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BP Is Moving Forward, Not Stepping Down

By James Beadle

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The timing of the latest bout of tension in the TNK-BP partnership is surely no accident. It comes immediately after the switch of Russia's ruling tandem and the announcement of seismic shifts in ministerial and state company control. Sector analysts continue to mull over the outcomes, but BP's adventures in Russia have always been something of a "canary in the coal mine," shedding light on the country's investment environment.

What does the current turmoil tell us about Russia's evolving investment prospects?

Many global companies have engaged in the Russian market since the fall of communism, but few have shed as much light on the country's investment climate as BP. Media headlines have mostly focused on the negatives, and there have been many. Yet, while these negatives provide interesting insights into the challenges inherent in the Russian business environment, positives have been ignored: BP has extracted $18 billion of dividends from its Russian partnership and stands to exit at more than four times its initial investment level.

An internal rate of return in the region of 30 percent is not bad for a nine-year project. Its participation has also benefited Russia, as skills and technological know-how have completely revitalized TNK's business.

Much of the turmoil has been caused by strategic divergences. The Russian partners were happy with the progress of their existing operation but wanted to expand internationally because of the lack of new opportunities in Russia. BP, of course, has a large global footprint and wanted TNK-BP to focus on developing its core assets in Russia. Over the years, there have been many missteps by both parties, and the relationship has deteriorated. The risks have been clear, but the rewards have also been high. Why would BP exit now?

The Russian energy sector is currently undergoing a major shift. As it does so, the opportunities for further growth that fit BP's skill set are elsewhere and managed by other companies. Predominantly, they are offshore and in the Arctic region. At present, BP is unable to participate in these projects without using the TNK-BP structure, but it is BP's core strengths that will be of value, not the competencies it has built up in TNK-BP.

The reality, then, is that BP has outgrown TNK-BP. It took a struggling post-Soviet operation and turned it into a more efficient and profitable enterprise. Now it wants to exit the venture at a fair market price, locking in its gains and moving on to create value in other areas. This is a standard corporate behavior and fits well with investor interests in transparent, well-managed companies. Exiting the joint venture would not represent a step down, but a move forward.

The owners of AAR also stand to benefit from this move. Their troubled relationship with BP has contributed to higher risk premiums that have suppressed the value of Russian assets. As previously mentioned, the lack of strategic direction has also inhibited their ability to develop the business as they would like. It is probable that a new shareholder structure would allow them to acquire the marginal stake necessary to prevent the recurrence of recent problems. What's more, the partnership agreement gives them de facto veto power over replacement owners, so they will be able to filter prospective bidders to find a partner with a common vision.

Rosneft may also benefit, even if it does not become the new partner with AAR. The company has repeatedly shown interest in buying into the joint venture but has not confirmed that it is bidding at present. Rather, the benefits to Rosneft would come elsewhere, perhaps in gaining BP as a partner for developing complex and technologically challenging projects in remote areas.

Russia as a whole would benefit as well. For years, the 50-50 joint venture between BP and AAR has been a thorn in the side of the country's investment reputation. Direct government intervention would certainly have upset the country's fragile balance of power, harming either the largest foreign investor or one of the country's most powerful business groups. The state maintained a hands-off approach, leaving the two owners to fight it out. But this put the country's weak institutional framework and underhanded corporate negotiating tactics on newspaper front pages around the world. If BP and AAR can finally divorce, these issues will cease to attract such negative attention. More significant, future corporate partnerships — particularly in the strategically important energy sector — will surely come

with clearer ownership control structures, protecting them from such complications.

It is not so much that Russia will become a more open and transparent place to do business, but the 50-50 agreement, which was once such a shining example, has become an anachronistic burden. It gives rise to problems that other foreign investors don't face.

In that sense, a divorce is arguably good news for investors, too. The joint venture has provided an informative expose of how businesses can clash in Russia, but the corollary tale of improved operations and huge profits came in a pale second to the gripping battle for strategic direction. Russia is a high-risk, high-return market, but the issues at TNK-BP shed excessive light on only one side of the coin.

The rules in Russia are constantly being challenged and developed. Despite the acrimonious disputes it has unleashed, the TNK-BP relationship contributed much to both its owners and the nation's development. Its troubled ending represents the beginning of a new era rather than a downshift in the country's investment climate.

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