete with Gazprom for the Bashneft and Bashkir oil refineries, because they are better than those of YUKOS. There are also remaining assets of YUKOS to be disposed of in the process of the company's bankruptcy, and Gazprom and Rosneft are the most likely contenders. Rumors circulate in the market about the potential sale of the 50% stake in TNK-BP by its Russian shareholders – another sphere of dispute for the rivals. Lastly, Surgutneftegas might lose its independence and be devoured by either Rosneft or Gazprom.

As Vladimir Milov remarked, the danger of the current situation is that the Kremlin does not control competition between its structures, i.e. Gazprom and Rosneft.¹²⁶

Thus, present today are all the symptoms of escalating tension in the upper echelons of power in Russia, and Alexei Makarkin from the Center of Political Technologies is sure that it

¹²⁵ See *Oil and Capital*, # 12, 2006, p. 7.

¹²⁶ *Vedomosti*, 02.08.06.

will only be aggravated with the approaching elections of 2008.¹²⁷ However, from an optimistic point of view, it is better to have two dominating companies in the domestic oil and gas sector, which ensures a system of checks and balances, rather than only one, that would encounter no barriers in its expansion drive.

Privatization à la Authoritarian Capitalism

Rosneft's IPO became its most important milestone for 2006. It was organized to redeem the \$ 7.5 billion debt incurred by Rosneftegas when it acquired 10.7% shares of Gazprom.

Value Driver. In preparation for the IPO, Vladimir Putin very unambiguously confirmed his approval of Rosneft and personally Sergei Bogdanchikov. He invited head of Rosneft to his residence on Bogdanchikov's birthday (August 10, 2005). On September 7, 2005 Putin visited the Tuapse refinery owned by Rosneft, and praised Bogdanchikov to the sky saying that "over the last 5 years the company's capitalization grew by a factor of five. It is a significant contribution to the capitalization of the whole country".¹²⁸ This benevolent attention of the country's leader became an important value driver for Rosneft. In Russia, investors perceived the personal approval of the president as the guarantee of no political risks and the minimal probability of prosecution.

The international IPO of Rosneft was the real state business that had a great political significance for Russia. Since Russia was trying to position itself as a world energy superpower, it was vital for its leadership to show that its oil companies were a match for the global leaders of the oil business. Therefore, enormous efforts were taken at the top level to

¹²⁷ Oil and Capital, # 8, 2006, p. 4.

¹²⁸ Vedomosti, 07.09.05.

strengthen the position of the company, pump it with valuable assets and enhance its attractiveness for potential investors.

Before the IPO, the government wanted to improve the image of Rosneft since foreign businessmen perceived the appointment of Igor Sechin as its BoD Chairman negatively. To this end, it invited Donald Evans, the former U.S. Minister of Trade, to work for Rosneft. Putin said that Rosneft was interested in attracting high-class managers on the eve of the IPO, and that it was “an element of transparency of the Russian economy and transparency of the Russian companies”.¹²⁹ However, not surprisingly, Mr. Evans refused.

Also, in an image-building measure, Rosneft nominated independent directors for the first time in its history. They were Hans Jorg Rudloff, president of Barclays Capital, Andrei Kostin, BoD Chairman of Vneshtorgbank, and Alexander Nekipelov, vice-president of the Russian Academy of Sciences (see Appendix 4).

Also, before the IPO Rosneft had to resolve a sensitive issue which arose in the process of consolidation of its subsidiaries. YUKOS would have become the biggest minority shareholder of Rosneft because it owned 23.2% of preferred stock of Yugansk, Rosneft’s new subsidiary. This situation seemed politically unacceptable for the RF government.¹³⁰

To Buy or Not to Buy. However, the placement of Rosneft’s shares provoked many questions in the international investment community. Foreign analysts were worried about its huge debt burden (after all the recent acquisitions, its debts amounted to some \$ 11.6 billion at the end of the first quarter in 2006). George Soros was concerned about ethical problems that arose from the Yugansk acquisition and problems with European energy security.¹³¹ He was

¹²⁹ Vedomosti, 19.12.05.

¹³⁰ Oil and Capital, # 3, 2006.

¹³¹ Financial Times, 26.04.06.

convinced that Rosneft was the instrument of the state and would always service Russia's political goals to the detriment of shareholders' interests.

Before the IPO, many investment analysts were saying that they did not recommend buying Rosneft's shares if they were priced higher than those of LUKOIL. One of the bankers elaborated upon these reservations by explaining that Rosneft was ideally pumped with assets, it had good reserves, but investors were not sure that the company would be able to efficiently use those advantages. Also, there were some concerns about its corporate culture. Investors trust LUKOIL more, partially because they know the company better.¹³²

Also, YUKOS's case turned some investors away from acquiring Rosneft's shares. An expert from Axa Investment Managers said that she lost a lot of money because of the YUKOS's case, and now she was offered to buy the same asset at a higher price.¹³³

To demonstrate its new transparency, Rosneft identified key risks of the company in its IPO memorandum. They were connected with Yuganskneftegas acquisition: huge debts and consolidation threats (lawsuits of minority shareholders who are unhappy with share swap ratios). Interestingly, it also named the actions of the RF government which created a difficult business climate in Russia and could have affected the oil and gas companies in Russia "through informal channels". In addition, the interests of the RF government as the key shareholder may not have coincided with the interests of other shareholders.

Tactical problems continued for the company. On the eve of the IPO, Rosneft's CFO Sergei Alexeev resigned, which made some experts fear that the placement would not

¹³² Vedomosti, 22.06.06.

¹³³ Vedomosti, 14.07.06.

happen.¹³⁴ Furthermore, in July 2006, YUKOS asked FSA (UK) to forbid the placement of Rosneft's shares in LSE because it illegally expropriated Yuganskneftegas.

The Triumph. But, despite all these aforementioned setbacks and concerns, the IPO was held in July 2006. The Company managed to sell shares at \$7.55, i.e. almost at the top of the price range (\$5.58-7.85), which corresponds to the company's capitalization of \$ 79.8 billion. It means that at the time of the IPO, Rosneft overtook its eternal rival, LUKOIL, the biggest Russian company in terms of reserves and revenues (LUKOIL's capitalization at that time was \$ 70.9 billion).

Rosneft's IPO turned out to be the biggest in Russia, and ranked fifth in the world. The company sold 14.8% of shares for \$ 10.4 billion, 75% of Rosneft was held by the state-owned Rosneftegas, and 9.44% by YUKOS. The IPO of Rosneft permitted the corporation to kill two birds with one stone: it managed to raise the required \$ 10.4 billion and remain under the state control.¹³⁵

Rosneftegas received \$ 8.5 billion from the IPO and repaid the syndicated credit of \$7.5 billion that it raised in September 2005. Rosneft collected \$ 1.9 billion from the placement proceeds and spent the lion's share to repay ahead of schedule its \$ 1.34 debt to ONGC, which it incurred in 2001, when the Indians joined the Sakhalin-1 project.

Four investors bought 49.4% of all issued shares. Now, Rosneft had foreign majors among its shareholders: British Petroleum that bought shares worth \$ 1 billion, Malaysian Petronas (\$ 1.5 billion) and Chinese CNPC (\$ 0.5 billion). Rosneft did not name the fourth

¹³⁴ Later, Peter O'Brien from Morgan Stanley was hired as CFO.

¹³⁵ Izvestiya, 29.12.06.

investor, though it got the biggest stake. There were rumors that the mysterious fourth player may have been Gazprombank or structures affiliated with Surgutneftegas.¹³⁶

The success of IPO was also largely determined by the active participation of Russian billionaires. Roman Abramovich bought shares worth some \$ 300 million, Oleg Deripaska - \$ 0.5-1 billion, Vladimir Lisin - \$ 200 million. In reality, these oligarchs usually prefer to get the controlling interest in a company rather than act as portfolio investors. This IPO permitted them to demonstrate their loyalty to the state – as analysts commented, they’ve “paid the party fees”.¹³⁷

The leadership of the company tried to avoid concentration of Rosneft’s shares in the hands of one investor in order to limit the chances of external influence over its most important strategic decisions. Sergei Bogdanchikov proposed not to sell to one entity more than 1.5-2% of the company during the IPO since he did not need a strategic investor in the classic sense of this word. Hence, many investors that bought Rosneft understood that their stakes were designed to be too small to be able to participate in the company’s management, and they regarded the IPO as an “entry ticket” to the Russian oil sector and a chance to win the goodwill of the Russian authorities.

“People’s Company”. Besides, the government also organized the so-called “IPO for the people” among citizens of Russia – though it could be called “for the people” with great reservations. The minimal investment was established in the amount of 15 thousand rubles, while the average salary in Russia by the spring of 2006 amounted to some 10 thousand rubles.¹³⁸

¹³⁶ Oil and Gas Vertical, # 13, 2006.

¹³⁷ Vedomosti, 24.07.06.

¹³⁸ www.gks.ru.

So, 115,000 Russians became shareholders of Rosneft after having spent approximately \$ 750.5 million. Some experts attributed this “IPO for the people” to the desire of the Kremlin to use these shareholders as a “human shield” for Rosneft in the event of any further court actions and lawsuits by Group Menatep, which promised to persecute both sellers and buyers of Yuganskneftegas. In this case it would have to fight not only against Russia’s establishment – corrupt state officials that expropriated property of YUKOS, - but also against its citizens who became Rosneft’s shareholders.¹³⁹

It is noteworthy to mention that for these “people’s shareholders” the attractiveness of Rosneft’s shares lay in its state status reflecting the specific mentality of Russian citizens. 59% of shareholders interviewed claimed that the company had advantages over other oil corporations: 37% of those investors see these advantages in the “support of the state” (other options of answers, such as “rates of production growth”, “huge reserves”, “efficient management” scored only 6-7%).¹⁴⁰ Thus, they perceived the state as a guarantor of their investments: 77% of the respondents were sure that the government should support Rosneft using budget funds if the company faced financial problems. Although this reliance on the state seemed excessive and not in line with the market relations, it still constituted a specific feature of the state capitalism that was developing in Russia. It also is consistent with the typical Russian mentality. Public opinion polls show that the return to the state regulation of economy has consistently been number 3 priority of the RF government policy in the minds of the Russians, while continuation of reforms, further privatization and private ownership on land ranked only 12-13 (see Appendix 6, Table A).

¹³⁹ Vedomosti, 20.10.05.

¹⁴⁰ Vedomosti, 19.07.06.

Analysts of Antanta-Capital believed that Rosneft should be regarded as a “political phenomenon rather than an oil and gas company”. They are sure that the pending elections for the Duma and presidential elections would not permit the government to remain indifferent to the possible drop in Rosneft’s share price, since more than one hundred thousand people from the electorate became its shareholders.¹⁴¹

Rosneft’s Godfather. Everywhere else in the world, investors value private companies more, because they are better managed. But in Russia administrative clout is now more important, since it guarantees stability, and, ultimately, profit. As Vladimir Putin admitted in Summer 2006, “...I know the plans of the government to support it [Rosneft], including in terms of increasing its opportunities to get reserves”,¹⁴² i.e. he actually promised to support and protect the company.

After the initial success, the shares of Rosneft began to depreciate and for some time were trading below the placement price. However, in September, Renaissance Capital published a report, which said that Rosneft would get all the remaining assets of YUKOS. After that, Rosneft’s shares began to rise. By November, Rosneft’s capitalization reached \$ 100 billion. It became the second most expensive company in Russia after Gazprom. Rosneft shares were also included in MSCI Russia where its weight would be some 4.0-4.5% - the same as Norilsk Nickel and Surgutneftegas.

In October, Vladimir Putin personally congratulated the leadership of Rosneft, investment bankers that organized IPO and the biggest shareholders on a successful placement. Experts are sure that this attention of Putin would help the company in its negotiations with

¹⁴¹ Vedomosti, 13.07.06.

¹⁴² Oil and Gas Vertical, # 13, 2006, p. 6.

foreign banks on an unprecedented loan of \$24.5 billion that Rosneft needed in order to buy the remaining assets of YUKOS.¹⁴³

However, there are other dissenting views of this transaction that do not remain in conformity to this triumphant attitude. After naming the sale of Yugansk as the “shady deal of 2004”, Andrei Illarionov, the former economic advisor to Vladimir Putin, named Rosneft’s IPO the “shady deal of 2006”. First, because Yuganskneftegas, the “stolen asset”, was included in the sale. Second, because Rosneft, the state company, deposited funds raised during the IPO at its own accounts, rather than at the state budget accounts. Then, the fees of lawyers and advisors were four times higher than usual. Last but not the least, by the results of the year the Russian citizens that invested in Rosneft’s shares lost as compared to those who invested in the standard Russian Trading System package.¹⁴⁴

Undoubtedly, Rosneft, for which state support was a powerful competitive advantage, will continue its transformation into a mighty international corporation. The irony of fate is that the company that successfully managed to avoid privatization during the 1990s, i.e. the period of the broad-scale privatization, was partially privatized in the Putin’s Russia, during the period of strengthening of the state ownership over strategic sectors.

There are rumors about possible further privatization of Rosneft – though there are different opinions about its potential scale and timing. Presumably, it means that the processes that are now underway in Russia are much more complex than the simple re-nationalization as they are usually described. They are in all probability closer to the redistribution of assets in the oil sector in favor of the new generation of oligarchs, i.e. people who are closely connected with

¹⁴³ Vedomosti, 30.10.06.

¹⁴⁴ WPS, 28.12.06.

siloviki. Only time will show if the new owners will be more effective and efficient managers than their predecessors.

Crystal Gazing

The appetites of Rosneft are constantly growing: when Bogdanchikov met with Putin in August 2005, he promised the RF president that Rosneft would produce 125-128 mt of oil by 2015, and when Putin remarked that the state did not intend to create a monopoly in the sector, Bogdanchikov assured him that normal competition was present within the oil industry.¹⁴⁵ At that time it was clear to analysts that the company could not achieve these targets by the means of purely organic growth and it would have to acquire new assets. Later, the bar was raised somewhat: Bogdanchikov said that the company would produce 135 million tons by 2015 versus its current 75 million tons.

Now, Rosneft wants to catch up with ExxonMobil and BP within the next 5 years. Currently, it is behind them by key parameters. Its revenues under the U.S. GAAP for the first 6 months of 2006 were \$16.4 billion versus \$188 billion for ExxonMobil and \$139.4 billion for BP. Its capitalization is \$100.2 billion versus \$217.5 billion for BP and \$422.4 billion for ExxonMobil. However, it is closer to them in terms of reserves.¹⁴⁶ It needs to expand its activities worldwide to become a global major. To keep in line with this objective, it intends to create an alliance with Malaysian Petronas for oil production and refining. It also aims to acquire the remaining assets of YUKOS, Surgutneftegas, 50% of TNK-BP and the Bashkir refineries.

¹⁴⁵ Vedomosti, 11.08.05.

¹⁴⁶ Net proved reserves of Rosneft under SPE classification as of early 2006 were 18.9 billion barrels of oil equivalent; oil reserves are 14.9 billion barrels. LUKOIL has 20.3 billion barrels of oil equivalent (16.1 billion barrels of oil reserves). LUKOIL is number one in the world in terms of oil reserves, and number three in terms of total reserves (BP with TNK-BP has 22.7 billion barrels, ExxonMobil – 21.9 billion barrels). Rosneft is number one in the world among private companies in terms of reserves to production ratio (28 years).

Should this happen, it would seem that the Wheel of Fortune would have made practically a full circle, and Russia's oil industry would return to almost what it had in 1991 – Rosneft (containing almost all Russian oil companies) + LUKOIL + Gazprom with an oil arm represented by Gazpromneft. Will this evolution benefit Russia? Will it help to strengthen its positions as the energy superpower and enhance the global energy security? Only time will tell. The energy thriller “Lord of the Rigs” continues.

APPENDIX 1: ROSNEFT (BEFORE YUGANSKNEFTEGAS ACQUISITION) AMONG ITS PEERS

Company	Proved Reserves (2002), SPE*	Oil Production**		Oil Exports**		Oil Refining (2003)**	Gas Output (2004)***	Number of Fuel Stations	Lifting Costs (2002)#	Drilling (2003) ##		Number of Oil Wells (Dec 2004)	
		2004	2003	2003	% of Oil Output					Devel.	Expl..	Total	Idle
YUKOS	13.7	85.7	80.7	30.3	35.3%	31.5	3.4	1100	1.52	1,180.90	43.1	17,366	4,540 -26%
LUKOIL	15.3	84.1	78.8	31.8	37.8%	35.2	5	1400	2.59	1,073.40	125.3	26,502	4,741 -17%
TNK-BP	9.4	70.3	61.5	29.1	41.3%	14.6	8	2100	2.49	399.2	21.9	25,749	10,366 -40%
Surgut	6.6	59.6	54	20.8	34.8%	15.9	14.3	300	2.96	2,777.50	244.1	16,719	1,985 -11%
Sibneft	4.6	34	31	10.1	29.7%	14.3	1.9	1000	1.75	687.8	50.6	8,099	4,643 -57%
Tatneft	6	25	24	11.5	46.0%	6.4	0.7	400	4.17	602.5	48.2	21,682	3,904 -18%
Slavneft	1.6	22	18	8.1	36.8%	12.4	0.9	600	2.22	251.8	N/a	3,987	761 -19%
Rosneft	2.9	21.6	19.5	7.4	34.2%	9.3	9.3	600	3.02	483.2	39.1	8,529	573 -6%
Rank	7	8	7	7	7	7	2	5 - 6	7	6	7	7	1
Bashneft	N/a	12	12	3.8	31.6%	-	0.3	N/a	N/a	333.9	70.9	18,600	3,202 -17%

* billion barrels

** million tons

*** billion cubic meters

\$ per barrel

kilometers

APPENDIX 2: EVOLUTION OF ROSNEFT'S STRUCTURE

1993	1996	2006
Purneftegas Noyabrskneftegas Nizhneartovskneftegas Samaraneftegas Tyumenneftegas Sakhalinmorneftegas Stavropolneftegas Krasnodarneftegas Termneft Permneft Tomskneft Astrakhanneft Nizhnevolzhskneft Kaliningradmorneftegas Dagneft Grozneft Chernogorneft Kondpetroleum Saratovneftegas Varyoganneftegas Udmurtneft Megionneftegas Tomskneftegas Orenburgneft Komineft Kalmneft Tyumenneftegas Soyuznefteotdacha Arktikmorneftegazrazvedka Arkhangelskgeoldobycha YenisseyNGgeologiya Orenburggeologiya Yenisseygeophysica Megionneftegazgeologiya Vostsibneftegazserive TomskNGgeologiya PurNGgeologiya ZapolyarNGgeologiya SurgutNGgeologiya NoyabrskNGgeologiya KrasnoleninskNGgeologiya UktanNGgeologiy KhantyMansiiskNGgeologiya Udmurtgeologiya YamalNGgeologiya UrengoiNGgeologiya Omsknefteorgsyntez NORSI Ryazan refinery Moscow refinery Tuapse refinery Groznyi refinery Yaroslavnefteorgsyntez Krasnodarnefteorgsyntez Khabarovsk refinery Komsomolsk refinery Ukhta refinery Saratov refinery Angarsk Petrochemical Company Yaroslav refinery Salavatnefteorgsyntez Achinsk refinery Nizhnekamsk refinery Orsknefteorgsyntez	Purneftegas Sakhalinmorneftegas Stavropolneftegas Krasnodarneftegas Termneft Dagneft Arkhangelskgeoldobycha Komsomolsk refinery Krasnodarnefteorgsyntez Tuapse refinery	Yuganskneftegas Purneftegas Stavropolneftegas Sakhalinmorneftegas Severnaya Neft Krasnodarneftegas Vankorneft Polar Lights Grozneftegas Verkhnechonskneftegas Udmurtneft Tuapse refinery Komsomolsk refinery

APPENDIX 3: DYNAMICS OF ROSNEFT OIL PRODUCTION, 1990 – 2005
(UNIT: MILLION TONS)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Rosneft	18	16.7	15.2	14	12.9	12.8	12.5	12.1	11.9	12.6	13.4	15.1	16.1	20.1	21.6	74.4
Including:																
Purneftegas	11.7	10.8	9.8	9.4	8.4	8.4	8.4	8.3	8.2	8.1	8.9	9.6	9.9	9.8	9.6	9.4
Sakhalinm-orneftegas	1.9	1.8	1.6	1.5	1.5	1.5	1.4	1.6	1.5	1.4	1.4	1.4	1.5	1.6	1.8	1.8
Yugan-skneftegas	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	51.2

APPENDIX 4: BOARD OF DIRECTORS OF ROSNEFT

<p>Igor Sechin BoD Chairman; Deputy Head of the RF President Administration, Aide of the RF President</p>
<p>Sergei Bogdanchikov President of Rosneft</p>
<p>Hans Jorg Rudloff Chairman of the Audit Committee of Rosneft; Management Board Chairman of Barclays Capital</p>
<p>Andrei Kostin Chairman of the Personnel and Remuneration Committee of Rosneft; President-Management Board Chairman of Vneshtorgbank</p>
<p>Alexander Nekipelov Chairman of the Strategic Planning Committee of Rosneft; Vice-President of the RF Academy of Sciences</p>
<p>Kirill Androsov Deputy Minister of Economic Development and Trade</p>
<p>Sergei Naryshkin Deputy BoD Chairman; Head of the Apparatus of the RF Government</p>
<p>Gleb Nikitin Head of Department of the Federal Property Agency</p>
<p>Andrei Reus Deputy Minister of Industry and Energy</p>

APPENDIX 5: ROSNEFT'S ORGANIZATIONAL CHART

ROSNEFT			
Upstream		Downstream	
Projects	Exploration and Production	Refineries	Petroleum Product Distributors
Sakhalin-5	RN-Yuganskneftegas	RN-Komsomolsk Refinery	RN-Nakhodkanefteproduct
Sakhalin-4	RN-Purneftegas	RN-Tuapse Refinery	RN-Vostoknefteproduct
Sakhalin-3	RN-Severnaya Neft	MZ Nefteproduct	RN-Arkhangelsknefteproduct
Vankor block of fields	RN-Sakhalinmorneftegas		Smolensknefteproduct
West-Kamchatka shelf	Sakhalin-1		Murmansknefteproduct
Kazakhstan	RN-Krasnodarneftegas		Kubannefteproduct
Tuapse depression	RN-Stavropolneftegas		RN-Tuapsenefteproduct
Temryuksko-Akhtarskiy plot	Grozneftegas		Stavropoliye
Vostochno-Sugdinskiy plot	Polar Lights		Kabardino-Balkar Fuel Company
Algiers	Vankorneft		Karachaevo-Cherkessknefteproduct
	Verkhnechonskneftegas		Artag
	Udmurtneft		Altainefteproduct
			Kurgannefteproduct
			Yamalnefteproduct

APPENDIX 6: RESULTS OF PUBLIC OPINION POLLS

TABLE A: WHAT 3-4 OUT OF THE FOLLOWING DIRECTIONS OF THE GOVERNMENT'S ACTIVITIES ARE THE MOST IMPORTANT NOW?

Options of answers	1998	2000	2001	2002	2003	2004	2005
1.Economic growth	51	61	52	46	47	46	51
2.Social orientation of reforms in the country	30	30	30	29	32	32	42
3. Return to the state regulation of economy	24	31	28	32	27	27	30
4. Repayment of wage and pension debts	51	36	35	31	28	32	30
5. State support to the basic industries of economy	22	26	22	25	26	27	29
6. Decrease of fiscal burden on individuals and legal entities	23	27	23	27	28	27	26
7. Revision of privatization of major state companies	20	25	22	27	28	23	26
8. Incentives to private activities, credits to fledgling entrepreneurs	13	12	14	17	14	17	15
9. Reduction of influence of natural monopolies and new financial and industrial groups on the life of the country	8	10	10	13	13	11	13
10. Improvement of tax collection	13	19	14	12	8	12	12
11. Closure of loss-making enterprises	8	13	11	12	9	11	10
12. Deepening of reforms, strengthening of the private capital positions	8	10	9	11	9	14	10
13. Continuation of privatization, private ownership on land	7	8	8	9	6	8	7
Other	1	1	1	2	3	4	4
Did not know what to answer	5	6	11	6	7	6	7

(Source: www.levada.ru/press/2005092901.html)

TABLE B: IS FOREIGN INVOLVEMENT IN STRATEGIC SECTORS OF RUSSIAN ECONOMY ACCEPTABLE?

Sector	Acceptable without limitations	Not more than 50%	Not more than 25%	Not acceptable at all	Index of sector openness
Car manufacturing	15.84	26.11	20.23	29.43	33.55
Trade, advertising, marketing	11.52	24.86	26.3	27.24	30.53
Construction	10.64	24.48	25.61	31.37	29.29
Transportation	9.27	22.98	26.24	33.25	27.32
Communications	6.95	20.16	24.17	39.39	23.07
Food industry	7.01	19.79	23.04	41.52	22.67
Agriculture	8.52	16.28	20.41	46.09	21.76
Banks, investment and insurance companies	6.57	17.78	24.42	38.89	21.57
Aircraft manufacturing	5.51	13.78	19.91	51.47	17.38
Forestry	3.07	6.45	14.9	66.81	10.02
Power generation	2.38	7.2	15.47	66.06	9.85
Mineral production (except oil and gas)	2.5	7.26	14.53	67.13	9.77
Oil industry	2.38	7.26	13.21	68.44	9.31
Gas industry	1.88	7.2	13.59	68.69	8.88
Defense sector	2.19	3.57	6.32	79.96	5.56

(Source: Vedomosti, 29.08.05)