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BP's Fickle Russian Bride Better Than No Bride

By Matthew Hulbert

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BP has not had a good 2011 so far. One year after securing Macondo in the Gulf of Mexico, the ailing oil giant has failed to seal a signature deal with Rosneft that would have boosted its reserves and long-term production outlook. Considering the whirlwind choreography of the proposed wedding with the attractive Russian bride, BP's failure to broker an amicable divorce from its TNK partners comes as a disappointment. Two years ago, Robert Dudley, then head of BP's operations in Russia, was chased out of the country after he also locked horns with the TNK partners.

In January, Dudley sat down with Rosneft president Eduard Khudainatov to sign the world's first-ever equity alliance between a national and international oil company. But the oligarchs behind TNK-BP not only stopped BP and Rosneft from walking down the aisle, they also forced Deputy Prime Minister Igor Sechin to backtrack. As the deadline for the share swap agreement has lapsed, BP's affair with Rosneft is hanging by the thinnest of vows. Nonetheless, it is still hanging.

BP knows better than anybody that doing business in Russia is no bed of roses. As embarrassing as recent headlines may seem, the embattled giant would have been foolish to not discount the political risk associated with a rare chance to up the game and deal directly with the Kremlin rather than keep walking the TNK-BP tightrope. BP has long hinted that it considered Rosneft a better long-term partner for its Russian operations than its erratic partnership with AAR, which represents the TNK partners.

There is no doubt that Rosneft's refusal to extend the May 16 dateline to conclude the $16 billion deal is a major setback for BP. But as anyone familiar with merger and acquisition deals knows, deadlines come and go. The British company still has a small window of opportunity to act before Moscow starts looking for a new suitor. If anything, the game has just got more serious. BP has to decide whether the brinkmanship is worth it or whether it's time to cut losses. Either way, it's going to be costly to restore BP's market credibility.

TNK-BP accounts for one-fifth of BP's reserves and a quarter of its production. Since 2003, the company has pulled in $16 billion in earnings from a $9 billion investment. Depending on what criteria you use in terms of production, reserves, discounted cash flows and earnings, that equates to a price tag of $32 billion to $68 billion. Including markups, this is well beyond BP's last floor-price offer of $32 billion and a serious chunk of change, particularly when you consider BP is still facing huge legal bills in the United States.

The real price band depends on how much BP is willing to pay for operational freedom in Russia. The company still has about $13 billion of disposals flagged from Macondo. It could look to Moscow for a contribution or indeed tap Middle Eastern and Asian pockets as a Plan C. Each option has clear downsides, but once you add in the "political discount" of helping the Kremlin make Russia look like a good place to do business, then the deal looks better than its detractors would have it. Breaking the TNK shackles will be as costly as it is necessary.

For many, this will still sound like a long shot, at least as long as AAR stubbornly refuses to sell out and the Kremlin insists that it doesn't want to let TNK in on the Rosneft act. But amid all the smoke and mirrors, business can still be done, provided BP is willing to up the ante in terms of commercial and political punch.

More important, even if the Rosneft nuptials are called off and BP never makes it to the altar, Dudley's overall rationale remains evidently sound. The biggest threat facing global oil companies today is not being caught politically offside now and again with the wrong partner, but not raising the stakes in the upstream game in the first place. Any oil major that doesn't understand that won't last very long in today's environment. Having drifted downstream and dabbled in renewables, large oil companies must get back to what they know best: exploration and production. They have to bend the harsh frontiers of technological and political viability. That's where the juiciest finds, highest returns and political sway will be found. It's also where political risk can be balanced between old and new production streams.

BP's mistake was that it was too hasty in trying to shed its past with TNK-BP in favor of a future with Rosneft. BP knew that its new Russian venture would come with a major price tag. But it clearly counted on the Kremlin to make AAR yield. No one expected Sechin's stumble, and the fact that TNK's top guns, Mikhail Fridman and German Khan, had to turn to a London-based arbitration court to seek a first injunction suggests it was a close call. But

Dudley of all people should have known that the people behind AAR are masters at their game.

Rosneft still needs BP's access to capital, technology, experience and human resources to bring the Arctic reserves online. London might still greet Dudley with a standing ovation, and politicians might admit that arranged marriages have considerable merit. In any case, upstream options remain inherently limited elsewhere, and a difficult bride is better than no bride at all.

In short, upstream prizes have never been more lucrative than they are today, but getting there — let alone staying there — is not for the fainthearted. BP was strategically wise but tactically stupid. It's too early to classify the deal as annulled, but expect BP and other oil majors to keep going upstream in search of new partners. This could well mean that Shell, Total and ExxonMobil will soon be knocking on the Kremlin's door, but the question is whether they are as ready and willing as BP to accept that going upstream and national is the way of the future.

Don't be too surprised if Beijing proves to be the next groom walking down the Russian aisle. Political risk, price and contractual wrangling aren't core concerns for Beijing, but long-term security of supply certainly is. Who knows, PetroChina might even decide that BP would make for an attractive groomsman.

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