

## **No.2 Energy Series**

### ***ROSNEFT.***

#### ***Kremlin's Trojan Horse.***

##### **Early days**

Rosneft was one of the last vertically integrated oil companies to emerge from the reorganization and large-scale privatization of Russia's oil industry in the years following the dissolution of the Soviet Union. The state's main oil and gas assets, previously managed by Soviet ministries or other government agencies, formed the basis of new vertically integrated companies created on the model of major international corporations. Among these were SIDANCO, Sibneft, Slavneft, Eastern Oil Company, Lukoil, YUKOS, Tyumen Oil Company (TNK), ONAKO, Sibur, and others.

The state, however, retained ownership of a number of assets in order to establish an efficient commercial structure capable of competing with the large domestic private companies. The result was the creation of Rosneft, on the basis of the assets previously held by Rosneftegaz, the successor to the USSR Ministry of Oil and Gas. Rosneft was established in November 1992 by President Boris Yeltsin's decree regulating the privatisation of Russia's oil producers. The decree, created Rosneft as a state-owned company that would manage production units that were not yet privatised and would also play a role in the management of government stakes in privatised companies.

However, the reality of Rosneft turned out to be different from Yeltsin's designs. Rosneft's subsidiaries sought to derive the same benefits as their private peers, who could export oil without state intervention. As a result, between 1993 and 1998, the subsidiaries began to drift out of control of Rosneft and into the hands of private companies, in particular Sibneft. Sibneft actively bought stakes in these subsidiaries and was preparing for the privatisation of Rosneft as a whole. In 1995, a Russian government decree transformed Rosneft into an open joint stock company (OJSC).

## **Crisis and recovery**

During the mid 1990s, Rosneft operated in an environment of continuously changing management and shrinking assets as the privatization process continued. Following Russia's 1998 financial crisis, while Rosneft still owned 32 large-scale enterprises and had reserves that would sustain production for the next 60 years, the company's assets had become increasingly difficult to manage due to the lack of a growth strategy and management leadership. Production was declining and refining throughput was only at one third of its capacity.

In order to secure Rosneft's position as an important player in Russia's energy industry, the government appointed a new management team in October 1998, headed by the Company's current president, Sergey Bogdanchikov. The new team — consisting largely of Mr. Bogdanchikov's former colleagues from Sakhalinmorneftegaz who had spearheaded exploration at Sakhalin's large-scale offshore projects — began to implement what would become a full-scale turnaround for the Company. By 2000, Rosneft was again realizing profits. That year also marked the start of a new period of growth, with average oil production increases in excess of 11% annually.

## **Continued growth and expansion**

Improved management, asset acquisition and consolidation, financial discipline and technological integration all resulted in significantly improved performance from existing assets and allowed Rosneft to embark on a program of growth and expansion. From 2000-2004, Rosneft nearly doubled its annual oil production, from 268 kb/d in 2000 to 433 kb/d in 2004. Gas production increased from 5.6 billion cubic meters in 2000 to 9.4 billion cubic meters in 2004.

In 2001, Rosneft became the official state representative in Production Sharing Agreements (PSAs). In 2002, Rosneft expanded its international operations by entering into projects in Algeria and in 2003, began producing oil at the Adaysky block in the Caspian Sea region of Western Kazakhstan.

Rosneft pursued its upstream asset acquisition strategy with a focus on geological quality and transport efficiency. Its main oil-loading terminals at Archangelsk, Tuapse, Nakhodka and De-Kastri play a key role in the Company's strategy of

exporting the majority of its production to diverse global markets, from Europe to the rapidly growing economies of East Asia.

Alongside its strategy of acquiring high quality assets, Rosneft has also begun a major overhaul of its refining capabilities. In addition to establishing 100% control over the Tuapse Refinery, extensive modernization efforts have been initiated at both the Tuapse and Komsomolskaya Refineries, which are expected to bring refining yields to over 90%. During the refineries' reconstruction, there will be no decrease in throughput capacity.

Among the key assets acquired in 2000–2004 were Selkupneftegaz (2000), Severnaya Neft (2003), the Veninsky block at Sakhalin-3 (2003) and the Anglo-Siberian Oil Company (2003), owner of the license to the Vankor oilfield in Eastern Siberia. In December 2004, the Company purchased a controlling stake in one of Russia's largest oil and gas companies, Yugaskneftegaz. This acquisition, together with significant organic growth, has propelled Rosneft into its current position as Russia's second largest oil producer, with average daily production of approximately 1.72 million boe in 2005<sup>1</sup>.

In early 2005, Rosneft won the auction to the Vorgamusur field in the Timano-Pechora province, an acquisition that will ensure further growth of Severnaya Neft, whose operations are located only 80 kilometres away. At the end of 2005, Rosneft announced the acquisition of a 25.94% stake in Verkhnechonskneftegaz, which was later complemented by the acquisition of an exploration license to the East Sugdinsky field. These acquisitions are consistent with the Company's strategy to establish Eastern Siberia as one of Russia's newest oil and gas production bases.

Finally, in April 2006, Rosneft announced plans to consolidate 12 of the Company's upstream and downstream subsidiaries. This consolidation program will allow for further improvements in management efficiency and market performance and will help pave the way for decades-long growth.

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<sup>1</sup> This acquisition became one of the most enthralling incidents in the history of the Russian Energy industry, since Yugaskneftegaz was removed by Yukos for various political and financial reasons, due to the power struggle between Mr. Chodorkovsky and the Kremlin.

## **Roles- Production Portfolio.**

Right from the start Rosneft assumed the role of a caretaker. This small, although sustained role was the result of the acquisition of the main and most wealthy production areas by other companies which created mainly under the loans for shares scheme in 1995. In parallel the company controlled what's left, which were the oldest production facilities in Russia and some of the most problematic ones.

On the one hand, under the Rosneft umbrella we found Grozneft- the production organization responsible for oil in the Chechen Republic- and some units in Daghestan, Krasnodar Kray and Stavropol Kray. These production units were the pioneers of oil production in the country and were important in the first half of the 20<sup>th</sup> century. Their importance was insignificant for an oil major in the late years of the century. On the other hand though, Rosneft had in its portfolio, Purneftegaz. Perhaps one of the most important production units in the country.

This unit, which is situated near the Ob River at the northern-most of the old Soviet production associations of Western Siberia, was slightly depleted giving the company a high growth potential. As such the Purneftegaz unit not only provided Rosneft with a solid production base in order the company to retain a form of legitimacy in the oil sector, but also contributed hugely for making the company quite successful commercially. From 1995 until 2002, this unit contributed over 60% of Rosneft's output while in 2003 the share fall to 50%.

Right from the start of the Putin administration the company's status revitalised. Rosneft possessed a small production base while its strategy was mainly concentrated on other areas. From a caretaker of the other majors- a role it could not follow- the company tapped to become the major Russian partner in strategic projects. Although Putin and his entourage foresaw the coming role of the Russian energy industry they could not make any move against the oligarchic club that controlled the Russian hydrocarbon base. This made Kremlin use the only oil company still in state hands in order to acquire a foothold in energy projects with future potential.

Rosneft in 2000 started to gain access to several high profile, multinational projects like those in Sakhalin Island, the negotiations with the Kazakhs over the Kyr Mangazy project or the development of the first major field –Prirazlomnoye- in the Pechora

bay.<sup>2</sup> The result of these moves was a firm grasp for the company of major production units that in the short to medium term future would provide a much more important role in the regulation of the industry as a whole. Additionally, Rosneft with the valuable help of the state, started in the first years of the Putin administration to become much stronger both in terms of production, but also in terms of real power, since it would compete and as it seems gain access to projects, facing strong competition from other Russian majors. This apparently was by design, pushing one of state's clearest agents into small roles in a string of large projects regarded by Moscow as strategic.

The big boom happened in just two years (2003 & 2004). The frenetic activity which saw Rosneft establishing as one of the most powerful Russian oil majors, happened under the same strategic plan on behalf of the government. Putin and Bogdanchikov used the company as a pawn for elaborating their agendas in full. In 2003, Rosneft began competing with Lukoil, in the latter's bid to control the entire Timan-Pechora basin. In so doing, it raised its position in the Conocophillips project-Polar Lights and acquired a major independent in the basin, Northern Oil. During the same year, the company also secures the Vankorskoye field in the extreme north-eastern part of Western Siberia. This aggressive expansion made Rosneft hugely important for the domestic Russian politics of the energy industry. However, the real explosion for the fates of the only state oil major happened in the year 2004.

After a bitter struggle with Yukos and its main man Mikhail Khodorkovsky the state almost doomed Yukos financially and politically. Although it's not our intention to analyse this important incident here, we must say that the power struggle between the Kremlin and the last of the oligarchs,<sup>3</sup> had its roots in the political ambitions of Khodorkovsky and its supporters. The result was not only a strong message towards anyone that the Kremlin was back in control, but also that the most important production unit of the Yukos group Yuganskneftegaz, was put into sale.

To our biggest surprise, it was Rosneft which made hay of this and acquired full control of the main Yukos subsidiary. Adding this production unit in the portfolio of Rosneft would not only permit the company to become one of the most important but also recaptured for the state a large share of the nation's oil recourse base privatised in

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<sup>2</sup> Almost always the access gained with a status of a partner since Rosneft was too small to carry the entire investment burden.

<sup>3</sup> Berezovsky was in exile, Guzinsky was politically inactive, Ambramovich and Potanin were on hold, while Friedman, Aven, Vekselberg, and Luzhkov have been largely subdued.

the 90's. The output of Yuganskneftegaz would give an additional 1,6mb/d, or almost one fifth of Russian oil production, a major expansion for the profits and also for the company as a whole.

The last incident that made Rosneft too powerful for the other majors to handle was the announcement of the merger between Gazprom and Rosneft in September 2004. Gazprom would acquire Rosneft as a subsidiary called Gazpromneft. The transaction is to be structured so that the government will return to majority equity ownership in Gazprom (which owns 38%). This move is considered to be that last link of the state strategy to regain almost absolute control in the internal, and not only, workings of the Russian hydrocarbon base. On the one hand, the Putin administration radically increased centralisation of political power in the hands of the executive branch of the federal government, thus achieving total control. While on the other hand, placing top Putin aides in board and executive positions in the state sector of the hydrocarbon industry, further concentrates economic power in the hands of a very few men surrounding Putin.

Russian must have a strong, state run energy company to gain its deserved position in world energy markets, where it faces strong competition from the national companies of OPEC, and Rosneft gradually evolved from a small caretaker company into perhaps the most important financial organisation (not financially but strategically) in the Russian federation

### **Rosneft Today.**

Rosneft is a vertically-integrated Russian oil and gas company with upstream and downstream operations in each of Russia's oil-producing regions. Headquartered in Moscow, it is the world's second largest company in terms of proved SPE oil reserves and Russia's second-largest hydrocarbon producer.

Rosneft operates ten oil and gas producing enterprises across Russia and is involved in over ten world-class exploration projects. In addition to its strong upstream operations, the Company also owns two refineries, which have a combined capacity of 10 million tons per year, as well as four main oil export terminals and a nationwide network of over 600 service stations.

## Key figures

### Reserves

Proved oil reserves (SPE)	14.88 billion barrels [2.05 billion tons]
Proved gas reserves (SPE)	24.39 trillion ft <sup>3</sup> [690.52 billion m <sup>3</sup> ]
Total proved reserves (SPE)	19.23 billion boe

\* DeGolyer and MacNaughton SPE Reserves Report as of December 31, 2005.

### Operations

Average daily production (2005)	1.72 million boe
Annual oil production (2005)	74.56 million tons
Annual gas production (2005)	13.08 billion m <sup>3</sup>
Annual refining capacity	10.5 million tons

### Financial

Revenues (2005)	US\$16.94 billion
Net income (2005)	
EBITDA (2005)	US\$5.69 billion
Capex (2005)	US\$1.54 billion

## Corporate Structure

### Oil and gas production enterprises

- RN-Yuganskneftegaz LLC
- RN-Purneftegaz LLC
- CJSC Vankorneft
- RN-Severnaya Neft LLC
- Polyarnoe Siyanie LLC
- RN-Sakhalinmorneftegaz LLC
- CJSC Sakhalinskie proekty
- OJSC Grozneftegaz
- RN-Krasnodarneftegaz LLC
- RN-Stavropolneftegaz LLC
- OJSC OC Rosneft-Dagneft
- OJSC Dagneftegaz
- Caspoil LLC

## **Refineries**

- RN-Komsomolsk NPZ LLC (Komsomolsk Refinery)
- RN-Tuapse NPZ LLC (Tuapse Refinery)
- OC Rosneft-MZ Nefteprodukt (Moscow Refinery)

## **Sales enterprises**

- RN-Nakhodkanefteprodukt LLC
- CJSC Vostochny Neftenalivnoy Terminal
- RN-Rosneft-Arkhangelsknefteprodukt LLC
- OJSC Rosneft-Smolensknefteprodukt
- OJSC OC Rosneft-Murmansknefteprodukt
- OJSC OC Rosneft-Kubannefteprodukt
- RN-Tuapsenefteprodukt LLC
- OJSC OC Rosneft-Stavropolye
- OJSC Rosneft-Kabardino-Balkarskaya Fuel Company
- OJSC OC Rosneft-Karachaevo-Cherkessknefteprodukt
- OJSC OC Rosneft-Artag
- OJSC OC Rosneft-Altainefteprodukt
- OJSC OC Rosneft-Kurgannefteprodukt
- OJSC OC Rosneft-Yamalnefteprodukt

## **Service enterprises**

- CJSC Rosnefteflot
- OJSC All-Russia Regional Development Bank
- NPF (Non-Government Pension Fund) Neftegarant
- SK Neftepolis LLC

## **Short-term Strategy**

Central to Rosneft's short-term growth strategy is Yuganskneftegaz, one of Russia's largest production enterprises. Fully integrated into Rosneft's core production base in early 2005, it represents approximately two thirds of the Company's annual oil production and over 70% of its proved SPE oil reserves.



Purneftegaz is Rosneft's second largest production enterprise and with enormous non-associated natural gas reserves at the Kharampur field, it will play an increasingly important role in the Company's strategy of developing and monetizing its gas reserves.

Severnaya Neft, Rosneft's main oil production enterprise in Northern Russia, has experienced remarkable success since its acquisition in 2003, with average annual production increases of over 46%. Of its 17 licenses, 10 have already reached production stage. Acquisition of additional exploration licenses in the Timano-Pechora oil province and expansion of export capacity at the Arkhangelsk terminal have delivered excellent value to Rosneft and provide the Company with ample room for significant growth.

Finally, Rosneft holds a 20% stake in the Sakhalin-1 project, which is currently being developed under a Production Sharing Agreement (PSA) implemented in 1996 with Exxon Mobil and Sodeco of Japan (and, since 2001, with India's ONGC). Sakhalin-1 began oil and gas production in late 2005 and is anticipated to experience substantial growth over the next several years. Sakhalin-1 will play a major role in diversifying Rosneft's export markets, with the majority of its production heading for rapidly developing East Asian economies.

### **Medium-term Strategy**

Rosneft's medium-term strategic efforts are focused on Eastern Siberia, where the Company is currently developing the vast Vankor field in the Krasnoyarsk Territory and, in cooperation with TNK-BP, the Verkhnechonsk field in the Irkutsk Region.

A recent evaluation has put the Vankor field's proved SPE reserves at 946 million barrels [135 million tons] of oil. Production is scheduled to start in 2008 and is expected to last for nearly 30 years. Commissioning the Vankor pipeline will not only give Vankor oil substantial export potential, but it will also help make economically viable the Far East Pipeline — Transneft's landmark project. The countries of the Asia-Pacific region, among the fastest growing in the world in terms of energy demand, are expected to be the primary customers for the Vankor field in the medium-term.

The Verkhnechonsk field, which is being developed under a three-year pilot production program unveiled by TNK-BP in 2005, will also be instrumental in filling

the Far East pipeline. Rosneft is working actively to help launch full production prior to completion of the pilot production period.

### **Long-term Strategy**

While the Sakhalin-1 project will play an important role in Russia's short-term growth strategy, Sakhalin Island also offers one of Russia's most exciting potential sources of sustainable long-term growth. Rosneft currently controls over one third of total Sakhalin offshore oil and gas resources, and while still at the early stages of exploration, the Sakhalin-3, Sakhalin-4 and Sakhalin-5 projects (Rosneft ownership of 49.8%, 51% and 51%, respectively) hold great potential to make Rosneft a major player in the region for years to come.

Rosneft's exploration project on the West Kamchatka shelf, being carried out in cooperation with Korea's KNOC, is also an important element of Rosneft's long-term growth strategy, as the Company's potential resources there could eventually rival those of the entire Sakhalin shelf.

The enormous Vankor province in the Krasnoyarsk Territory contains a number of 100% owned structures surrounding the main Vankor field, which is already under development. A recent evaluation by DeGolyer and MacNaughton estimates that 4.4 billion barrels [601.67 million tons] of potential recoverable oil resources could be located at the structures surrounding the Vankor oilfield subject to successful exploration.

Finally, substantial resources on both the Black Sea and Sea of Azov shelves as well as at the enormous Kyrmangazy structure in Kazakhstan are key to Rosneft's long-term strategy of remaining a key oil supplier to markets served by the Caspian Pipeline Consortium and Mediterranean export routes. A recent evaluation by DeGolyer and MacNaughton has placed the latter's estimated potential recoverable oil resources at nearly 13.16 billion barrels [1.80 billion tons].

## **FUTURE**

At the moment Rosneft is one of the most important oil majors in Russia, not only because of its downstream assets. Its political connections, the merging with Gazprom and the special ties with Kremlin are the elements that provide the company with real political strength a clear cut advantage over the other majors in the domestic energy arena. Future plans are already under consideration, and include firstly a focus on Northern Oil-Rosneft's second most important asset. The company expects to triple production in three years to about 7 mil tonnes per year. Secondly focus would be given on the launch of production at Prirazlomnoye, and to the development of the Kyrmangazy field with KazMunayGaz in Kazakhstan.

The targets set by the Rosneft board are impressive enough and relatively feasible. Aggressive production growth for the next few years is the main corporate target, with an estimated increase of production of around 15-20%. Exploiting existing reserves and maintains an efficient crude oil and gas production are the main pillars of that strategy which it is expected to help the company establish an important foothold in the Russian market.

The unlocking of the potential of various projects in the country is also a vital target for the future corporate portfolio, since it will make the company expand considerably in order to be able to confront the vast Lukoil network. Governmental guidance is crucial here since as we saw it helped the company in the past and it will be present again. Rosneft is the only real state oil major and as such it has an advantage not only in domestic competitions but also regarding expansion in the near abroad. Exploiting the gas market is the last big corporate bet of the company and things are good in that sector since Rosneft's merge with Gazprom is vital.

As we already seen, Lukoil<sup>4</sup> is the No.1 oil major in Russia. Alekperov received many times help from the state –especially during the Yeltsin administration- and lately from Putin. However Lukoil is a private company. It depends on state decisions but it can decide for its agenda according to corporate strategy mainly. Kremlin needs a private Lukoil and Lukoil needs Kremlin's support. One the one hand Lukoil is the biggest proof that in Russia a private company can flourish and taking into advantage the resource base of the country be among the top oil majors worldwide. Lukoil is for

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<sup>4</sup> See Energy Series No.1. from [www.cere.gr](http://www.cere.gr)

Kremlin an institutional advertisement. It demonstrates the good investor client in the country, the stable economic background and the favourable political situation. Lukoil needs Kremlin since the last years the ties of the energy sector have been pulled by Putin. Good relations with Kremlin are vital for the well being of any company regardless its size and importance. Why we started the analysis for Rosneft with Lukoil?

What separates these two companies is the extent of state support at a huge percentage, and the fact that one is privately owned while the other is not. Rosneft started as a safe keeper of the energy jewels in Russia and it evolved through constantly changing. It acquired more assets, more state support; its portfolio converged with that of the Kremlin and by many it is considered the organ in the hands of Putin. In reality the control of the state in the case of Lukoil is almost clandestine, very subtle to be understood properly. It is No.1 in Russia, one of the most respected and healthy majors worldwide but it can not do anything for its future if its Russian board thwarts Kremlin's long term strategy.

Rosneft is the Trojan horse in the hands of the state. There the control is glaring and it's the price that Bogdanchikov has to pay for seeing its company transform to the most important oil major in the country. In terms of assets and economic power Lukoil is first, but in reality Rosneft is the most powerful oil major right now in Russia. Its medium to long term strategy is excellent, state control is ever present and prospects are bright.

Quite simply the state needs Rosneft as a counterweight for other oil majors. Controlling a powerful company, the Kremlin controls the entire market since it can check the growth of others and through Rosneft can cut their power in the market whenever necessary. Either it is acquisition of domestic production assets or expansion in the near abroad, the state through governmental competitions can grant at will any project to any company or to Rosneft. Its importance is vital for the whole Russian energy strategy and this can be understood since the company's agenda changed in the past according to the direction of Kremlin's energy policy. Rosneft was a safe keeper in the first years, it started to expand later and now it regulates through its position the entire domestic market regarding oil. Rosneft it's not just a plain pawn in the energy chessboard of Russia, it's the queen pawn and Gazprom is the king.

Profile: Sergei Bogdanchikov.

Born in 1957, Sergei Bogdanchikov studied engineering at the Ufa Oil Institute and graduated in 1981. His subsequent career has been closely tied to Sakhalin. During his first job as a specialist in underground repair of wellheads, Bogdanchikov worked for a subsidiary of Sakhalinmorneftegaz (SMNG), the island's chief production company. After a successful climb up the corporate ladder, Bogdanchikov spent 1985-88 as a functionary in the Sakhalin regional committee of the Communist party. Subsequently, he returned to SMNG and became the company's general director in 1993. At SMNG, he played a key role in the development of Russia's biggest production sharing agreements to date Sakhalin 1 and 2. In 1997, Bogdanchikov was appointed vice president of Rosneft, SMNG's parent company, and the biggest fully-state owned played in the Oil sector. In October 1998 he became president of Rosneft.

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