

When Global Oil Giants Dance With the Kremlin

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BP's hopes to partner with Rosneft in exploring the Arctic and producing lots of oil for decades to come were dashed this week after the Russian state-owned oil major signed off on a \$3.2 billion exploration joint venture with ExxonMobil. All this makes for great headlines, but what does the drama say about Russia's investment climate?

The deal was a coup for ExxonMobil and a disaster for BP, for whom the writing is on the wall after court marshals raided its Moscow office on the day after the Exxon-Rosneft announcement. One of the minority shareholders in BP's joint venture with TNK is suing for a reported \$3 billion in compensation for the failed BP-Rosneft tie-up.

Regarding the BP lawsuit, the chances that the minority shareholders at TNK will win the case seem slim. If the courts rule that shareholders can be paid compensation for a deal that doesn't go through, then every business in the country would end up suing every other for promised deals that didn't happen.

More poignantly, the case is bad news for BP because the company could well face the legal runaround that is the hallmark of Russian shareholder disputes. The warning sign is that the orders to search BP's office come from a court in Tyumen. As Norwegian telecom firm Telenor found when it was in dispute with TNK-BP shareholder Mikhail Fridman, lawsuits initiated in regional courts are a perpetual motion machine. As soon as you defeat one lawsuit, another one appears in another region — and sometimes in less than 12 hours, giving you no chance to act on the previous ruling.

The case and the deal highlight the dangers of doing business at the very top levels in Russia, where the process is highly political. BP CEO Bob Dudley, who once headed the TNK-BP joint venture, understood this very well. But he made the fatal error of trying to put that knowledge into practice, playing politics with Rosneft and his Russian partners in TNK-BP.

Everyone knew from the start that there was going to be a problem with the BP-Rosneft deal because of the TNK-BP shareholders agreement giving TNK exclusive rights to work with BP on Russia projects. But it seems that Dudley ignored this problem, assuming that Rosneft could find a fix. In other words, he tried to do business “the Russian way,” relying on the power of the Kremlin to override the legitimacy of the courts. But it didn't work. Instead of allying with Deputy Prime Minister Igor Sechin, then-chairman of Rosneft, BP found itself crushed between the Kremlin and the most powerful oligarchs in Russia. You have to wonder whether Sechin engineered the whole fiasco because clearly someone promised Dudley that TNK-BP's objections to the deal were not going to be a problem.

This story highlights that although global oil majors are dinosaurs with sharp claws, they are unable to resist the changing climate that will eventually kill them. During their heyday in the 1970s and 1980s, the oil multinationals went to dirt-poor countries and invested billions of dollars that local governments didn't have to extract oil, paying the owners of the assets a pittance in royalties. In the last 20 years, many of these countries have gotten their act together and set up domestic producers like Rosneft and Brazil's Petrobras to keep 100 percent of the oil revenues at home. The reaction of these multinationals has been to bulk up, hence their Soviet-esque compound names following a string of mergers.

But this process is coming to an end. Despite its problems, much of the oil that BP produces comes from Russia, and it is getting increasingly difficult to diversify as fewer and fewer countries need the multinationals' services. The key aspect of this particular deal is that it is focused on exploring the Arctic, where Rosneft simply doesn't have the technology to drill wells. The same is true with the other big oil and gas projects where foreigners are involved — for example, the Shtokman gas field at the bottom of the Bering Strait off Russia's north coast. You can be sure that no foreigners will be invited to exploit the easy-to-reach oil assumed to lie under Eastern Siberia.

Many commentators are quick to conclude that BP's fiasco highlights just how hard it is to do business in Russia. But this is not necessarily the case. Compare the original TNK-BP tie-up with the deal struck this week. Then-President Putin traveled to London in 2003 to stand next to British Prime Minister Tony Blair and announce the deal on the floor of the House of Commons. This was sold very much as Putin's personal triumph as it was a government-to-government deal. Fridman stood in the background against the wall while Putin basked in the limelight.

But those were the days when Russia was desperate to get anyone to invest anything in the economy. The state was even offering production-sharing agreements that have since been abandoned. This time around, however, when the Kremlin tries to cut a deal with one multinational, it blows up. Then Sechin simply moves to the next person in line, presumably securing better terms, as he implied in comments after the Exxon-Rosneft deal was signed Tuesday.

The structure of the ExxonMobil deal is entirely different from the TNK-BP deal, a 50-50 split that was bound to cause problems when no one side is clearly in charge. The Exxon-Rosneft deal calls for the establishment of a joint Arctic research and design center for offshore development in St. Petersburg to explore the Kara and Black seas for untapped oil and gas reserves. Rosneft will hold a 66.7 percent interest and ExxonMobil a 33.3 percent interest in both those ventures with a total capitalization of \$3.2 billion. Rosneft will also get some of Exxon's offshore oil fields in Texas and the Gulf of Mexico, as well as access to badly needed technological know-how.

Given that Putin said total investments into the project could reach a "scary" \$500 billion, the upshot is that Exxon will have to raise most of the money, do most of the work and give up part of its international assets in return for one-third of the royalties, which won't be forthcoming for about two decades.

But the biggest difference between the two deals is that the Exxon-Rosneft agreement is being sold as a commercial deal with a state-owned company that has strategic importance for Russia, whereas the TNK-BP merger was sold as a political deal between private companies that was at the end of the day a money-making exercise.

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