



Russian Roulette

Impacts for BP and Rosneft of continuing international sanctions

US and European sanctions against certain Russian industries and individuals in response to the Ukraine crisis have now been in place for twenty months.¹ The sanctions prohibit International Oil Companies (IOCs) from providing services, goods, or technology to frontier oil projects in Russia. They also restrict financing for a set of Russian companies including the state-controlled oil giants Rosneft and Gazprom.

The immediate impact of sanctions has been to freeze joint venture deals for Arctic exploration between Rosneft and Gazprom on the one hand, and Shell, Eni, and Exxon on the other.²

BP remains the IOC with the most exposure to Russia, due to its 19.75% stake in Rosneft, which is otherwise 69.5% controlled by the Russian government. Rosneft accounted for one third of BP's oil output³ and \$470 million out of BP's \$2.2 billion profit in Q4 2014.⁴ When BP posted its Q4 profits in 2014, the \$470m forecast Rosneft dividend included in these results was reported as the one positive item on BP's presentation.⁵ However with Rosneft's overall financial difficulties and significant changes in its board of directors

(see below), this apparent reliance on Rosneft potentially raises concerns for BP's shareholders.

As we pointed out in Russian Roulette⁶ in 2012, potential changes to Rosneft's near-monopoly access to offshore oil concessions and the extent of political control over the company represented risks that BP could not control. Three years later and with Western sanctions against Russia in place, both of these risks are beginning to manifest. Officials are considering opening up offshore concessions to private Russian companies while Rosneft and Gazprom's exploratory offshore drilling has been stalled by sanctions and there are indications in the form of board appointments that the political control of Rosneft has increased in recent months. At the same time the once strong relationship between Rosneft CEO, Igor Sechin, and President Putin appears strained according to commentators⁷.

This briefing lays out the implications for IOCs (particularly BP) of the continued sanctions regime, recent political developments and changes to Rosneft's board. It suggests some questions for BP shareholders to ask the company.

The current sanctions affecting Russian oil companies

US and EU corporations are barred from providing services, goods or technology⁸ to Russian deepwater, Arctic offshore, or shale oil projects. EU sanctions only prohibit new contracts,⁹ whereas US sanctions also cover existing contracts too.¹⁰ US, EU and Norwegian sanctions are targeted specifically at projects “that have the potential to produce oil” (US) or “oil exploration and production” (EU and Norway), meaning that purely gas extracting projects such as the paused Shtokman field are not affected.

Rosneft and Gazprom’s oil extraction subsidiary Gazpromneft cannot borrow money for more than 90 days on US and Norwegian markets¹¹ and 30 days on EU markets.¹²

Igor Sechin (Rosneft CEO and Chairman of Rosneftegaz – Rosneft’s controlling shareholder on behalf of the Russian government) is barred from entering the US or doing business with US citizens – but only in a personal capacity rather than as head of Rosneft.¹³

Extension of Sanctions

On 21 December 2015, EU officials extended the existing sanctions regime against Russia until July 2016, citing Russia’s non-compliance with the Minsk treaty which required the complete withdrawal of Russian troops from Eastern Ukraine.¹⁴

November statements from French officials,¹⁵ as well as from the European Council President Donald Tusk¹⁶ indicate that sanctions against Russia as a result of the Ukraine conflict are unlikely to be lifted unless the Minsk peace agreement between Russia and Ukraine is implemented.

Some commentators raised the possibility that Russia’s relations with the West may thaw in the light of a possible alliance against ISIL.¹⁷ Putin’s press secretary told reporters on November 27 that such an alliance was currently unlikely because “our partners are not ready to work as one coalition,” and that recent talks with the French president Francois Hollande did not mention the possibility of lifting sanctions.¹⁸

Indeed, it’s possible that developments in Syria and deteriorating relations with Turkey may actually lead to the imposition of additional sanctions.

Questions for BP

- In light of continuing sanctions does BP anticipate that Rosneft will be able to maintain its dividend payments to BP at similar levels as to date?
- What is BP’s assessment of both a ‘worst case’ and ‘best case’ scenario with regard to the continuation of sanctions and the impact on Rosneft and by implication BP? What steps is BP taking to mitigate the worst case scenario?

What is the impact of sanctions on offshore drilling?

Rosneft's plans for exploratory drilling in offshore Arctic waters in Russia have been stalled by sanctions: as explored in Russian Roulette,¹⁹ Rosneft's exploration JVs with Exxon, Statoil and ENI are all financed and likely to be operated by the Western partner – activities now prohibited. Exxon wrote off approximately \$1bn as a result of exploratory drilling in the Kara Sea being stopped by sanctions.²⁰ A September 2015 presentation by Russia's energy ministry forecast that exploratory drilling in the Kara Sea would not restart until 2020–2021.²¹

Unable to drill, Rosneft alongside Gazprom applied to extend the deadlines specified in its Arctic exploration licences. The Ministry for Natural Resources approved the application. The two companies are now required to drill seven offshore exploratory wells rather than 17 in 2015 and two rather than 14 in 2017. However it is difficult to see how even this reduced requirement will be possible in the absence of IOC support – which is prohibited by sanctions.

The Russian Natural Resources Ministry is concerned that the companies will be unable to complete the drilling (mostly due to sanctions). The vice-minister Denis Khramov is repeatedly quoted in the media as suggesting opening up licensing for private Russian companies to drill offshore.²² This would end Rosneft and Gazprom's monopoly over offshore concessions in Russia, raising concerns for BP as a significant shareholder in Rosneft.

BP shareholders should ask how BP is managing risks associated with Rosneft either a) proceeding ahead with exploratory drilling as an operator with no funding or expertise from an IOC partner; or b) losing its current near-monopoly on offshore exploration in Russia, negatively impacting Rosneft's potential to grow its Russian reserves.

Questions for BP

- In light of Rosneft's Arctic lease obligations, is BP concerned that Rosneft will either a) go ahead with exploratory drilling as an operator with no funding or expertise from an IOC partner; and/or b) lose its current near monopoly on offshore exploratory licences, affecting Rosneft's potential to grow its Russian reserves? What steps is BP taking to address these issues?

The financial impacts of sanctions

In September 2015, Rosneft was named Russia's most indebted company,²³ according to a corporate debts rating compiled by Russian business news agency RBC – with a net debt of \$43.3bn at the end of Q1 2015.²⁴ Much of the debt originates from Rosneft's purchase of TNK-BP as part of the same deal in which BP acquired its Rosneft shareholding. But the dramatic rise in Rosneft's debt is attributable at least in part to the crash of the rouble, caused by a combination of falling oil prices and the imposition of sanctions.

Rosneft's profits, which rose sharply in 2013 following the acquisition of TNK-BP, fell to a pre-2012 level (in Russian Rouble terms) in 2014 – after the imposition of sanctions and the fall of the rouble.

At the end of November 2015, Rosneft announced a surprising reduction in its debt, to \$24.5bn. In the Q3 2015 earnings call, the company said it received \$15.7bn "under long-term supply contracts"²⁵. Analysts surveyed by the Financial Times said the majority of the sum was likely to have come from a specific long-term pre-pay contract with the Chinese National Petroleum Corporation (CNPC). Rosneft signed a large-scale 25-year supply deal with CNPC in 2013, with overall value of the deal estimated at \$270bn and estimates of the Chinese partner's prepayment sum ranging between \$30bn-\$70bn.²⁶ Details of the deal, such as the pricing mechanisms for the oil supplies and any interest Rosneft is to pay on the pre-payment,²⁷ are undisclosed.

	2010	2011	2012	2013	2014
Rosneft net income, USD mln	10,400	12,452	11,395	15,711	5,300
(RUR bln)	(319)	(342)	(365)	(551)	(350)



Rosneft has also been disposing of assets on a scale described by commentators as unprecedented

Rosneft has also been disposing of assets on a scale described by commentators as unprecedented.²⁸ In September 2015, Rosneft sold a 15% stake in its subsidiary operating the Vankor onshore field in Siberia to the Indian company ONGC Videsh Limited. Vankor is the largest oilfield to have been discovered and proceed to extraction in Russia in the past 25 years.²⁹ Rosneft announced in September 2015 that the company was negotiating the sale of a further 10% stake in Vankor to the Chinese company CNPC.³⁰ The value of these sales has not been disclosed, though Bloomberg estimated ONGC's stake at \$900 million.³¹ Apart from this deal, Rosneft also traded a refinery to ChemChina³² for shares in Chinese refineries; sold a 20% stake in the onshore oilfield Taas-Yuriakh to BP for \$750 million; and a 29% stake in the same oilfield to Skyland Petroleum, said to be backed by a private Chinese investor.³³ Investors need query what such sell-offs mean for Rosneft's long-term prospects.

Rosneft also attempted to access financing from the Russian state. In October 2014 the company applied for 2.4 trillion roubles (\$56.5bn) from Russia's National Welfare Fund (state pension fund) for four capital investment projects.³⁴ In August 2015, Russian business press reported that the government would decline to issue Rosneft with loans for all but one of the projects Rosneft applied for.³⁵ This refusal may be connected to the growing tensions between Vladimir Putin and the company's CEO Igor Sechin³⁶.

Questions for BP

- What is Rosneft's strategy to reduce its debt? Are further asset sales or pre-payments under long-term supply contracts likely? How confident is BP in Rosneft's debt reduction strategies?
- Does BP have any concerns about the impacts on Rosneft's medium and long-term strategy and revenue of the asset sales it is being forced to make as a result of sanctions?

Board changes at Rosneft

In March 2015, a new set of directors was unveiled at Rosneft. While BP has finally secured its long-promised second board member, the other changes to the board do not reflect corporate governance best practice and have led to suggestions of increasing control being exerted by President Putin.

In accordance with the terms of its 2012 deal with Rosneft BP has finally nominated a second director on Rosneft's board, alongside BP CEO Bob Dudley – the Guillermo Quintero, BP Brazil's Brazil, Uruguay, Columbia & Venezuela president.

However, the new set of directors includes only one independent director (ex-Exxon manager Donald Humphreys), down from the previous three. The new directors include President Putin's assistant Andrei Belousov, energy minister Alexandr Novak and ex-energy minister, now Putin's special representative for international energy partnerships Sergei Shmatko. Commentators surveyed by Russian business daily Vedomosti suggest that the list indicates an ambition to strengthen control of Rosneft by Vladimir Putin's government.³⁷

Further backing up this suggestion, President Putin criticised Rosneft CEO Igor Sechin's fiscal decisions in a meeting a transcript of which appeared on the official Kremlin website. Putin's words are the first such public criticism in Sechin's career at Rosneft, and in their decades-long alliance in official posts. Commentators including Bloomberg suggest Putin was asserting a stronger grip over Rosneft, showing cracks in this alliance: "A weaker relationship with Putin might see Sechin forced to rein in his ambitions for Rosneft."³⁸ Putin and Sechin's disagreement may impact on Rosneft being able to rely on support from the Russian state (as suggested by the National Welfare Fund's refusal of loans to Rosneft), and adds further uncertainty over the political control of the company.

With the increased number of direct government representatives on Rosneft's board alongside only one remaining independent director, and with Putin directly criticising Rosneft's CEO, BP shareholders should be concerned about the implications for corporate decision-making and BP's influence.

Questions for BP

- Is BP concerned about the nature of the changes made to the Rosneft board and in particular with the reduction of independent directors? If yes, what steps is BP taking to ensure corporate governance best practice is followed at Rosneft?



Commentators including Bloomberg suggest Putin was asserting a stronger grip over Rosneft

Conclusion

Twenty months into the sanctions regime, there is no sign that sanctions against the Russian oil industry are going to be lifted. Beyond simply stopping exploration projects such as Rosneft's joint venture with Exxon, the sanctions, combined with a fall in the rouble and a low oil price, have also resulted in asset sales by and mounting debt for Rosneft, which it has partly sought to diminish by through pre-payment oil deals. Moreover, according to commentators and some public statements by officials, a political rift has been developing between Russian President Vladimir Putin and Rosneft CEO Igor Sechin. A recent reshuffle in the Rosneft board brought in more direct government representatives and reduced the number of independent directors to one – changes not in line with corporate governance best practices. These developments indicate that investors in BP (Rosneft's largest minority shareholder with a 19.75% stake) need to raise questions about Rosneft's future performance and strategic direction.

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