

### **Energy Series No.3: TNK-BP**

The TNK days

TNK stands for the Russian initials of Tyumen Oil Company boasted-before it's merging with BP- the least stable and most confusing history of any in the industry. One of its two original companies started as the rump descendent of the top tier of the Soviet Ministry of Oil in West Siberia, Glavtyumenneftegaz. However, this organization as all other governmental organizations was talanised by pure bureaucracy. Actually the company produced no oil itself, but only oversaw the basin's associations. When the Soviet oil industry collapsed at the end of 1991, a new organization called Tyumenneftegaz somehow ended up with a dozen or more fields which were almost all underdeveloped. Tyumenneftegaz was resource rich, but possessed no capital in order to expand accordingly.

The major problem for TNK was the legislation of the new Russian federation. The production associations that were not included in the first private conglomerates assigned immediately to Rosneft, which at the start had the role of the caretaker of the country's energy jewels.<sup>1</sup> Tyumenneftegaz was among them along with two important associations of the Samotlor field- Nizhnevartovskneftegaz and Chernogorneft. In 1995 the company emerged officially after it 'escaped' the patronage of Rosneft. Tyumen Oil Company (TNK) combined its production assets in the Tyumen and Nizhnevartovsk areas, a refinery in Ryazan, and petrochemical assets in Western Siberia and European Russia.

TNK under the new structure continued to run things in the old fashioned way since all of its constituent parts remained under the management of Soviet-Era managers. The total production and all other areas that measure successful oil major proved that the entire commercial viability of the organization needed a boost. The revival of the company came in 1997 when a group of outside investors acquired 40% of the TNK stock held till that time from the Russian government. The privatization completed in a parallel way as the infamous loans for shares program.

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<sup>1</sup> See: Energy Series No2, Rosneft

The investors were a consortium of Alfa group and Access-Renova. Alfa group was established in the early 1990's by Mikhail Friedman originally around commodity trading and Alfa Bank, which is now Russia's top bank. Access-Renova is headed by Victor Vekselberg, who, in addition to oil, has focused on other sectors, including aluminium, electricity generation and consumer goods. It is important to refer to the way TNK ended to Alpha's ownership since in 1997 the price paid for approximately 90% of the company's stock was 260\$ million. In 1993 the resources of the Tyumenneftegaz and Nizhnevartovskneftegaz were roughly 14, 6 billion bbl that means that Friedman and the investors of the Alpha group obtained the oil for approximately 4 cents per barrel. At the same time Brent oil averaged 17\$ per barrel. If we do the math we realize that TNK sold almost for free to Alpha group.<sup>2</sup>

At that point the company expanded aggressively and started to wage a war with other oil majors. Actually it was Friedman and Vekselberg waging combat against other oligarchic groups. Chernogorneft acquired from Sidanco (Vladimir Potanin) in 1999, and after a year Sidanco's Kondpetroleum division also begun operating under the TNK auspices. These Byzantine dealings between oligarchic groups were something usual in Russia during Yeltsin's rule.

Mass privatizations instigated by Gaidar and Chubais in order to transform Russian economy to capitalist had the result of delivering the vast natural resources, industry, etc of the USSR to the hands of the very few nouveau-rich Russians. These groups exploited the situation at the time and above all Yeltsin's tolerance and became wealthy beyond any imagination, virtually controlling the economic, political and many aspects of the Russian federation up until the start of Putin's rule in 2000.<sup>3</sup>

Back to TNK, we discover that from 1999 the company expanded considerably. By the end of 1999, TNK established effective control over Sidanco. In July 2000, it acquired Lisichansk refinery in Ukraine. In October 2000, it acquired an 85% stake in ONAKO oil company (reserves of about 300 million tons) for 1billion US \$. In December 2002, TNK jointly with Sibneft acquired a 75% stake in Slavneft for 1, 8

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<sup>2</sup> See: Grace, D, John. (2005), Russian Oil supply, ( Oxford: Oxford Institute for Energy Studies), p. 138

<sup>3</sup> For the oligarchic group creation see: The Oligarchs

billion US \$. Between 2000 and 2002, TNK also made acquisitions of stakes in RUSIA Petroleum, which holds the license for the Kovykta gasfield in Eastern Siberia, raising its total holding in RUSIA Petroleum to 29%.

#### BP in Russia

BP has been operating in Russia since 1990, but made a large-scale entry in 1997, acquiring 10% of Sidanco and 21% of RUSIA Petroleum from Potanin's Interros group for 571 million US \$. In the following two years Sidanco was bankrupted and BP wrote off 200 million US \$ of its investment before reaching an agreement with Interros and TNK, which ultimately enabled BP to increase its holdings in Sidanco and RUSIA Petroleum to 25 and 33% respectively. Furthermore, BP has concluded 49% pre-bidding agreements with Rosneft for the Sakhalin-4 and Sakhalin-5 projects. The alliance has commenced exploration in the Southern portion of Sakhalin-5 following the award of a 5 year exploration license on 2002. The Sakhalin 4 and 5 were not included in the TNK-BP merger and continue to be developed by BP and Rosneft. BP has also developed substantial downstream assets in Moscow (42 filling stations) through Petrol Complex, its joint venture with ST Group, a Russian company closely connected to the Moscow city government. BP owns 75% of Petrol Complex.

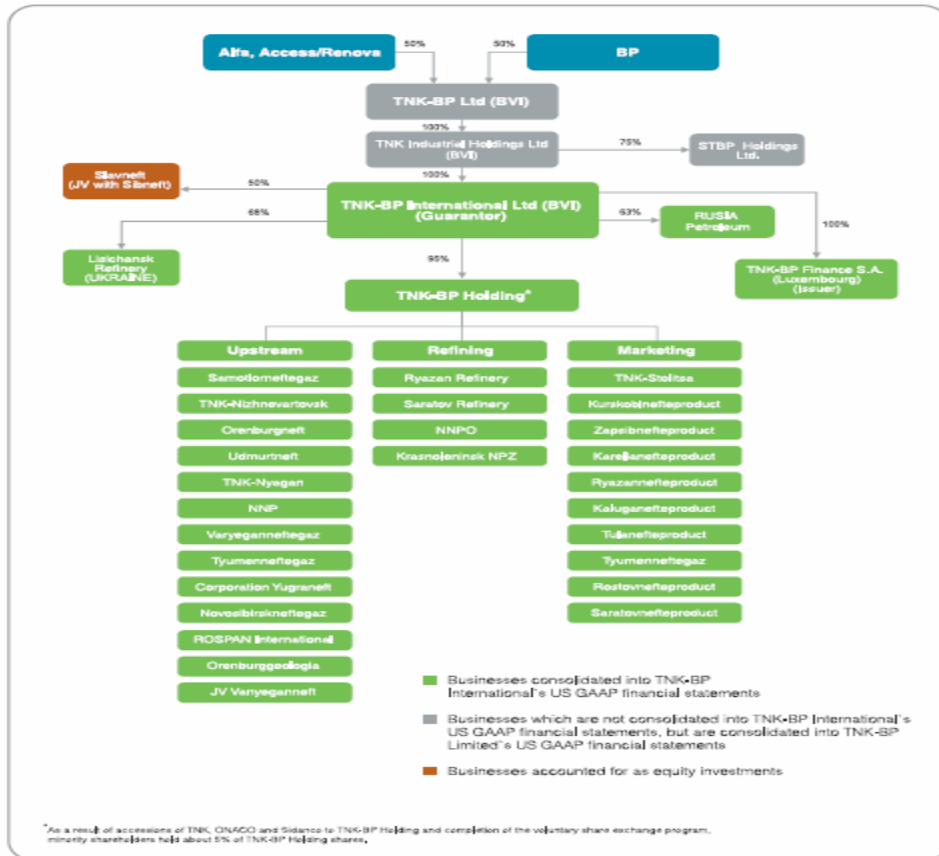
#### TNK-BP

In February 2003 TNK-BP created, capitalized by the assets of TNK and Sidanco and most of the Russian interests of BP. The British major also provided over 6\$ billion in cash and securities. Alpha group and BP control 50% each combining assets of oil and gas in Russia and Ukraine, as well as a 50% equity interest in Slavneft which is separately managed. Friedman, Vekselberg and Bleating control the company and we see the corporate structure in the relative graphic. TNK-BP in 2005 was currently Russia's 3<sup>rd</sup> largest oil producer generating approximately 15% of Russian production (17% if we include Slavneft in the grand total).

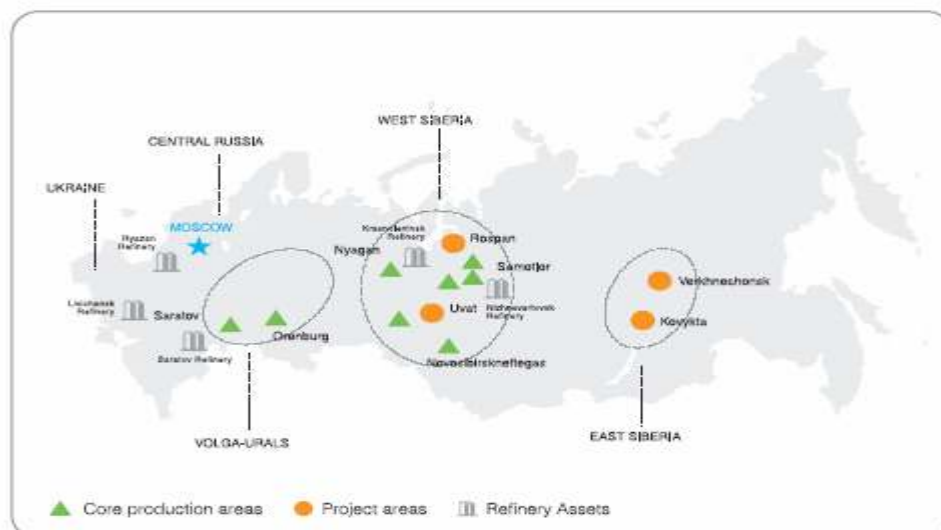
The main production assets of TNK-BP are located in west Siberia and Volga-Urals regions, while the main gas business asset are the Kovykta field in East Siberia and the Rospan project in Novy Urengoi regions. In addition the company holds four

major refineries in the central part of Russia and one in Ukraine. With 1,600 retail outlets branded either as BP or TNK the company's activity in the downstream sector is very important and one of the largest in the country.

### Corporate Structure

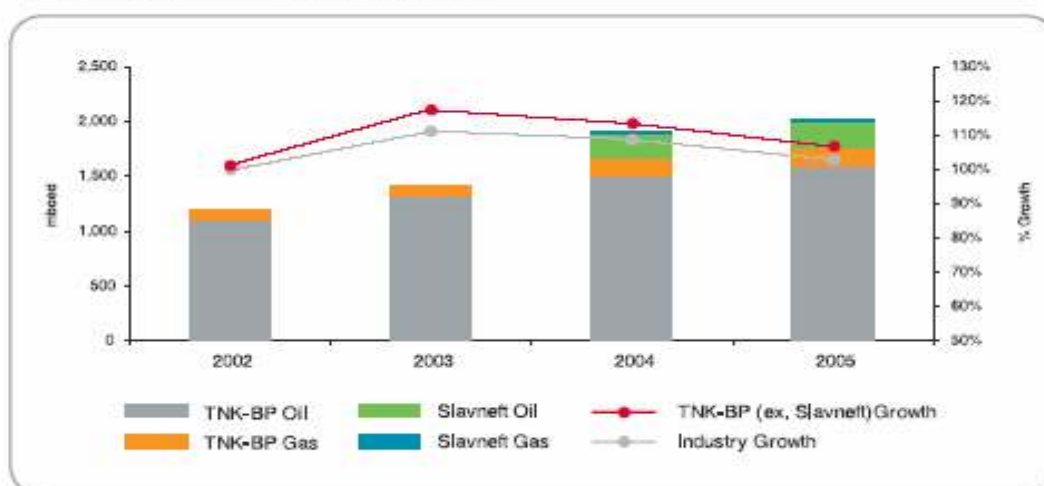


### Map of TNK-BP operations



The principal asset of TNK is Russia's biggest field, Samotlor, situated in Western Siberia. When it peaked in 1980 at 3, 4 million b/d, it contributed 28% of the total output of the USSR, then the biggest producer in the world. Despite 40 years in the mainstay of Russian production, the field remains rich in oil resources with 3, 7 billion bbls of high quality crude. This volume credited to Samotlor is greater than the proved reserves of any single field in the United States. In addition, the company possess the Krasnoleninskoye field in the same area while other untapped accumulations exist in the company's inventory.

**TNK-BP production history 2002-2005**



**TNK-BP Liquids (Oil & Condensate) Reserves**

Million barrels

Reserve	2004		2005		2005/2004	
	SPE	SEC*	SPE	SEC*	SPE	SEC*
Proved Developed (PD)	6,139	6,139	6,108	6,108	-1%	-1%
Proved Undeveloped (PUD)	2,943	1,878	3,121	2,122	6%	13%
<b>Proved Total</b>	<b>9,082</b>	<b>8,017</b>	<b>9,229</b>	<b>8,230</b>	<b>2%</b>	<b>3%</b>
Probable	8,578	-	8,211	-	-4%	-
Possible	11,547	-	11,888	-	3%	-
<b>Resources Total</b>	<b>29,207</b>	<b>-</b>	<b>29,329</b>	<b>-</b>	<b>0%</b>	<b>-</b>
<b>Reserves/Production ratio</b>	<b>17</b>	<b>15</b>	<b>16</b>	<b>14</b>		

However, the biggest gamble lies to what the company possesses in the area of East Siberia, the Kovykta field and the Rospan project. These two were actually the main reason that BP was attracted to the merger with TNK. Both these two represent the company's long run assets and a significant production update.

## KOVYKTA

The Kovykta regional project is projected to provide over 2, 5 bcm of natural gas per year with an estimated investment of 1, 2 \$ billion. Full scale scope envisions a 670 Km gas pipeline from the field to Irkutsk via the cities of Sayansk, Ussol'ye Sibirsk and Angarsk. In addition ROSNEFT petroleum plans to install a gas treatment and condensate processing plant. TNK-BP expects that deliveries of gas to the city of Irkutsk will take place by the end of 2009.

Kovykta gas field has reserves of 2 trillion cubic meters of gas, which is equivalent to four fifths of the annual global gas consumption. The field can satisfy the needs of gas in Irkutsk but will also be able to give gas to China and other Asian states, though no sooner than 2013. TNK-BP is to bring the scheme to an end on its own, although it has been trying to find a common denominator with Gazprom to form a joint venture for Kovykta for nine months. TNK-BP offered to create a holding that would comprise of four enterprises with Gazprom receiving 100% of shares in the transportation company in charge of both regional (within Russia) and export pipelines' maintenance.

Two months later a meeting was held between BP chief John Browne, Gazprom CEO Alexei Miller and Russian Prime Minister Mikhail Fradkov, once again without success. Gazprom, which is developing a competing project to supply the fuel to the Irkutsk region, opposed TNK- BP's plans to break its monopoly by supplying fuel directly to China or South Korea from Kovykta. Its stalling in interfering in the project seems to be an attempt to gain the greatest benefits possible when the time is right.

On November 7<sup>th</sup>, Russian prosecutors launched a probe against one of Rospan International's heads, for "violations of licensing requirements and reaping

excessively high profits" as the Prosecutor General's Office said in a statement. Two days before they had called for the oil major's biggest gas license in west Siberia to be revoked. They also stated that the reason for this move was multiple ecological and licensing violations at the Novo-Urengoi and East-Urengoi fields, which belong to TNK-BP's unit Rospan. The fields, Rospan's key assets, are located near West Siberian production sites operated by Gazprom and belonged to the gas monopoly before being spun off in the early 1990s.

The movement on TNK-BP did not come out of the blue. On September 25<sup>th</sup>, Russian prosecutors warned BP Plc's Russian venture, OAO TNK-BP Holding, that it may lose its permit to develop the \$18 billion Kovykta natural-gas field in Siberia because of license and environmental violations. Valery Pak, the head of TNK-BP unit OAO RUSIA Petroleum, was summoned to the Prosecutor General's Office and was "officially warned" that his company must fix the problems or face losing its license in the Irkutsk region. According to the license terms for the Kovykta asset, TNK-BP has to produce 9 billion cubic meters of gas for the needs of the Irkutsk Region. TNK-BP's executives insist that the current gas demand of the region is not anywhere near this volume, but even so the Ministry of Natural Resources can make use of that clause in order to revoke the license. The pressure put on Russia's third oil producing enterprise did not stop there. On November 10<sup>th</sup>, it was announced that TNK-BP paid 1.44 billion dollars in back taxes. The tax claim is the largest levied against a Russian company apart from the multibillion-dollar claims that led to the downfall of Yukos in 2004. Although the bill refers to a period prior to BP's involvement and it's up to the Russian shareholders to divide the cost, the announcement of the amount of money came as a surprise to the market and caused the company's shares to fall.

This wave of accusations and the unexpected large sum of back taxes, which came on the same period, seem to have influenced TNK-BP's policy, leading it to an effort to smoothen its relations with the Russian state. The beginning was made on November 13<sup>th</sup> when the company announced a \$2.2 billion plan to cut the number of its idle oil wells, although it could be unprofitable to do so. TNK-BP executive director German Khan and CEO Tim Summers said the firm would spend \$2.2 billion to reduce the number of idle wells up to 2011, with \$611 million invested next year alone and that TNK-BP plans to cut the number to 31 percent in 2007 and below 20

percent by 2009. Natural Resources Minister Yury Trutnev said he was "satisfied on the whole" with the program, although TNK-BP still will not meet the "allowable" 10 percent maximum for idle wells.

The profitability of the company may suffer but at least this movement reassures TNK-BP that oil field licenses are not also under threat of being withdrawn. Moreover, on November 15<sup>th</sup> TNK-BP and OAO SIBUR Holding, Gazprom's petrochemical unit, announced the establishment of a joint venture to process associated petroleum gas (APG) produced by TNK-BP and other oil and gas producers in the Nizhnevartovsk region. SIBUR will own 51% of the new venture and TNK-BP will hold 49% and equally share management control. "This is a good example of partnership between private and state companies," TNK-BP executive director German Khan said at the signing ceremony in Nizhnevartovsk. We want to broaden our cooperation to other regions where our interests intersect. Meaning, among others that TNK-BP seeks Gazprom's green light to the vast Kovykta project. The company is trying to enhance its relations with the state monopoly so as to proceed in its other schemes without the fear of an imminent license withdrawal.

Wanting to interpret these acts against an enterprise which is 50% owned by a British giant, BP, brings us vis-à-vis with the general Russian policy on the energy sector and the new air that surrounds Kremlin, after Vladimir Putin reelected to power. The Russian president has declared the energy sector "Holy of the Holies" making that way evident the importance it maintains for Russian interests. After Vladimir Putin gained the presidential elections for the first time, he foresaw the lurking potentials of Russia's natural resources.

The TNK-BP subject is also of crucial importance to Russia's plan to increase its control and needs a more thorough look to understand its impact on those involved. As it was mentioned before, the conditions in the merger which became TNK-BP cannot be altered before spring 2007. Since the 2003 merger, the state has made it clear that all new oil and gas projects will be majority-owned by a Russian company. State-run Gazprom has said it is interested in scooping up the TNK shares. One of the main goals of this pressure put on the company is to persuade BP to abolish that specific clause so that Gazprom, most likely, or Rosneft will be able to penetrate the



venture before that period. Even if that is not possible, TNK-BP's Russian billionaire shareholders are being pushed to sell their 50 percent stake in the venture, as cheap as possible, to a state firm such as Gazprom. TNK-BP has paid 3.6 billion dollars for interim dividends for the first nine months of 2006, a movement that leads to speculations that a sale could be on the way.

Regarding the Kovykta license and its possible revocation some points have to be mentioned. We have to keep in mind that Gazprom, since 2001, in agreement with the Ministry of Industry and Energy of the Russian Federation, is responsible for developing a “Program for Creating a Unified Gas Production, Transportation and Supply System in East Siberia and Far East with Possible Export of Gas to China and Other Countries of the Asia-Pacific Region.” According to the version proposed by Gazprom, gas produced in the Kovykta field should be directed to the internal market, whereas China and South Korea should be supplied with gas from the fields of Sakhalin. TNK-BP’s effort to provide gas to these countries puts Gazprom’s monopoly at stake. Therefore, its effort to expand its ventures to the east while simultaneously gaining a great deal of profits, as the Chinese and South Korean receivers are ready to buy at a relatively high price, is under threat. Gazprom seeks to keep these profits under Russian control and is trying to persuade TNK-BP to use the Kovykta field for regional consumption only. The Russians seem to give priority to Sakhalin-2 project for providing gas to APE countries and Gazprom’s own scheme for the Kovykta field, which predicts development of the area’s deposits in 2015, comes second. However, TNK-BP representatives are convinced that gas from this field will ineluctably be in demand.



The Chinese and Koreans seem to share that point of view. Gazprom has plans to create a gas pipeline network in the region known as the United Gas Supply System (UGSS), in which China, North and South Korea will be part of. The need to strengthen the energy links between these states became more necessary after the latest events concerning North Korea. China put pressure on North Koreans in order to bring them back to the negotiations withheld. South Korea - a big consumer, and therefore a crucial part of any gas pipeline network in the region - would be reluctant to buy gas that first has to be shipped through its capricious northern neighbor, and would prefer either to ship it across the Yellow Sea from China, or, as a last resort, to receive the Russian gas in the form of LNG. Gazprom would be reluctant to accept a pipeline-and-LNG scheme, because it would be much more expensive according to Keun-Wook Paik, a regional energy specialist from the London-based Royal Institute of International Affairs. Therefore, Kovykta originated gas is more welcome by South Korea and China, but Gazprom is dedicated to the Sakhalin project.

Within the Russian perimeter the Kovykta field will also be a worthy scheme as it will estimated triple the gross regional product of the Irkutsk Region. It will also create a network of gas supply to the chemical industry, power generation, and public utility enterprises. In TNK-BP retrospective, there is no reason for calling back the license and putting the field back into a tender, but Gazprom is by no means ready to allow gas exportation by any other than Gazexport, with reluctance to regional benefits deriving from TNK-BP exploitation.

## The Future

The corporate future of the company is well established since not only possesses a large hydrocarbon base but also because some of the projects have a huge potential. The BP presence is also very important for the company's good working since as we shall see the company due to Kremlin's policy regarding energy security dealt with major issues recently.

Fourteen major projects are under development each of which has estimated or actual capital expenditure in excess of 100\$ million. In Ryazan the refinery will be renovated for achieving greater performance for the whole TNK network, while the Kovykta project is also moving steadily but slowly. The Uvat/ Demiansky reservoir is

inside the general plans for further development. Four advanced technology rigs recently contracted and first stage development will have a plateau production of around 5million per year by 2009. The Ust-Vakh, Verkhnechonskoye, Kamennoye and Bolshehetskaya projects are under way as well. The first will contribute with 300 million barrels of oil, while the second has the capacity of 1, 4 million barrels. In the remaining two, exploration and other work is under way.

The major problem that TNK-BP is facing at the moment is the stance of the Kremlin regarding major future projects- especially Kovykta. The days were every energy major had the capacity to expand without any sort of control has passed and at present the trends have reversed totally. The state controls the expansion of energy companies not only in the domestic environment but also in the near abroad and values its companies (Gazprom, Rosneft, Transneft) more. All animals are equal, but some are more equal than the others.

The logic behind this is that geopolitics now more or less underlines the whole agenda of Kremlin. Putin and his entourage understood the importance of energy for the revival of the whole country as a whole. As a result TNK-BP has been hit by Kremlin's dual policy, the Janos characteristic.<sup>4</sup> The company dealt with a severe resistance from officials of various ministries, especially in the last two years. More recently for instance the company has not recognized as of Russia's origin. Regarding the future Bourgas-Alexandroupoli project TNK-BP does not exist among the holders of the Russian JV that will get 51% for constructing the pipeline. Aimed at attaining control over the transport flows in the neuralgic area of Southern Europe, Russia it seems trusts only the state companies to take part in the project.

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<sup>4</sup> The TNK-BP merge would not happen for any reason in the year 2006-2007. Kremlin officially welcomes foreign involvement in the energy business in the country; however it seems to despise really any foreign energy major that tries to abide by the international commercial practice. The Russian state at the moment wants foreign presence in order to provide the know-how and technical assistance. Any attempt to gain and control Russian reserves is dealt with extreme suspiciousness. The regulation of the market cannot be complete on Russia's point of view simply because it does not want to accept foreign control on what is its greatest weapon in modern international conjuncture: energy. Russia is trying to renegotiate agreements signed in the past when it lacked the room for maneuver that it has now, especially the Production Sharing Agreements the so called PSAs. TNK-BP, Exxon Mobil Corp., Royal Dutch Shell Plc and Total SA face demands from Russia to cede some control of oil and gas fields to state-aligned companies, OAO Gazprom and OAO Rosneft. The foreign-led ventures have become anomalies in Russia as President Vladimir Putin increases state control over the energy industry. Environmental authorities have let their "watchdogs" after both Shell, which is in charge of the 20 billion dollar LNG project of Sakhalin 2, and Exxon Mobil which is the main player in Sakhalin 1 scheme. Quite simply we witness a reversal of the Yeltsin and early Putin policies. Russian energy will remain in Russian hands totally.

TNK-BP faces the biggest problem regarding the Kovykta project. Although the license has not suspended it places a severe strain in the working of the company in that area. It is likely that the report will help Gazprom in its attempt to wrestle control of the company from TNK-BP, thus placing one of the most important future gas reservoirs under state control. TNK-BP is known to want to retain at least a 33% stake in the project, and Gazprom is said to be holding out for leaving TNK-BP no more than 25%, which would give the Russian gas giant a 74, 4% stake in total.

If that will happen the path will open for the total control of the Russian gas reserves by the state through Gazprom. The obstacles, especially of commercial nature will cease to exist for the state and the oil majors will remain the only alternative gas suppliers in Russia. However, many of them, if all, are already selling their gas business to Gazprom. Last summer for example, Gazprom bought 51% in Sibneftegaz, while Gazprom has large stakes in Novatek and Itera the only two big gas producing companies left.

#### Conclusion- TNK/BP

The 3<sup>rd</sup> oil major in Russia was born as we saw inside the turmoil that characterized the country after the collapse and its workings continue to be distinguished by certain instability until the merger with the western oil giant BP. However this exact move that seems to immunize the company in the past at the exact moment may become a serious pitfall.

TNK-BP due to some specific circumstances is the perfect example of a company captive to the policies of the Kremlin. At present the Putin administration made a reversal regarding the environment that characterizes the energy sector in the country becoming extremely stringent regarding the involvement of any foreigner. The result is that the presence of BP brakes the expansion of TNK, to put it mildly. The company will continue to exist and work as the country's 3<sup>rd</sup> largest energy major, but it will become stagnant regarding any future projects.

The company highlighted the desire of the Kremlin regarding the involvement of foreign energy corporations in the country and above all denudes almost all Russian officials. In almost every speech energy officials stress that Russia welcomes and

desires foreign involvement in its energy sector. However, they do not want a 100% participation in the dealings of the Russian energy. Funds, technology and know-how is what Moscow needs not ownership of shares and involvement in Russian fields. TNK's future also coincided with a sharp reversal for Kremlin as we now witness state energy majors having the upper hand in receiving the most favorable contracts almost everywhere. Even Lukoil is facing this discrimination and it's forced to lower its exploration standards, despite Alekperov being a political ally and allegiant to the Kremlin at the moment.

The future of TNK-BP is a mixed bag. It will continue to exist and function, but it will as we already said remain relative stagnant, something that violates standard commercial practices. The company has the potential to grow but on the reverse pole has to face state institutions that made energy and its geopolitical importance their No.1 priority. As such, future projects of great potential- Kovykta the best example- might become dangerous for the company's future as a whole, especially if the foreign investors choose to proceed against the will of the Kremlin.

Yukos dissolved totally due to its vast and aggressive expansion (other majors were threatened by the company's profile and strategy) but most importantly due to the accumulation of power that transformed into a political force in the making; something that the Putin administration could not exactly cope with. At the moment, TNK-BP faces directly Kremlin's strategy of using energy for the sole benefit of the state supported energy complex, and that clashes with the good function and the future expansion of the corporation (TNK-BP). At present a precarious position in Russia for a corporation of any stature.

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