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### **BP, Russian billionaires, and the Kremlin: a Power Triangle that never was**

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The year 2011 will go down in global corporate history as the year when one of the world's largest energy companies, BP, and the Russian state company, Rosneft, unsuccessfully attempted to form a strategic partnership on Arctic development. This failure was caused by the contractual and legal objections of the AAR consortium – BP's partners in the Russian oil company TNK–BP. In 2003–5, BP and the AAR consortium led by three billionaires with Russian connections - Mikhail Fridman, Len Blavatnik, and Viktor Vekselberg – merged their Russian oil corporate assets – TNK, Sidanko, and Onako and their subsidiaries – under the umbrella of TNK–BP.<sup>2</sup> This joint venture was established on a 50/50 basis, the operation of which required mutual joint decision making. The partners also signed a shareholding agreement on TNK–BP's right of first refusal in relation to potential future oil and gas projects offered to BP or AAR in Russia and Ukraine. This agreement was subsequently used by AAR to stop the BP–Rosneft deal in international courts.

Unfortunately, this was not the first time that BP had been unable to change the way it conducted its business in Russia. The first example occurred in 2007-8 when BP was reported to be keen on having Gazprom as a partner instead of AAR. This move would have transformed the TNK–BP joint venture into Gazprom–BP. This did not transpire. Second, in the spring-summer 2008, there was a turbulent 'misunderstanding' between BP and AAR, over the corporate governance and future strategy of their joint venture. This led to the removal of Robert Dudley from the helm

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<sup>2</sup> See next footnote.



of TNK–BP, and an exodus of BP personnel from Russia. In January 2011 Mr. Dudley, as the new head of BP, tried to form an alliance with Rosneft which was to collapse only a few months later. In August 2011 Rosneft found another foreign partner for its Arctic operations – ExxonMobil.

One may argue that it is easy to take a retrospective view of BP’s problems in Russia. However, this Comment reveals that the ever evolving politics of the Kremlin and the motives of key decision makers in Moscow and of BP’s own corporate partners in Russia – the AAR consortium – have been at the heart of the testing events in BP’s Russian operations.

Understanding the Russian political system can be a challenging and daunting task, since it is very different to those of Western democracies with their long histories of free elections and multi-party systems, developed civil society, and an established middle class. The weakness of these institutions in Russia results in a situation where relations between administrative and industrial elites become the main political and economic arena in the country. A super-presidential system of government has been another key characteristic of this political system, in which the survival and success of political and economic elites is based on privileged personal contacts with the chief executive.

Consequently, competition between corporate actors is focused on the level of their access to the president or prime minister. Naturally, such a system lacks an institutionalized mechanism for the succession of political power and transparent interactions between economic and political players. As a result, there is potential for inter-elite conflict, where the political and economic fortunes of financial–industrial groups can be turned overnight.

This Comment, therefore, explores BP’s recent problems in Russia through one fundamental question: Why has the Kremlin always opted out of backing BP, either in its bid to have a state-controlled company (Gazprom or Rosneft) as its main partner in Russia, or in BP’s corporate conflicts with the AAR consortium? The answer to this question lies in three areas:

- the Kremlin’s views on the role that Russian state and private companies should play in the domestic energy sector and abroad;
- the Kremlin’s preoccupation with maintaining political and economic stability within the country and ensuring the status quo between the key economic players;
- the unique character and position of the AAR consortium in Russia and abroad.



## *TNK–BP and the Changing Times*

On 2 February 2003, BP reached the pinnacle of its involvement in the Russian oil sector when it signed an agreement to form the TNK–BP joint venture with the AAR consortium of three companies with Russian connections, Alfa Group, Access Industries, and Renova.<sup>3</sup> The ‘corporate marriage’ between BP and AAR turned TNK–BP into the third largest oil producer in Russia and catapulted the joint venture into the top ten of the world’s largest private oil companies (see insert **TNK–BP**). It seemed that in BP, the AAR consortium had found an important foreign partner with highly ranked technological and management skills, as well as access to the international finance which was vital for the corporate growth of TNK–BP. At the same time, AAR may have appealed to BP as a consortium of powerful Russian entrepreneurs with excellent political connections and notable corporate assets of great potential.

However, the relationship between the parties involved in TNK–BP appeared to start becoming strained during a period of political change in Moscow. TNK–BP was established during the transition between two eras in Russia, when the era of considerable influence of Russian oligarchs in domestic political and economic affairs was coming to its end, and while an era of greater state involvement in the energy sector was already on the horizon. In February 2003, Russia’s President Vladimir Putin and Britain’s Prime Minister Tony Blair blessed BP’s joint venture with the AAR billionaire consortium. By the end of the same year Mikhail Khodorkovsky, Russia’s richest billionaire, found himself in prison facing tax evasion charges. Khodorkovsky’s imprisonment dashed his hopes of repeating AAR’s success on a much bigger scale – by merging his oil company Yukos with that of Roman Abramovich’s Sibneft, while simultaneously offering a large stake in the newly merged Yukos–Sibneft corporation to ExxonMobil or ConocoPhillips. The Khodorkovsky affair has often been viewed as signalling not only the political demise of prominent billionaires in Russia, but also their forthcoming economic downfall.

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<sup>3</sup> The formation of TNK–BP was finalized on 29 August 2003. For its 50% share in TNK–BP, AAR contributed its 100% stake in TNK Industrial Holdings Limited, a company with 100% control over TNK–BP International Limited. The latter owned 96.1 % in OAO Tyumen Oil Company (TNK) and 100% in Sbarsare Management Limited, which controlled 68% in OAO Sidanco. For its 50% share in TNK–BP, BP plc contributed its 29.6% share in Sidanco, 33.4% in OAO Rusia Petroleum, 75% in BP Moscow Retail (or BP Retail Assets), and made a direct payment to AAR in cash and BP shares over three years. In 2005, TNK–BP completed a corporate restructuring programme. As a result, in December 2005, OAO TNK–BP Holding (TBH), a newly created holding company and a subsidiary of a British Virgin Islands’ company, TNK–BP Limited, took over TNK–BP’s key holding companies in Russia – TNK, Sidanco, and ONAKO. As part of the restructuring programme, TBH issued approximately 5% of its shares to the minority shareholders in these Russian entities. TNK–BP’s equity interests in OAO NGK Slavneft, OAO Rusia Petroleum, OAO East Siberian Gas Company, the BP Retail Assets, and its Ukrainian companies were kept outside of TBH. See: TNK–BP Holding company reports.



***TNK–BP***

(including its subsidiaries)

- One of the world's top ten private oil producers;
- Russia's third largest oil producer after Rosneft and Lukoil;
- 16% share in Russia's oil output;
- Production (Jan.–June 2011): 1.76 million barrels of oil equivalent per day;
- Proven reserves: 13.1 billion barrels of oil equivalent;
- Refining throughput: 761 million barrels a day;
- Annual net income: \$5.2–5.8 billion in 2008–10 and \$6.8 billion in January–Sept. 2011;
- Exposure to nearly all of Russia's major hydrocarbon regions, including west Siberia (Tyumen, Khanty-Mansiysk, Yamal-Nenetsk, and Novosibirsk Regions); the Volga–Urals (Orenburg and Saratov Regions), and east Siberia (Irkutsk Region).

Source: Company reports. It should be noted that Slavneft's performance figures are often excluded from TNK–BP's statistical data due to the fact that TNK–BP's 50 per cent ownership in Slavneft is managed independently and hence is treated as a separate entity.<sup>4</sup>

The demise of the politically active Russian oligarchs Khodorokovsky, Berezovsky, and Gusinsky during Vladimir Putin's first presidential term (2000–4) may have sent a false message to foreign investors about the decline of Russian billionaires' influence in Russia, implying that cooperation with them should be abandoned as soon as possible in favour of the state champions Gazprom or Rosneft. Naturally, in the course of these events any international oil company (IOC) with a big exposure in Russia would be preoccupied with the question of how to ensure its long-term success in the country's energy sector and to protect its already invested financial resources. In this context, an IOC would view Russia's state energy champions as safer business partners than a private Russian corporation. At the same time, some foreign investors assumed that in those changing political times its Russian billionaire partners would be happy to sell their energy assets to the state champions. For example, Roman Abramovich did not appear to have second thoughts when he was presented with an opportunity to sell his oil company Sibneft (originally obtained for just over \$100 million) to Gazprom for \$13.1 billion in September 2005.

However, in the case of the Russian share in TNK–BP, the story turned out differently from that of Abramovich's Sibneft. As highlighted later in this Comment, Gazprom would not have been allowed to buy 50 per cent in TNK–BP from AAR in any case, while Rosneft could not really have afforded it. Moreover, in BP's potential deals with Gazprom and Rosneft it was AAR that appeared to be 'calling the shots', not the state champions or the British IOC. Both AAR's unique character and its position in Russia and abroad have contributed to the fact that the billionaires' consortium did not need to fear the growing state presence in the Russian energy sector, or being forced to sell their share in TNK–BP to Gazprom or Rosneft.

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<sup>4</sup> Slavneft was established in 1994 and was privatized in 2002 under the parity ownership of TNK and Sibneft (later Gazprom Neft). In 2004, AAR transferred its share of Slavneft to TNK–BP. In 2010 Slavneft produced 18.4 million tons of oil, 851.9 million cubic metres of gas, and 22.9 million tons of refined products.



## *AAR – the Potential of BP’s Partner in Russia*

When BP formed an alliance with the Alfa–Access–Renova consortium in 2003, it secured the support of a powerful and unique private corporate partner for its upstream operations in Russia. AAR seemed to stand out amongst other domestic corporate groups for several reasons:

- AAR’s internal corporate composition was unlike any other in Russia;
- AAR was one of the very few Russian corporate groups with control over a highly lucrative oil asset – Tyumenskaya neftyanaya kompaniya (Tyumen Oil Company) or TNK in short;
- The billionaires’ consortium had traditionally enjoyed excellent communications channels with the Kremlin, while never challenging those in power;
- Top corporate executives from AAR (Alfa Bank, in particular) had often moved up to high positions in the Russian government;
- AAR sought to turn its joint venture with BP into a Western company, one which based its operations on international legal standards.

The AAR consortium has always been very different in comparison to its Russian counterparts. To begin with, AAR is owned by entrepreneurs with perhaps the most diversified investment portfolio among any Russian corporate players (see insert **AAR consortium**). The AAR partners also appear to be decidedly international in terms of their assets and country affiliations, with Len Blavatnik being a US citizen and Viktor Vekselberg becoming a Swiss resident in 2004. AAR’s highly diversified portfolio and its international nature not only distinguished them from other Russian billionaires, but also ensured that their assets would not be an easy target for state intervention.

At the same time, Mikhail Fridman, Viktor Vekselberg, and Len Blavatnik have not appeared as political challengers to Vladimir Putin, unlike the other trio of billionaires – Mikhail Khodorkovsky, Boris Berezovsky, and Vladimir Gusinsky. Moreover, Peter Aven, Mikhail Fridman’s key business partner in Alfa Group, has known Vladimir Putin since 1991 when Aven was Russia’s Minister for External Economic Relations and Putin was Aven’s counterpart in the Mayor’s Office in St Petersburg. Interactions between Peter Aven and Vladimir Putin were bound to be intensive due to the key role that St Petersburg has traditionally played as Russia’s gateway to European and international markets. The careers of some prominent Russian government officials have been built in the corridors of Mikhail Fridman’s Alfa Bank. One example is Alfa Bank’s former Deputy Board Chairman Vladislav Surkov who, since becoming the Deputy Head of Russian presidential administration in August 1999, has been widely perceived as the Kremlin’s key ideologist and political manager.





### **Alfa-Access-Renova (AAR) consortium**

ALFA GROUP (25% in TNK–BP) is a Russian financial–industrial group established by Mikhail Fridman, German Khan, and Alexey Kuzmitchev in 1989. Alfa’s main interests are in the financial sector, oil and gas, telecommunications, retail trade, and water services. Alfa Group’s key assets involve one of Russia’s largest banking houses, Alfa-Bank Russia, with financial subsidiaries in the Ukraine, Belarus, Kazakhstan, and the Netherlands, as well as important stakes in the telecommunication companies VimpelCom, MegaFon, Turkcell, and the Russian supermarket chains, Pyaterochka, Perekrestok, Kopeyka, and Karusel. Mikhail Fridman appears to play a leading role in the AAR consortium, having orchestrated the formation of TNK–BP in 2003.

ACCESS INDUSTRIES (12.5% in TNK–BP) was founded by an American industrialist, Len Blavatnik, in 1986. His company’s interests spread across continents, including the USA, Europe, and South America and involve diversified investments in natural resources and chemicals, media and telecommunications, real estate, technology, and retail. Apart from stakes in the two Russian companies, TNK–BP and Rusal (Russian Aluminium), Access Industries has other important assets which include a large share in the world’s third-largest independent chemical company, LyondellBasell and a recent purchase of the iconic Warner Music Group.

RENOVA (12.5% in TNK–BP) was established by a Russian academic turned entrepreneur, Viktor Vekselberg, in 1990. Today Renova has a diversified investment portfolio encompassing the energy sector, utilities, mining, machine building, construction, telecommunications, nanotechnologies, chemical industry, precious metals, and the financial sector. Renova is particularly active in Russia, Switzerland, Italy, South Africa, the Ukraine, Latvia, Kyrgyzstan, and Mongolia. Renova’s important assets incorporate stakes in TNK–BP, UC Rusal, Integrated Energy Systems, Oerlikon, and Sulzer.

Source: Company reports, *Financial Times*, *Wall Street Journal*.

Employees of Renova and Access Industries have not displayed the same level of career movement between their employer and the Russian government as those from Alfa Group. Vekselberg, however, seems to enjoy good relations with the Kremlin, having been appointed Russia’s presidential envoy responsible for economic modernization at Skolkovo – a Russian start-up equivalent to the USA’s Silicon Valley.<sup>5</sup> Vekselberg’s university friend Len Blavatnik, as an American citizen, has never shown much interest in Russian politics. However, he appears to have been particularly valued within the AAR consortium for his acute business sense as a Harvard Business School graduate and for his success as an American entrepreneur prior to the commercial opportunities unleashed by Gorbachev’s economic reforms.<sup>6</sup>

Therefore, AAR appears to possess not only a strong entrepreneurial drive, a good grasp of the Russian political and economic system, and Western ways of doing

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<sup>5</sup> Irina Malkova, Sergey Smirnov, ‘Medvedev naznachil Veksel’berga otvetsvennym za Kremnivuyu dolinu’ (Medvedev makes Vekselberg responsible for the [Russian] Silicon Valley), *Vedomosti*, 23 March 2010.

<sup>6</sup> In 1987, Vekselberg went into business and invited Len Blavatnik, an already successful American entrepreneur, to cash in on newly presented opportunities. In October 2011 *Forbes Magazine* named Len Blavatnik, who emigrated from the Soviet Union to the USA in 1978, as the most successful global investor of Russian origin. See: ‘50 Russians who conquered the world’, *Forbes-Russia*, October 2011, [www.forbes.ru/rating/ekonomika-package/lyudi/75416-50-russkih-zavoevavshih-mir-novyi-reiting-forbes](http://www.forbes.ru/rating/ekonomika-package/lyudi/75416-50-russkih-zavoevavshih-mir-novyi-reiting-forbes); ‘Forbes Gives 50 Reasons to Stay in Russia’, *The Moscow Times*, 25 October 2011, [www.themoscowtimes.com/news/article/forbes-gives-50-reasons-to-stay-in-russia/446183.html](http://www.themoscowtimes.com/news/article/forbes-gives-50-reasons-to-stay-in-russia/446183.html)



business (including the use of Western contracts), but has also enjoyed excellent communication channels with the Kremlin. Therefore, it is unsurprising that the rise of Gazprom and Rosneft did not shake AAR's position in Russia. In fact, the Kremlin has always recognized AAR's unique role in the Russian oil sector. In 2003, TNK–BP was blessed by Vladimir Putin as the only Russian joint venture to be allowed to form a partnership with an IOC with a foreign stake larger than 49 per cent. Since then TNK–BP has been a showcase of what Russian billionaires could achieve if they didn't challenge those in power. The alternative scenario is also well known.

### ***From TNK–BP to Gazprom–BP: Mission Impossible?***

In 2007 BP was alleged to have initiated negotiations with the Russian gas monopoly, Gazprom, over the replacement of AAR with Gazprom in the TNK–BP venture.<sup>7</sup> Apart from the political decline of Russian oligarchs, there seemed to be other important reasons driving BP towards a strategic partnership with Gazprom. In 2006 Gazprom was made responsible for all exports of gas from Russia's east Siberian fields, including Kovykta – one of TNK–BP's important gas assets.<sup>8</sup> The field is located close to Asian gas markets and contains over 2 trillion cubic metres of gas. Therefore, the successful commercial development of this field and export of its gas to Asia was impossible without Gazprom's involvement.<sup>9</sup> In June 2007, TNK–BP offered to sell its 63 per cent interest in the project to Gazprom for \$0.8–1 billion, with a buy back option of 25 per cent + one share.<sup>10</sup> However, the deal became stalled, and BP seems to have decided to seek a potential replacement of AAR with Gazprom in TNK–BP.

It was unlikely that Gazprom would have settled for less than a controlling stake in the joint venture. Therefore, the Russian gas monopoly would have needed to buy the entire AAR 50 per cent share, with an additional 1 per cent share from BP.<sup>11</sup>

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<sup>7</sup> First reports on the apparent negotiations between BP and Gazprom over the purchase of AAR's share in TNK–BP appeared in Russian media in May 2005, see: Dmitry Butrin *et al*, 'Dolevoi priem', *Kommersant*, 30 May 2005. However, any purchase of AAR's stake was not possible until 1 January 2008 due to the existing TNK–BP shareholders' moratorium on quitting the joint venture and/or selling their 50% share. On the 2007–8 negotiations see: Alida Smith, 'Gazprom wants oil and pushes for a bite of the TNK–BP apple', *FT Alphaville*, 24 April 2008; 'BP sklonyaet Gazprom k priobreteniyu doli AAR v TNK–BP' (BP encourages Gazprom to buy AAR's share in TNK–BP), *RBK Daily*, 25 June 2008; 'Gazprom mozhet kupit' dolyu v TNK–BP', *NewsRu*, 19 June 2008, [www.newsru.com/finance/10jun2008/tnkbezbp.html](http://www.newsru.com/finance/10jun2008/tnkbezbp.html); John Donovan, 'BP's Russian alliance with Gazprom put on ice', *Telegraph*, 5 September 2008, [www.telegraph.co.uk/money/main.jhtml?xml=/money/2008/09/05/cnbp105.xml](http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2008/09/05/cnbp105.xml); 'Gazprom priznal'sya v interese k TNK–BP' (Gazprom admits its interest in TNK–BP), <http://lenta.ru/news/2008/06/10/tnk1/index.htm>

<sup>8</sup> See: Jonathan Stern, *The Future of Russian Gas and Gazprom*, 152–9; James Henderson, *Non-Gazprom Gas Producers in Russia*, Oxford: Oxford Institute for Energy Studies, 2010, 151.

<sup>9</sup> Catherine Belton, 'TNK–BP under renewed Gazprom pressure', *Financial Times*, 23 April 2008.

<sup>10</sup> Henderson, *ibid*.

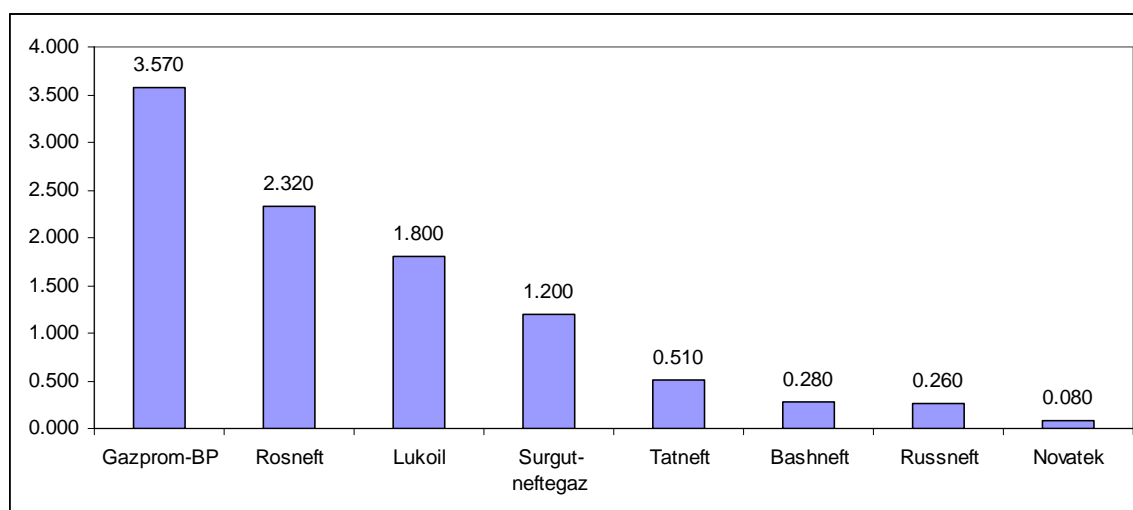
<sup>11</sup> Apart from purchasing AAR's 50% share in TNK–BP, Gazprom was also reported to be keen on securing up to 100% interest in other relevant corporate assets of BP and AAR, such as Slavneft. See: 'Khozyain nashel'sya. Gazprom prismatrivaetsya k Slavnefti', *Vedomosti*, 21 November 2005.



Although the transformation of the joint venture TNK–BP into Gazprom–BP made sense from a gas market point of view, the scenario of Gazprom becoming a major player in the Russian oil sector was bound to be impeded by the Russian prime minister, Vladimir Putin.

It was not only that the Russian government’s deputy prime minister Igor Sechin (Rosneft’s Board Chairman at that time) objected to the transformation of the TNK–BP venture into a Gazprom–BP partnership,<sup>12</sup> but having already acquired Roman Abramovich’s Sibneft (rebranded as Gazprom Neft), Gazprom’s further oil acquisitions undermined the existing prominence of Rosneft in the Russian oil sector (see Chart 1). Most importantly, the Gazprom–BP deal would have undermined the existing status quo between Gazprom and Rosneft as state energy champions responsible for their specific subsectors of the energy industry: gas and oil respectively. It would also have changed the existing political and economic balance between Gazprom and Rosneft, making Gazprom the only prominent energy company in the country.

**Chart 1: 2010 Scenario of liquids production by Russia’s leading oil and gas companies, mmb/d.**



Note: All figures are actual, apart from the hypothetical 2010 Gazprom–BP production, which is based on a scenario of Gazprom buying 51 per cent of TNK–BP in 2008. Estimated Gazprom–BP production represents the total volume of liquids produced by TNK–BP & affiliates (1.710 mmb/d), Gazprom (0.270 mmb/d) and its affiliate, Gazprom Neft (0.980 mmb/d) in 2010.

Source: Company reports, Bloomberg

Moreover, Gazprom’s increased prominence was bound to lead to discontent among Russian oil men and independent gas producers already wary of Gazprom’s monopolistic position in the gas sector. A possible Gazprom–BP partnership (with Gazprom retaining a 51 per cent controlling stake) would have increased the state

<sup>12</sup> Catherine Belton and Sylvia Pfeifer, ‘Putin ally delivers connects with the west’, *Financial Times*, 16 January 2011.





share in Russian oil production to over 50 per cent. The Kremlin was well aware of the potential implications this could have had on the investment climate and perceptions of Russia in the West, as well as on morale within the ranks of Russian oil men.

Vladimir Putin has always played a good and sensible balancing act between different corporate groups and their political backers within his own entourage. Therefore, a Gazprom–BP deal would have run counter to the very construction of the domestic energy and political system which Mr Putin built as Russia’s president in 2000–8 and wanted to remain stable under the interim presidency of Dmitry Medvedev.<sup>13</sup> In these circumstances, the Gazprom–BP joint venture was not going to gain Vladimir Putin’s approval.

Another important factor hindering BP’s partnership deal with Gazprom was that AAR did not appear to be interested in selling its prime asset – a 50 per cent share in TNK–BP. This highlights a significant difference between Roman Abramovich and the AAR billionaires: Abramovich always seemed keen on cashing in on his key asset, Sibneft, both in 1998 and in 2003 when Sibneft was to be merged with Yukos. AAR, on the contrary, has always hinted that TNK–BP is a long-term investment.<sup>14</sup>

Kovykta, the sale of which was announced in 2007, was sold by TNK–BP to Gazprom for \$700 million only in 2011.

### ***2007–8: the AAR–BP Corporate Clash***

The fierce stand-off between AAR and BP over the development of their Russian joint venture coincided with the alleged negotiations between BP and Gazprom over the replacement of AAR with the Russian gas monopoly in TNK–BP. However, the clash between AAR and BP was not primarily caused by Gazprom’s potential involvement in the joint venture, but was derived from some corporate governance issues and wider differences between the outward and inward strategies of AAR and BP. It is important to note that clashes of diverse corporate strategies within 50/50 joint ventures are not unusual, often complicating their operations.<sup>15</sup>

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<sup>13</sup> During Vladimir Putin’s first term in office the Kremlin looked at various scenarios of how to reconstruct the Russian hydrocarbon sector with greater state control and effective state capture of oil revenues. Some of these scenarios involved a merger between Gazprom and Rosneft, announced in 2004 and called off in 2005. Another unrealized idea included a potential merger between Rosneft and Surgutneftegaz. This merger was abandoned when the Yukos affair took place, with Rosneft subsequently acquiring Yukos’s key asset – Yuganskneftegaz. Subsequently, Vladimir Putin settled for Rosneft and Gazprom becoming the Kremlin’s two arms in their respective segments of the energy industry, with the state capturing oil revenues through increased taxation of the oil sector.

<sup>14</sup> See, for example: Il’ya Khrennikov, ‘Viktor Vekselberg. Milliardy obyazyvayut’, *Forbes-Russia*, 03 January 2007.

<sup>15</sup> For a thorough assessment of the challenges which joint ventures face, see: Jenik Radon, ‘Negotiating and Financing Joint Venture Abroad’, in N. Lacasse and L. Ferret (eds.), *Joint Ventures Abroad*, Montreal: Wilson & Lafleur Itee, 1989, 97–128.



One can assume that it would be natural for BP to attempt to increase its corporate presence in Russia, due to the country's ranking as a key non-OPEC oil producer and the world's largest gas exporter, which also controls almost 70 per cent of potential Arctic hydrocarbons.<sup>16</sup> From 2003 to 2008, TNK–BP benefited from BP's technical and management skills, which helped to increase the joint venture's hydrocarbon production by 30 per cent.<sup>17</sup> BP's apparent early strategy of focusing TNK–BP activities on Russian and CIS markets is therefore understandable.

However, in the eyes of AAR, BP appeared not only to have an upper hand in managing TNK–BP, but also seemed to treat the joint venture merely as its Russian regional subsidiary, focusing on projects within the former Soviet Union. AAR, on the contrary, wanted TNK–BP to become a global corporate player, not a regional one, with assets in the Middle East, North Africa, Latin America, Asia, and Europe. The Russian billionaires reportedly complained about BP constantly blocking their efforts to expand the joint venture's operations abroad. The most notable examples of this include AAR's unfulfilled 2003 deal to purchase four refineries from the Venezuelan national oil company PDVSA, its plans to get involved in Iraqi oil projects, and its plans to buy Yukos's former Lithuanian refinery, Mažeikių nafta, in 2006 (this was subsequently sold to Polish oil company, PKN Orlen). BP had its own reasons to rule out these deals – TNK–BP's involvement in Iraq appeared politically sensitive, while the asking price for the Lithuanian refinery seemed too high.

Nevertheless, BP's reluctance to allow expansion of TNK–BP's operations abroad began to receive bad publicity in Russia, where BP was portrayed as being afraid of international competition from TNK–BP, and was thus blocking the global aspirations of the Russian oil company with its 50 per cent foreign share.<sup>18</sup> One would, of course, assume that it would be against the commercial interests of BP to turn its Russian joint venture into a competitive IOC. Nevertheless, the Kremlin's stance on foreign expansion of Russian corporate entities represented an important factor strengthening AAR's argument in favour of the outward growth strategy, while undermining BP's inward focus on Russia and the CIS. On a number of occasions President Vladimir Putin encouraged Russian companies to go global by acquiring assets in other countries and continents.<sup>19</sup> BP's apparent resistance to TNK–BP's international reach was therefore beginning to be perceived in Russia as running against the country's national interests, and even against Vladimir Putin's Russian global corporate agenda.

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<sup>16</sup> See: S. M. Yenikeeff and T. F. Krysiak, 'The Battle for the Next Energy Frontier: The Russian Polar Expedition and the Future of Arctic Hydrocarbons', *Oxford Energy Comment*, August 2007, 2, available online: [www.oxfordenergy.org/wpcms/wp-content/uploads/2011/01/Aug2007-TheBattleforthenextenergyfrontier-ShamilYenikeeff-and-TimothyFentonKrysiak.pdf](http://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/01/Aug2007-TheBattleforthenextenergyfrontier-ShamilYenikeeff-and-TimothyFentonKrysiak.pdf)

<sup>17</sup> See Robert Dudley's interview, *Vedomosti*, 26 May 2008, [www.vedomosti.ru/newspaper/article/149336/](http://www.vedomosti.ru/newspaper/article/149336/).

<sup>18</sup> See: Vera Surzhenko, Irina Reznik, 'TNK protiv BP' (TNK vs. BP), *Vedomosti*, 26 May 2008, [www.vedomosti.ru/newspaper/article/149316/](http://www.vedomosti.ru/newspaper/article/149316/).

<sup>19</sup> See, for example, Vladimir Putin's speech at the XI St Petersburg International Economic Forum, 10 June 2007, [http://archive.kremlin.ru/eng/speeches/2007/06/10/1823\\_type84779\\_133777.shtml](http://archive.kremlin.ru/eng/speeches/2007/06/10/1823_type84779_133777.shtml)



In these circumstances BP's chances of getting the Kremlin's support in its growing conflict with AAR became very bleak.

Apart from the clash of the partners' strategies, AAR seemed to have additional reasons to suspect BP of treating the joint venture as its subsidiary. Mikhail Fridman, Viktor Vekselberg, and Len Blavatnik were unhappy that BP's man, Robert Dudley, appeared to have the upper hand in running the company, in his capacity of TNK–BP's CEO. There were also concerns over the composition of the TNK–BP board of directors, on which BP had five representatives whereas AAR had only four.<sup>20</sup> At the same time, the practice of bringing BP's expatriate staff to TNK–BP on a temporary basis was perceived by the Russian shareholders as expensive and not particularly vital. However, in BP's opinion, the management, technical, and financial expertise of its employees would be of great benefit to the Russian joint venture.<sup>21</sup>

BP seemed to be unmoved by AAR's continued calls for a change in the TNK–BP strategy, and the way in which the joint venture conducted its business. Due to the fact that BP and AAR both owned a 50 per cent in TNK–BP, the conflict brewing within the joint venture started to paralyse the company's normal operations. However, even before TNK–BP was established President Putin had warned Lord Browne, then the CEO of BP, of the dangers of getting stuck in a corporate governance deadlock with the AAR consortium under a 50/50 arrangement.<sup>22</sup> AAR apparently felt compelled to put pressure on BP as the only way of making the IOC get the billionaires' point and change its ways. In the spring-summer 2008, the AAR consortium allegedly facilitated tax, visa, and work permit investigations into BP personnel by Russian regulatory agencies. As a result, Robert Dudley had to flee Russia in July 2008 and even tried to run TNK–BP from abroad.

Some commentators went so far as to suggest that it was the Kremlin which orchestrated the attack on BP, in order to squeeze them out of the TNK–BP venture. However, such suggestions did not take into account the fact that it was the Kremlin in the first place which had blessed the formation of the joint venture, in which the largest stake in any Russian corporate entity was to belong to a Western company. If the Kremlin really wanted additional oil assets in Russia it could do so at the expense of other domestic oil companies, not at that of a joint venture with a 50 per cent foreign stake.

Despite open calls for Vladimir Putin and Dmitry Medvedev to interfere in the AAR–BP corporate conflict, the Kremlin had no reason to do so.<sup>23</sup> First, as previously mentioned, in 2003 Vladimir Putin had warned BP of potential problems with the

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<sup>20</sup> See: *TNK–BP Holding 2007 Annual Report*, 36–40.

<sup>21</sup> See: Robert Dudley's interview in *Vedomosti*.

<sup>22</sup> See: John Browne, *Beyond Business*, London: Weidenfeld & Nicholson, 2010, 130–51; Daniel Yergin, *The Quest: Energy, Security and the Remaking of the Modern World*, London: Allen Lane, 2011, 38.

<sup>23</sup> 'The Financial Times posovetovala Medvedevu vmeshat'sya v konflikt aktsionerov' (The Financial Times advises Medvedev to interfere in the shareholders' conflict), *Lenta.Ru*, 2 July 2008, <http://lenta.ru/news/2008/07/02/tnk/>.



50/50 joint venture arrangement.<sup>24</sup> Second, the Russian state had no stake in TNK–BP and therefore considered it inappropriate to interfere in the corporate conflict of the two shareholders. Finally, despite the predominantly international nature of the parties behind the TNK–BP ownership structure, it was still a Russian company from the operational point of view. Therefore, the Russian government’s involvement in the AAR–BP conflict on the side of BP would have run counter to Vladimir Putin’s commitment to protect the interests of big Russian businesses (private or public) in their battle to become global players.

In the end, BP and AAR opted to stop the corporate standoff by agreeing on a new shareholding arrangement, and the resignation of Robert Dudley as TNK–BP’s CEO. Under the provisions of this agreement, both BP and AAR would each have four board representatives, with an additional three independent directors: Gerhard Shroeder, former German Chancellor; Alexander Shokhin, Chairman of Russia’s Union of Industrialists and Entrepreneurs; and James Leng, former CEO of the international steel conglomerate Corus. The TNK–BP partners also decided that their company would start acquiring assets outside Russia and the Ukraine, and would be run by an independent CEO.

However, the peace between AAR and BP only lasted for a couple of years, until BP and Russia’s state oil company Rosneft decided to form a strategic partnership for joint development of Arctic hydrocarbons.

### ***BP’s Arctic (Or)deal***

Commenting on the collapsed BP–Rosneft Arctic deal in May 2011, Russia’s President Dmitry Medvedev hinted that both BP and Rosneft should have done better homework before signing their agreement some months earlier, in January 2011. According to the Stockholm Arbitration panel, BP had previously signed an international legally binding shareholding agreement with AAR, which stipulated that TNK–BP would be the primary corporate vehicle for BP’s oil and gas operations in Russia. Therefore, in this context, the BP–Rosneft *strategic* Arctic deal had to be blocked on legal grounds, as breaching TNK–BP earlier contractual arrangements.<sup>25</sup>

There were a number of pre-existing factors which ensured that AAR would not be afraid of challenging Rosneft and its powerful governmental backer, Igor Sechin, and guaranteed that the Russian government would refrain from ‘muscling out’ the AAR consortium for daring to challenge the BP–Rosneft deal.

#### *AAR’s uniqueness.*

As previously mentioned, this consortium of billionaires has traditionally enjoyed excellent communication channels with the Kremlin. This meant that AAR could present their objections to the BP–Rosneft deal directly to Vladimir Putin and Dmitry

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<sup>24</sup> See Jenik Radon, op.cit.

<sup>25</sup> ‘Stockholm court bans BP–Rosneft deal’, *RIA Novosti*, 24 March 2011.



Medvedev, while bypassing any government gatekeepers. Moreover, as acknowledged earlier, the international nature and asset diversity of the AAR consortium distinguished the billionaire partners from any other high-net worth individuals with Russian connections. Therefore, the international nature of the AAR consortium (unlike the ill-fated Yukos) made it an unlikely target for an attack by the Russian state. Had the state confronted AAR, international courts would have blocked the BP–Rosneft deal in any case, potentially causing reputational damage for the Russian government, Rosneft, and BP. It was also highly unlikely that the Kremlin would have risked political and economic stability in the country, and the existing status quo between key economic players, in the year of Russian parliamentary elections and the planned announcement of Vladimir Putin’s intention to run for president in 2012.

*The probability of AAR’s legal action.*

The probability of legal action by AAR against the BP–Rosneft deal was high even before it was signed in January 2011. The AAR consortium has always appeared to have wanted to establish a solid and respectable reputation in the West, and has therefore based its operations and contractual arrangements on international legal standards. Such a strategic approach has been adopted by most Russian billionaires, in order to ensure long-term protection of their investments by the international legal system. Members of the AAR consortium have never been afraid of suing large corporations in international courts. Examples of legal action by AAR members include Alfa Group’s 2008 lawsuit against the Norwegian telecoms operator, Telenor; Access Industries’ 2009 lawsuit against JPMorgan Chase Bank; and Viktor Vekselberg’s 2010 lawsuit against the auction house Christie’s.<sup>26</sup> Had AAR avoided legal action against BP’s Arctic deal with Rosneft, it would have undermined the billionaires’ adherence to international legal standards, potentially creating further problems with their other assets in the future.

*TNK–BP – a chosen company.*

The history of the Russian government’s reluctance to become involved in disputes between the shareholders of TNK–BP highlights an earlier-mentioned fact that TNK–BP was chosen by Vladimir Putin as a showcase of successful partnership between the private interests of big Russian business and international investors (IOCs). Hence any direct involvement by the Kremlin on the side of either AAR or BP would appear illogical and inconsistent from a political, commercial, and legal point of view.

*Rosneft’s options.*

One possible way of saving the BP–Rosneft deal was either to secure AAR participation in the Arctic partnership via TNK–BP or to buy the billionaires out. However, Rosneft ruled out TNK–BP participation in the Arctic partnership, citing

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<sup>26</sup> Catherine Belton, ‘Altimo division sues Telenor’, *Financial Times*, 26 March 2008, [www.ft.com/cms/s/0/a8f76b4e-fad6-11dc-aa46-000077b07658.html](http://www.ft.com/cms/s/0/a8f76b4e-fad6-11dc-aa46-000077b07658.html); ‘Blavatnik sues JPMorgan over investment losses’, *Reuters*, 22 June 2009, [www.reuters.com/article/2009/06/22/blavatnik-jpmorgan-idUSN2251796720090622](http://www.reuters.com/article/2009/06/22/blavatnik-jpmorgan-idUSN2251796720090622); Richard Eden, ‘Oligarch Viktor Vekselberg sues Christie’s over “fake” painting’, *Daily Telegraph*, 18 July 2010, [www.telegraph.co.uk/culture/art/art-news/7896460/Oligarch-Viktor-Vekselberg-sues-Christies-over-fake-painting.html](http://www.telegraph.co.uk/culture/art/art-news/7896460/Oligarch-Viktor-Vekselberg-sues-Christies-over-fake-painting.html).





the joint venture's lack of experience with the development of offshore projects. At the same time, Rosneft could not, on its own, afford to purchase the \$30+ billion AAR stake in TNK–BP. The Russian state oil champion already had a large debt of around \$23 billion which, according to the International Financial Reporting Standards, constituted 36 per cent of Rosneft's 2010 annual revenue. An acceptable debt-to-revenue rate ratio for international oil and gas companies is between 10 and 15 per cent.<sup>27</sup> Even in collaboration with BP, it was still questionable whether Rosneft could, or needed to, buy out the billionaires. First, AAR did not seem to be interested in selling their prime asset, despite Rosneft's and BP's reported offer of \$32 billion.<sup>28</sup> Second, the stalled deal with BP in fact boosted Rosneft's bargaining position in its relations with other potential foreign partners, including ExxonMobil. In comparison to BP's equity swap deal, Exxon's offer of making Rosneft its partner in other upstream projects seems more attractive (see Table 1). In the context of Russian energy players looking to expand beyond the realms of Russia, ExxonMobil made an offer Rosneft could not refuse.<sup>29</sup>

**Table 1: BP's and Exxon's offers to Rosneft**

	<b>BP</b>	<b>ExxonMobil</b>
<b>Share swap:</b>	BP gets 9.5% of Rosneft shares. Rosneft gets 5% of BP's shares.	None
<b>Research &amp; Development:</b>	Arctic Research and Design Centre for Offshore Development in St Petersburg	Arctic Research and Design Centre for Offshore Development in St Petersburg
<b>Fields and projects in Russia:</b>	East Prinovozemelsky Licence Blocks 1, 2, 3 in the Kara Sea	East Prinovozemelsky Licence Blocks 1, 2, 3 in the Kara Sea + Tuapse Trough Block in the Black Sea. Potential joint development of western Siberian tight oil resources.
<b>Fields and projects in other countries:</b>	None	Rosneft's access to Exxon's fields in North America, the Gulf of Mexico, tight oil fields in Texas (USA), and Canada + potential projects in other countries.

Source: Rosneft's press releases of 14 January 2011 and 30 August 2011.

<sup>27</sup> Vladimir Milov, 'Zachem Rosnefti pogloshchat' TNK–BP?' (Does Rosneft need to absorb TNK–BP?), *Forbes-Russia*, 8 June 2011.

<sup>28</sup> Various reports suggested that AAR partners were keen on selling their share if the offered price was around \$40 billion for 50% of TNK–BP. Nevertheless, it seemed highly unlikely that AAR could realistically have expected to sell its stake for this price. Arguably, BP could not have come up with this amount either on its own or together with Rosneft, due to BP's financial exposure following the environmental disaster in the Gulf of Mexico in 2010.

<sup>29</sup> Exxon's Arctic offer to Rosneft could also be examined in the larger context of this IOC's involvement in Sakhalin-1 project. See: Isabel Gorst, 'Moscow turns up heat on Sakhalin investors', *Financial Times*, 3 August 2007; 'Audit Chamber warns Exxon Neftegas over Sakhalin-1 spending', *RIA Novosti*, 26 October 2010; Ed Bentley, 'Exxon face Sakhalin-1 query', *The Moscow News*, 28 October 2010; Christopher Hellman, 'Rosneft Deal Shows Exxon To Be The Only Supermajor With Heft In Russia', *Forbes*, 31 August 2011; Ed Crooks, 'An embodiment of Exxon's no-nonsense culture', *Financial Times*, 2 September 2011.



## *BP's Future in Russia*

Despite some recurring problems in Russia, BP does not necessarily have to face bleak prospects in the country's domestic oil sector. At the core of BP's future involvement and commercial success in Russia lie its relations with the AAR billionaire consortium and the Russian state. In this context, the two key questions are whether BP and AAR can salvage their seemingly strained relationship, and whether BP has some strategic advantage over other IOCs which can be of benefit to the Russian oil sector.

In terms of the future of TNK–BP, AAR and BP may find it of mutual benefit to 'reload' their relations while sticking to contractual terms, instead of selling their respective shares in the joint venture.

### *AAR*

For the AAR partners – Mikhail Fridman, Len Blavatnik, and Viktor Vekselberg – TNK–BP is bound to be a jewel in the crown of their diversified corporate portfolios. First, the cash-generating ability and potential of TNK–BP surpasses that of many of their other companies. In 2009–10 the company paid \$3.5 billion per annum in dividends to its shareholders. Second, TNK–BP could be turned into an even larger corporate player on the global energy scene than it already is. The AAR billionaires have always appeared reluctant to sell their 50 per cent share in TNK–BP, thus undermining any attempts to have them replaced with Gazprom or Rosneft in the Russian joint venture partnership.

One may argue that in order to comprehend Russian billionaires, Western observers simply need to look at their own pioneers in the industry. John D. Rockefeller is remembered not for his interest in short-term start-up projects, but for his achievements in the long-term development and growth of his corporate assets. In this context, the scale of the stakes of AAR and BP is well illustrated by the shareholding composition of the partners in the TNK–BP venture (see Table 2). Mikhail Fridman, Viktor Vekselberg, and Len Blavatnik are the owners holding a majority, or a controlling, interest in their respective companies, whereas in the case of BP no shareholder has any controlling share capital. This illustrates the fact that AAR has had a long-term outlook in relation to its primary asset – TNK–BP.<sup>30</sup>

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<sup>30</sup> This, however, does not imply that BP, which is owned by a larger number of shareholders, has short term interests in Russia. The fact that BP was willing to invest in the Arctic clearly demonstrates this IOC's long-term outlook.



**Table 2. Key shareholders of BP and AAR (Alfa Group, Access Industries, and Renova).**

Companies	Shareholders with over 51%	Largest shareholders
BP plc	None	BlackRock Inc. (5.93%) Legal & General Group plc (4.18%)
Alfa Group	Trio of M. Fridman, G. Khan & A. Kuzmichev	Trio of M. Fridman, G. Khan & A. Kuzmichev (~70%)
Access Industries	Len Blavatnik	Len Blavatnik (~70%)
Renova	Viktor Vekselberg	Viktor Vekselberg (~70%)

Source: Company reports. *Vedomosti, Kommersant*. BP's shareholding data is based on the largest holders of voting rights of the issued share capital.

Therefore, as long as AAR has not fulfilled its aspiration of turning TNK–BP from a Russia-based company into a global player, it will be unwise for the billionaires to sell their core asset. TNK–BP only made its first steps in becoming an international company in 2010-2011, when it agreed to buy BP's \$1.8 billion worth of oil and gas assets in Vietnam and Venezuela as well as \$1 billion worth of Amazon oil exploration blocks from Brazil's HRT Participacoes.<sup>31</sup> At the time of writing, TNK–BP is also in the process of buying 50 per cent of Itera, the only Russian company operating in upstream projects (including the Caspian offshore) in gas-rich Turkmenistan.

#### *BP plc*

When Lord Browne, then the head of BP, signed a deal with the AAR consortium in 2003, he boosted his company's role among other IOCs considerably by securing access to new hydrocarbon resources and enlarging his company's income potential (See Insert **What is TNK–BP for BP?**).

<sup>31</sup> TNK–BP's new Vietnamese assets include: 35% in the offshore block project 06-1 (Lan Tay and Lan Do gas condensate fields), 32.7% stake in the pipeline and Nam Con Son terminal, and 33.3% Phu My 3 power station. Vietnamese assets allow TNK–BP to create an integrated corporate asset in Vietnam which includes gas production, transportation, and power generation facilities with a production capacity of 30,000 barrels of oil equivalent per day. TNK–BP's new assets in Venezuela include 16.7% of PetroMonagas SA, 40% of Petroperija SA – operator of the DZO project, and 26.7% of Boqueron SA. Venezuelan projects will yield 25,000 barrels of oil equivalent per day. In Brazil, TNK–BP bought a 45% stake in 21 oil and gas exploration blocks in the Amazon's Solimões river basin. This project would bring TNK–BP 'a net prospective and contingent resource of 789m barrels of oil equivalent'. TNK–BP could potentially buy an additional 10% share in the project and become its operator. See: Catherine Belton and Samantha Pearson, 'TNK–BP to buy \$1bn stake in Amazon venture', *Financial Times*, 31 October 2011; Kirill Melnikov, 'TNK–BP proburit Braziliyu' (TNK–BP will drill in Brazil), *Kommersant*, 1 November 2011, [www.kommersant.ru/doc/1807722](http://www.kommersant.ru/doc/1807722).



#### **What is TNK–BP for BP?**

- Over \$16bn in dividends since 2003;
- Nearly 25% of BP's annual output;
- One fifth of BP's reserves;
- One tenth of BP's profits in average years.

Source: company reports, *Financial Times*

BP's financial exposure, following the environmental disaster in the Gulf of Mexico, has compelled the IOC to raise up to \$45 billion by selling out some of its assets worldwide. However, BP has not indicated any plans to pull out of Russia. On the contrary, its Russian venture has benefited by purchasing \$1.8 billion worth of BP's assets in Venezuela and Vietnam. There is also a possibility that TNK–BP may buy into BP's projects in Algeria. Therefore, despite all the problems, TNK–BP still represents one of BP's prime corporate assets. Moreover, BP could still have some possible lucrative commercial opportunities in Russia, perhaps even potential involvement in the Arctic. In the future, the Russian government could amend the current rules which grant Gazprom and Rosneft a monopoly on offshore production. For example, the latest proposals of the Russian Ministry of Natural Resources seek to limit Gazprom's and Rosneft's existing monopoly to offshore exploration and production, whereas the stage of geological prospecting could be liberalized. In addition, the Ministry's experts suggest that Arctic hydrocarbons should be developed by international consortiums led by state-controlled Russian companies, instead of by partnerships established by Gazprom and Rosneft with IOCs. These changes may not appear significant, but could pave the way for greater involvement of IOCs in the Russian oil and gas sector.

BP's continued involvement in Russia is also important for the domestic oil industry, which requires Western technology not only to develop its new complex onshore and offshore resources, but also to modernize its refining sector. In this context, BP's world class technology of heat exchange and catalysis could be of benefit to the ageing Russian refineries which were predominantly built between the 1940s and the 1970s.

### ***Conclusions***

It seems that the problems between BP and AAR have been primarily instigated by the evolving Russian politics, as well as by the different backgrounds, perceptions, and motives of the 'newly-wed' TNK–BP partners. It is also apparent that the Russian billionaires of the AAR consortium and BP may lose out more if they sell their stake than if they continue in the unique 50/50 joint venture. The Kremlin, which authorized the TNK–BP venture in 2003, has always appeared reluctant to get involved in corporate conflicts inside the company – which Vladimir Putin selected as a showcase of a successful partnership between Russian billionaires and a leading Western IOC. The question remains whether BP and AAR can work out their



differences and continue to develop TNK–BP into a successful international company, or whether the relationship between the partners can no longer be sustained.

BP's problems in Russia, as well as the recent upheavals in the Middle East and North Africa, have once more highlighted the fact that the importance of politics and international legal standards in the energy sector can not be underestimated, especially in emerging markets and economies in transition.

BP's most recent challenging experience in Russia has wider implications for other international oil companies. Corporate oil executives, company chief economists, geologists, bankers, and management consultants may have an excellent grasp of geological data and technical challenges, supply–demand ratios, production and investment figures, government tax regimes, corporate financial data, and management structures and skills, but their failure to comprehend political and legal risks may result in inadequate corporate decisions which could subsequently cost billions to the industry, investors, and shareholders.

International oil companies often have to take risks when they invest outside politically stable Western democracies. These risks are often unavoidable, since over 80 per cent of global energy resources are controlled by national governments directly or through their national oil and gas companies. However, unnecessary political risks can be avoided if IOCs invest time and money to secure high quality political risk advice either externally, or by setting up their own in-house teams.

Risk taking is an inherent part of the oil and gas business, and pushing for new reserves is crucial to the survival and advancement of energy companies. All the more reason, then, that those risks are calculated and strategic.