

## Rosneft as a Mirror of Russia's Evolution

All animals are equal,  
but some animals are more  
equal than others.  
*G. Orwell, Animal Farm*

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In December 2004, Rosneft acquired Yuganskneftegas and soon after that successfully avoided consolidation into Gazprom. These two events, combined with the announcement about its IPO plans, generated a universal interest in the company that was previously known only to the oil experts.

Actually, the intrigue around Rosneft began much earlier, when the USSR Ministry of the Oil Industry was dismantled. The ups and downs in the evolution of this company faithfully reflect the development trends and changes in the role of private corporations and the state in Russia's oil business over the last 15 years.

### 1. Rosneft: Losing

#### The Fading Glory

In September 1991, after the Soviet Union collapsed, Rosneftegas corporation, a voluntary association of Russian oil enterprises, was formed to replace the USSR Ministry of the Oil Industry. Lev Tchurilov, the Minister, was appointed its president, soon to be replaced by Alexander Putilov, formerly general director of Uraineftegas (subsidiary of LUKOIL).

In November 1992, Presidential Decree # 1403 which launched privatization in the Russian oil sector, established three vertically-integrated oil companies (LUKOIL, Surgutneftegas and YUKOS), and the state entity Rosneft on the basis of Rosneftegas. Rosneft was to carry out trust management of the state stakes in 259 out of 301 oil enterprises operating in Russia; assist operating and financial restructuring of joint-stock companies; ensure stable deliveries of oil, gas and petroleum products for the state needs; represent interests of the state in managing boards of companies which shares it held in trust management; coordinate state investments in the oil industry; organize production of oil-field equipment; promote R&D programs and develop international trade, etc.<sup>1</sup>

In 1993, Rosneft accounted for over 60% of the domestic oil production. It consisted of 26 oil producers, 23 refineries, a multitude of petroleum product distributors, machine-building enterprises, R&D institutes and even gas processing plants. Given galloping inflation, falling oil prices, disruption of the established economic ties between the USSR republics, non-payments, and other maladies of the transition period, the state could not efficiently manage such a monster that stretched from Sakhalin to Kaliningrad. The old command-and-control system was destroyed, and market mechanisms were not yet developed, which created perfect conditions for

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<sup>1</sup> See in greater detail J.Hudson, N.Poussenkova, Russian Oil. Prospects for Progress: Industry Background and Status, Salomon Brothers, volume 4, March 1996.

the initial accumulation of capital. New Russian tycoons quickly and aggressively established control over assets which were effectively owned by no one. During the era of “gangster capitalism,” the collapse of Rosneft in its original form was inevitable.

In 1993-1994, new vertically-integrated oil companies (VICs) were formed, such as SIDANCO, Eastern Oil Company and ONACO, and Rosneft was forced to give up many of its upstream and downstream subsidiaries in favor of these new entities.

In April 1995, Rosneft was transformed into an open JSC by the presidential decree and was commissioned to perform the following special functions: trust management of state stakes in companies not included in the new VICs; support for the oil industry R&D efforts; and representation of state interests in production-sharing agreements (PSAs).

However, Rosneft continued to shrink. In August 1995, it was forced to cede Nizhnevartovskneftegas to the newly created Tyumen Oil Company. In the same month it suffered the worst blow when it was deprived of Noyabrskneftegas, Omsknefteorgsyntez (the most efficient and modern refinery in Russia), Noyabrskgeophysica and Omsknefteproduct in favor of Sibneft which was allegedly established to help fund Boris Yeltsin's 1996 election campaign.

The September 1995 Government Decree # 971 determined the new composition of Rosneft.<sup>2</sup> However, its hemorrhage did not stop. Thus, Rosneft received the blocking interest of the former state geological enterprise Archangelskgeoldobycha (AGD), which held 21 licenses for oil fields and 2 licenses for diamond deposits in the Timan-Pechora region. It was assumed that AGD would partially compensate the state company for the loss of Noyabrskneftegas. Rosneft was also interested in AGD because the latter was the co-owner of the JV Polar Lights (see below).

However, it turned out that the controlling interest in AGD was held by MAPO-Bank, and Rosneft could not manage its cash and crude flows. Unable to tighten its grip over AGD, Rosneft purchased from it a 20% stake in Polar Lights. Having fulfilled its role of an intermediary, MAPO-Bank transferred its stake in Archangelskgeoldobycha to LUKOIL in 1997.<sup>3</sup>

In downstream, Rosneft was even more of a failure than in upstream. The cumulative output of its three refineries was only 4.7 million tons in 1996, less than half of the amount of oil Rosneft produced. In 1997, its Krasnodarnefteorgsyntez was to be sold off to repay tax obligation of \$32 million - quite a modest sum as compared to other oil companies' debts. It was somewhat surprising that the government would choose to draw the line with respect to a subsidiary of Rosneft rather than that of debt-ridden privatized companies which were able to successfully lobby decisions in their favor.<sup>4</sup>

In addition, Rosneft lost the Moscow refinery and Mosnefteproduct that it had under trust management in accordance with the ordinance # 971. However, the Mayor of Moscow Yuri Luzhkov began to claim that Rosneft could exert price pressure on the Moscow fuel market

<sup>2</sup> Purneftegas, Sakhalinmorneftegas, Krasnodarneftegas, Stavropolneftegas, Termneft, Dagneft, Archangelskgeoldobycha, Kalmneft; Krasnodarnefteorgsyntez, Komsomolsk, Tuapse and Moscow; 16 petroleum products distributors.

<sup>3</sup> Since Rosneft held a blocking interest in AGD, LUKOIL could not actively invest in the development of the company and tried to consolidate its shares. Rosneft refused to sell or exchange its stake. The struggle between them continued for a long time. However, LUKOIL understood that in the new political situation it was better to live in peace with the strengthening state company. A compromise was reached in the late 2002 when they swapped the assets under disputes (see *Oil and Capital*, # 10, 2004, p. 116).

<sup>4</sup> After three unsuccessful attempts, Krasnodarnefteorgsyntez was sold in October 2000.

where the refinery is the key supplier. At that time, the Muscovites were still reeling from the shocking gasoline crisis of the mid-1990s and, therefore, it was not difficult for the Mayor to convince the government that he, rather than Rosneft, should control operations of the company that would supply Moscow with fuel. In February 1997, Victor Chernomyrdin signed the ordinance on creating the Central Fuel Company thus depriving Rosneft of any hopes to hold a stake in the Moscow refinery.

Over the years, Rosneft made several attempts to restore its former glory, but they largely ended in a fiasco. Thus, its application bid to participate in the auction for 40.12% of Surgutneftegas held on November 3, 1995 within the framework of the notorious “loans-for-shares” auctions was not even accepted under the pretext that its bank guarantees were filled in incorrectly. At that time, winners of such auctions were determined before the event.

Rosneft also tried in vain to strengthen its positions as a national company<sup>5</sup> in charge of various key functions. First, in the early 1995, Rosneft hoped to position itself as such an entity, but failed. Alexander Putilov realistically admitted that the project of creating the national oil company “was good, but time for its implementation already passed. Now it contradicts the established competitive environment. Commercial structures understand too well that this project will allow some entity to get priorities, therefore they'll hardly permit its implementation.”<sup>6</sup>

Then, in 1998, after the August 17 crisis, the government of Evgeniy Primakov intended to strengthen Rosneft by merging it with Slavneft and ONACO, the only other oil corporations where the state still held the controlling interests. However, Rosneft's influential private rivals foiled these plans because they were against the emergence of a strong competitor with a special status that would confer it additional important privileges.

The government apparently did not know what to do with Rosneft and how to take advantage of this important asset. The fiasco of the Leuna-2000 project – construction of the refinery in East Germany by Elf Aquitaine where Rosneft together with Surgutneftegas and Megionneftegas (subsidiary of Slavneft) was to be a key player - showed that the government was not willing (or able) to support the company it owned when its interests clashed with those of more powerful private groups.

The Russian partners were supposed to deliver annually 10 mln tons of oil to Leuna for 15 years, and could receive up to 24% of its authorized capital which would ensure them access to the European petroleum product market. But the proposals of Germany and Elf conflicted with the aspirations of certain major VICs and Transneft. It is not so surprising, therefore, that it took the government officials so long to grant oil export quotas to Leuna participants that this project also failed.<sup>7</sup>

In general, it seems that the state ownership was a mixed blessing for Rosneft. The company paid a price for its close ties with the Russian government, since it has fallen behind its Russian counterparts in the development of commercial skills that were becoming increasingly necessary as Russia was making a transition to the market system.<sup>8</sup> An indirect indication of this inability to develop market mentality was the average age of Rosneft's employees – 56 years in 1997 - one of the highest in the sector.<sup>9</sup>

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<sup>5</sup> In the international practice, national oil companies are commissioned by the state to perform certain strategic functions, and, in exchange, they are granted significant privileges.

<sup>6</sup> *Oil and Capital*, 1997, # 4, p. 16.

<sup>7</sup> *Ibid.*, p. 14.

<sup>8</sup> John Webb. *Rosneft at the Crossroads*. CERA, 1997, p. 6.

<sup>9</sup> *Oil and Capital*, 1997, # 7-8, p. 28.

## Poor Little Rich Girl

By mid-1990s, when Rosneft's privatization saga started, it already lost many valuable assets and became quite a minor player in the Russian oil sector, accounting for less than 5% of the country's oil output and oil reserves. In the pre-Yugansk era, Rosneft's contribution to the fuel and energy complex was more than modest. It was number 7 or 8 among its larger sisters in terms of oil production and reserves, drilling, refining and export volumes, and number of gas filling stations. It only did well in gas production (being number two among oil companies after Surgutneftegas), and had the smallest proportion of idle wells. Its headcount seemed frightening even among its peers that were notorious for their overemployment from the Western viewpoint. In 1996, 70,000 people worked in the company that produced only 13 mln tons of crude and 3 bcm of gas and refined 4.7 mln tons<sup>10</sup> (to compare: ConocoPhillips and ChevronTexaco employ 35,800 and 47,000 people, respectively).

Rosneft's key oil producer was Purneftegas located in the Yamal-Nenetsk Autonomous District. The subsidiary produced 8.2 mln tons of oil in 1998, i.e. more than one half of Rosneft's total output. The greater part of the territory licensed to it which is rich in high quality oil is not well explored and has a significant potential for reserve increment. Besides, Pur is the only crude producer in the region and owns the whole production infrastructure. Its main fields are relatively young and have a high daily output of wells, while water cut is roughly 45%, much lower than the average figure of 70% for West Siberia.

From the very beginning, Purneftegas had an advanced and progressive management team and showed its willingness to improve transparency. Already in 1995, the company hired Price Waterhouse to audit its financial statements and OPC Ltd. to assess its oil and gas reserves. Pur was also one of the pioneers in Russia to organize roadshows and presentations to Western investors in London and New York in 1995. Even in the troubled mid-1990s, Purneftegas was successful in raising significant international and domestic credits.<sup>11</sup>

In contrast to other oil producers in Russia, Purneftegas had few expensive social obligations (such as housing, schooling, healthcare, etc.) since some 67% of Purneftegas's employees worked on the basis of the "flight-in crews."<sup>12</sup>

Another key producing subsidiary of Rosneft, though quite minor by Russian standards, is Sakhalinmorneftegas (SMNG), which produced 1.5 million tons of oil in 1998. Its main upside potential lies in its participation in Sakhalin offshore projects (Sakhalin-1, 3, 4 and 5). In Sakhalin, the possibility of oil exports is not linked to Transneft export capacity limitations and bottlenecks, and they open a window to the fast-growing markets in the Asia-Pacific region.

SMNG operates on the island of Sakhalin where crude has been produced from onshore fields since 1921 and water cut has reached 84%. It holds licenses for 42 fields with a total of 324 mln tons of ABC1 reserves. Sakhalinmorneftegas's production costs are the highest in the Russian oil industry because of the high amount of energy needed to inject steam into productive layers of viscous oil and expensive transportation of materials and equipment to this remote location.

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<sup>10</sup> Proceedings of the Conference: Trade and Investment Opportunities in the Russian Oil Industry, March 1996, London, p. 42.

<sup>11</sup> At that time, the company received a \$158 million World Bank loan and a \$170 million loan from the EBRD under the oil and gas rehabilitation program.

<sup>12</sup> Russian Oil. Oil Producing Companies. London, Salomon Brothers, March 1996, p. 231.

The state subsidized oil and gas production in Sakhalin and provided considerable tax benefits and exemptions to SMNG throughout the 90s. This assistance was granted because of the difficult recovery conditions, the region's vital role in supplying crude to the Far East of Russia, the lack of major pipelines, and also to help the company recover from a devastating earthquake that hit the island in 1995.<sup>13</sup> Another important objective was the desire to maintain the federal government's influence in the region which became a synonym for energy crisis. Rosneft, as the state company, was commissioned to help resolve this crisis.

Timan-Pechora, the second biggest Russia's province in terms of hydrocarbon reserves after West Siberia,<sup>14</sup> was another important region for Rosneft. It had there a 50% stake in the Polar Lights JV together with ConocoPhillips that has been developing the Ardalinsk group of fields since 1994 (and it also acquired Severnaya Neft in 2003).

Besides, Rosneft worked in the South of Russia, a very mature oil producing region, where lifting costs are one of the highest in the sector, and the average daily output of wells is 0.5-0.6 tons. The main economic advantage there is the proximity to ports of Tuapse and Novorossiisk.

Thus, Rosneft's resource base was well diversified, and about one half of reserves lied in areas which have direct access to seas and oceans. However, the actual resource and production potential of the company (with the exception of Purneftegas) might not have been a sufficient reason for all the battles for Rosneft because it worked in old regions operating small or depleting oil fields. Mainly, its offshore Sakhalin ventures and Timan-Pechora projects made it a tempting prey for other oil sector predators during the 1990s.

### **Privatization a la Gangster Capitalism**

The saga of Rosneft unsuccessful privatization during the 1990s is a vivid illustration of the decision-making process in the oil sector at that time, when the fate of the state company was determined by the relative clout of various oligarchic groups.

Privatization history of Rosneft was closely connected with the vicissitudes of Purneftegas, the jewel in its crown. In May 1994, the ordinance of the RF Government established SIDANCO that was comprised of five oil producing enterprises (all of them originally incorporated in Rosneft), including Purneftegas.

Suddenly, in the early 1995 the top management of Purneftegas sent a letter to the government asking to return the enterprise to Rosneft, allegedly for technological reasons. In January 1995, Prime Minister Victor Chernomyrdin transferred the state stake in Pur to Rosneft. As a countermeasure, SIDANCO started litigation against the State Property Committee.

After Vladimir Potanin acquired the controlling interest in SIDANCO through loans-for-shares auction in 1995 the fight for Purneftegas began in earnest. Actually it was not the war between Rosneft and SIDANCO, but between V. Potanin, who was a Vice-Premier for a short while, and V. Chernomyrdin, the then Premier. Chernomyrdin very actively defended interests of Rosneft, largely because his team which included bosses of Gazprom, LUKOIL and Rosneft, was not eager to let SIDANCO, that had the potential for becoming one of the biggest Russian oil companies, grow stronger.

In April 1997, Ziya Bazhayev, a young and energetic Chechen entrepreneur, became president of SIDANCO, and zealously joined the battle for Purneftegas with the authorities. Bazhayev's task

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<sup>13</sup> Rosneft-Sakhalinmorneftegas, Troika Dialog Research, July 1997, p. 12.

<sup>14</sup> *Oil and Gas Eurasia*, March 2004, p. 62.

was daunting indeed: plans for Rosneft privatization were being developed at that time, and Boris Berezovskiy, the mightiest oligarch of the 90s, became interested in the state company, of course with Pur included in its structure.

After numerous arbitration court sessions and their controversial decisions the tug-of-war ended quite unexpectedly: in the late 1997, when judges recognized the validity of SIDANCO's claims, Vladimir Potanin voluntarily gave Purneftegas up. Observers saw the “invisible hand” of Berezovskiy in such a “generous” gesture. There is also an opinion that the government wanted to “sell Purneftegas twice:” first in the structure of SIDANCO, and then Rosneft.<sup>15</sup>

During the previous decade, several attempts to privatize Rosneft were made. However, its leadership showed exceptional agility (or luck) in evading privatization. While its competitors who had a clearer long-term strategy, wanted to become private owners and masters of their own destiny, bosses of Rosneft preferred to stay under the patronage of the state. Was it an acute case of shortsightedness, or, on the contrary, the ability to see far ahead in the future, as the latest events in Russia's oil industry are demonstrating?

Initially, the sale was planned for summer 1996, but was put off due to the drawn-out court battle between Rosneft and SIDANCO over Purneftegas.<sup>16</sup>

In 1997, most experts were betting on Rosneft's takeover by Sibneft. At that time, foreign majors were also considered eligible bidders for Rosneft. Even George Soros was interested in Rosneft and was prepared to pay \$1 billion for the state company.<sup>17</sup>

Rosneft's president Alexander Putilov was fired because he resisted the privatization plan proposed by the State Property Committee and tried to retain his own influence in the company<sup>18</sup>. He was made BoD Chairman and Yuri Besspalov, the ex minister of industry, widely believed to be “the man of Berezovskiy,” was appointed president in April 1997. The new boss immediately started to get rid of the “old team,” bringing his own people to Rosneft, probably preparing it through this infiltration for incorporation into Sibneft.

The plans to sell the company in 1997 dismally failed because certain influential players were interested in postponing the auctions for as long as possible. Boris Berezovskiy needed a delay because in November SIDANCO/BP and Gazprom /Royal Dutch Shell/LUKOIL alliances were formed, and the magnate was not confident that he would be able to triumph over these giants. The state was also not in a hurry since it was definitely not a seller's market in autumn 1997. Besspalov and his team were unhappy about the terms of privatization, particularly about the meager block of shares allocated for the personnel and management, and conducted what could be termed an “Italian strike.”<sup>19</sup>

In the early 1998, Victor Chernomyrdin approved a new plan of Rosneft privatization. It was decided to sell 75% + 1 share of Rosneft for \$2.1 billion, with additional \$400 million worth of investment conditions. The winner was to be declared in May.

What happened later was one of the most mysterious stories of the 1990s. Initially, a fierce battle for Rosneft among the powerful players was anticipated. In the beginning, the newly created Yuksi (the first attempt at YUKOS-Sibneft alliance that existed for about half a year),

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<sup>15</sup> Capital Markets Russia, February 6, 1997, p. 2.

<sup>16</sup> Interfax Oil and Gas Report, February 28, 1997, p. 11.

<sup>17</sup> *Kommersant-Daily*, July 30, 1997.

<sup>18</sup> *Oil and Capital*, 1997, # 6, p. 7.

<sup>19</sup> *Oil and Capital*, # 12, 1997, p. 8.

SIDANCO/BP and Gazprom /Royal Dutch Shell/LUKOIL were prepared to fight to the end. However, in the late March Mikhail Khodorkovskiy suddenly announced that his company would not participate in the tender since the “initial price was ridiculously inflated.”

The privatization attempt ended in a complete fiasco: foreign investors shunned the auction. Some experts believed that it happened because at that time Rosneft was in danger of completely falling apart. Also, the company that was the traditional “raw material” for new VICs suffered additional losses: the President deprived it of its three special functions.<sup>20</sup>

After the May debacle, the tender was postponed till October. The new price for Rosneft was reduced to \$1.6 billion (and the investment conditions to \$65.5 million) after the drop of the Russian stock market in late May.<sup>21</sup> Bespalov and Putilov were both fired and the government decided to hire an outside organization to prepare Rosneft for the auction. This “turn-around artist” was the Alliance Group created by the former president of SIDANCO Ziya Bazhayev. On August 3, the Vice-Premier Boris Nemtsov presented Bazhayev as the General Manager of Rosneft.

When Bazhayev came to Rosneft the company was in a sorry state, with huge debts, low level of integration and poor manageability. Assets of 40 enterprises, including Purneftegas, were arrested.<sup>22</sup> Within two weeks, Bazhayev's team developed and presented a program for enhancing efficiency and improving investment attractiveness of Rosneft aimed at holding the tender as scheduled on October 30. The Alliance Group reached an agreement with a number of key creditors on debt restructuring. A contract with Price Waterhouse about the audit was signed. Ziya Bazhayev managed to return the controlling interest of Purneftegas to Rosneft and increase it to 55% by buying 4% of shares at the secondary market.<sup>23</sup>

To continue transformation of Rosneft the Alliance Group needed an officially confirmed authority. The Government Ordinance of August 11 ordered the BoD to sign within 3 days a contract with the crisis managers, but directors ignored this ordinance and did nothing for 2 weeks. During these two weeks the situation in the country radically changed and the government was dismissed. On August 27, Ziya Bazhayev said that the Alliance Group could not continue to manage Rosneft.

Now we can only guess whether the sabotage of the contract with the Alliance Group was a malicious intrigue by somebody who wished to postpone the tender, or the officials were simply too busy in the crisis situation. In any case, the officials were forced to bow to the inevitable and to postpone indefinitely the sale of Rosneft.

To make things worse, in autumn 1998 Rosneft lost Purneftegas again. The controlling interest in the subsidiary ridiculously valued at \$10 mln was handed over to four creditors practically unknown in the oil community to cover Rosneft's debts.<sup>24</sup> However, the new Prime Minister Evgeniy Primakov returned Purneftegas's controlling interest to Rosneft in November 1998 with the support of the General Prosecutor Office.

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<sup>20</sup> *Oil and Capital*, # 4, 1998, p. 6

<sup>21</sup> *Oil and Capital*, # 8, 1998.

<sup>22</sup> *Oil and Capital*, # 9, 1998.

<sup>23</sup> In 1997, a number of Rosneft's subsidiaries that reported net profit, including Purneftegas, made decisions not to pay dividends on preferred stock which, according to the RF legislation, automatically turned into voting stock; as a result, the share of voting stock owned by the parent company was reduced.

<sup>24</sup> *NefteCompas*, 01.10.98, p. 1-2.

To some extent, all failures of Rosneft in the 1990s might have been caused by the human factor: L. Tchurilov, A. Putilov and Yu. Besspalov were no match for the new generation of oligarchs that acquired control over a large segment of the oil industry benefiting from the increasing weakness and corruption of the state authorities. If a powerful leader, such as V. Alekperov, took the helm of Rosneft from the very beginning, the fate of the company and of the domestic oil sector in general could have been completely different.

But in general the story of Rosneft during the 1990s reflected political and economic trends and the evolution of the role of the state in Russia. During the previous decade, Rosneft (and, largely, the Ministry of Fuel and Energy) were victims of centrifugal and privatization processes in the Russian energy sector. The Ministry has been consistently losing its competencies, while Rosneft was a tempting target for domestic financial-industrial groups that have gained a good experience in acquiring attractive oil assets.

## 2. Rosneft: Winning

Failures and losses of Rosneft culminated during the 1998 financial crisis. However, after this nadir, a new era began for the state company.

In October 1998, the new Rosneft management team headed by Sergei Bogdanchikov, formerly the general director of Sakhalinmorneftegas, was appointed and he began to consolidate the company, which was in danger of completely falling apart.

The main threat for Bogdanchikov was Rosneft's acquisition by powerful oligarchic groups. To protect the company, he began to search for powerful allies in the Establishment. Initially, Evgeniy Primakov became such an ally.

Then, Vladimir Putin was elected President of Russia. He needed a mighty state oil company that could be used to counterbalance the influence of private corporations and oligarchs. Subsequently, Rosneft became a foundation of such organization. And Bogdanchikov fit in very well in the presidential team: he turned out to be the right man in the right place at the right time, the executive of the new type deemed appropriate for the current political and economic situation.

When Bogdanchikov was appointed president of Rosneft, few experts could bet on him staying in this position for a long time: he was neither a high profile figure, nor an envoy of oligarchs. However, it was probably the reason why Putin approved of this low-key professional oilman with no apparent political ambitions. Both presidents are of the same generation; their careers really took off during the end of Yeltsin's reign rather than during the period of the initial redistribution of the state property.<sup>25</sup> Bogdanchikov headed SMNG for five years and worked for three years in the Sakhalin Region Party Committee during the mid-1980s.

Initially, Rosneft's boss was perceived as the integral element of the so-called "BMP Group" – Bogdanchikov-Miller-Pugachev.<sup>26</sup> The "BMP factor" determined some projects of Rosneft which created Sevmorneftegas with Gazprom and Rusugol together with Mezhprombank which also credits Rosneft's activities in Chechnya (see below). Currently, experts include Bogdanchikov in the nomenclature and political group of *siloviki* which is headed by Igor Sechin who became Rosneft's BoD chairman in 2004.<sup>27</sup>

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<sup>25</sup> *Oil and Capital*, # 10, 2002.

<sup>26</sup> Sergei Pugachev is an influential banker and senator from Tuva, founder of Mezhprombank

<sup>27</sup> *Deloviy Lyudi*, March 2006, p. 37.

With such patron and partners, Bogdanchikov quickly got a chance to avenge the humiliations of the previous decade when Rosneft was plundered by the oligarchs. Now the state company acquired a mighty administrative resource, which it used to consolidate its holdings and redistribute in its favor assets in the choicest enterprises.

### **Rewriting the Past**

Under Bogdanchikov's leadership, Rosneft began offensive operations on all fronts.

First, Rosneft became a formidable force on the Arctic shelf. In 2001, to develop 5 northern fields,<sup>28</sup> Gazprom through its subsidiary Rosshelf and Rosneft through Purneftegas established JV Sevmorneftegas. By 2002, Rosneft turned into an actual leader of Sevmorneftegas's projects, and some experts even predicted that it might well become a leader on the whole northern shelf.<sup>29</sup> However, in 2005 Rosneft sold its share in the JV to Gazprom allegedly to raise funds to pay for Yuganskneftegas. Thus, the "\$9 billion headache" quickly resulted in substantial losses for the company.

Rosneft also began to establish its control over other offshore petroleum projects. In summer 2002, Rosneft and TNK obtained licenses for geological studies in Sakhalin-4 and Sakhalin-5. Therefore, now TNK-BP and Rosneft control all Sakhalin projects of the "second wave."

In addition to the shelf projects, Rosneft is conquering the East-Siberian petroleum province which it considers its zone of strategic interest. In September 2004, the state company received from the Ministry of Natural Resources 10 licenses for geological exploration in East Siberia. Rosneft also bought 25.9% of Verkhnechonskneftegas from Interros in 2005.

2003 was an important milestone in Rosneft's entrenchment in the East of Russia since the Gazprom-Rosneft-Surgutneftegas consortium was created for the joint development of hydrocarbon resources. Interestingly, some experts consider Bogdanchikov to be the chief ideologist of the consortium.<sup>30</sup> Apparently, the Kremlin intended to leverage this consortium to establish its dominance in the promising petroleum frontier and to counterbalance the influence of private companies in the region where YUKOS used to reign supreme. Now, the consortium does not actually operate, likely because of the disagreements between its members: with Rosneft evolving into a heavyweight, the balance of forces between them might have been disturbed.

However, despite the success Rosneft enjoyed in its turnaround, it failed to realize the full potential of Purneftegas for which it fought so hard during the 1990s. Purneftegas was unable to intensify oil production, and this debacle was particularly visible against rapid output growth of YUKOS, Sibneft and TNK. Though Purneftegas is the youngest and the most promising producer in West Siberia, its output is declining: from 9.9 mln tons in 2002 to 9.4 mln tons in 2005. Maybe a more efficient company would have had more luck in taking full advantage of this "jewel in the crown" of Rosneft. But Rosneft was never famous for its efficiency: for example, in terms of lifting costs it lagged behind all its peers outperforming only Tatneft in 2002.<sup>31</sup>

<sup>28</sup> Prirazlomnoye, Shtokmanovskoye, Kh arampurskoye, Vyingayakhinskoye and Etyurovskoye.

<sup>29</sup> *Oil and Capital*, # 12, 2003.

<sup>30</sup> *Finansoviye Izvestiya*, 30.12.03.

<sup>31</sup> TNK-BP Databook, 2003, p. 50.

Rosneft, the only one out of all Russian oil VICs, tried to diversify into the coal industry. Sergei Bogdanchikov said in 2001 that Rosneft was to become a full-fledged energy holding with annual coal production of 30-40 million tons, and, in line with these ambitions, SMNG acquired a 55% stake in the Sakhalin Boshnakovsk Coal Mine in 2002. Rosneft planned to mine coal in East Siberia, Kuzbass and the center of Russia and intended to enter the coal market in cooperation with Mezhprombank. To this end Rusugol (Russian Coal), a JV between Rosneft and Mezhprombank, was established in 2001. However, two years later Rosneft withdrew from the JV.

Rosneft was also making resolute efforts to expand its lost downstream positions. One of its major investment projects is the \$700 million upgrading of the Komsomolsk refinery. Besides, Rosneft further consolidated its export positions in the Far East by buying shares of the Eastern Oil Loading Terminal in spring 2003 (now it has 3 ports in the Far East).

In addition, Rosneft is recapturing a niche in the fuel market of Moscow. In 2005, it opened its first gasoline filling station that used to operate under YUKOS brand name.<sup>32</sup> In the nearest future another five fuel retail outlets bearing Rosneft brand will open in Moscow. Rosneft needs presence in the Moscow market both to enhance its image and because after its acquisition of Yuganskneftegas, the company faces a shortage of refining capacity and retail network.

### **Taming of the Shrews**

Parallel to the strengthening of its production positions, Rosneft was cementing its corporate structure. Bogdanchikov managed to quickly tighten his grip on its independent minded subsidiaries by installing loyal executives and boards of directors in Purneftegas and Sakhalinmorneftegas and establishing very strict control over managers' activities: they had to get Bogdanchikov's approval on such issues as personnel structures, business plans, contracts and loans, communications with the state and regional authorities. Rosneft introduced a policy whereby all crude exports by the subsidiaries were to be channeled through the holding company.<sup>33</sup>

In 2000, Rosneft got the permission of the RF Anti-Monopoly Ministry to increase its stake in subsidiaries to 75% and began to buy their shares through affiliated companies. This process was accompanied by many scandals in the best Russian traditions. Experts commented that “Rosneft organized the process in such a way that shareholders had no right to demand buyout of shares by the issuer at market prices.... The state company selected assets itself, priced them itself using unclear methodology and took them away.”<sup>34</sup>

The most serious battles were fought over Krasnodarneftegas, a 1.5 million tons oil producer located in the South of Russia. In the late 1990s, Rosneft practically lost control over its subsidiary and did not even have majority in its Board of Directors. Actually, Krasnodarneftegas was under the real control of Alexander Putilov, the former Rosneft President, since 1997. Other shareholders of Krasnodarneftegas acted in a very coordinated fashion blocking all initiatives of Rosneft aimed at establishing control.

However, in the “Putin's Russia” Bogdanchikov got an important trump card in his efforts to make his “prodigal daughter” come to heel: in July 2000 the session of the RF government was held where the issue of the controlling interest in KNG was discussed with the involvement of the General Prosecutor Office, the Ministry of Internal Affairs and the Federal Security Service.

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<sup>32</sup> *Vedomosti*, 08.09.05.

<sup>33</sup> *NefteCompas*, May 29, 1999, p. 6.

<sup>34</sup> *Oil and Capital*, # 3, 2002, p. 23.

So, in the new political situation *siloviki* turned into a powerful instrument for resolving economic disputes that was available to certain “privileged” companies.

Another conflict with minority shareholders began after Rosneft began to buy oil produced by Krasnodarneftegas at transfer prices. A new round of lawsuits and letters to the federal authorities was arranged by the Association for Protection of Minority Shareholders of Rosneft that was organized by offshores affiliated with Sibneft. Rosneft dismissed all attacks as “greenmail.” However, in the first half of 2002, Rosneft faced many problems, even an armed invasion of Krasnodarneftegas's office by court bailiffs and a group of minority shareholders.<sup>35</sup>

By summer 2002 some compromise was reached, and minority shareholders practically ceased fire. However, the saga of Krasnodarneftegas continued in 2005, when Rosneft was preparing for consolidation. Over the year, Rosneft bought out 45% of its Krasnodar subsidiary and now holds a 95.46% stake. The press-service of Rosneft kept silent concerning the transaction and did not name the seller and the amount paid. In general, investment analysts approved of the policy of Rosneft that bought shares of subsidiaries before consolidation, but deplored its less-than-transparent methods. Sergei Suverov from Gazprombank commented that “it is unclear why shares of this very subsidiary were bought, who got money for this stake, and why they were bought out before the market value of the company was made public.”<sup>36</sup> However, Rosneft was never famous for its transparency: in 2005, Standard & Poor's named it an outsider in terms of information disclosure even among 11 Russian state companies (only Tatneft and Russian Railways got a worse rating).<sup>37</sup>

Minority shareholders of Rosneft's subsidiaries regularly accused the holding of infringing on their rights by systematically withdrawing assets, using transfer prices and attempting to dilute their stakes, i.e. of the same practices that “capitalist sharks” employed in the past when oil VICs were consolidated. However, now it was the state company that behaved like a robber baron. Rosneft was acting within the law, but the laws in Russia were such that they could not ensure protection of minority shareholders. And Rosneft (read the state) was taking advantage of this weakness of legislation<sup>38</sup>

### **The New Heavyweight Champion**

An important milestone in Rosneft's comeback was passed in 2003, when the company acquired Severnaya Neft from Senator Andrei Vavilov, and it became its third biggest subsidiary in terms of oil production volumes after Yuganskneftegas and Purneftegas.<sup>39</sup> In 2004, Bogdanchikov admitted that Severnaya Neft was Rosneft's most interesting project.<sup>40</sup>

This acquisition vividly demonstrated that the status of the state company is now not only a competitive advantage in the Russian market, but also a sign of the wholehearted presidential support. In February 2003, a loud signal about the current balance of power between the state and private oil companies and the new role of Rosneft was given at the meeting between V. Putin and representatives of the Russian Union of Industrialists and Entrepreneurs. Then, Mikhail Khodorkovskiy complained about Rosneft's acquisition of Northern Oil for \$622.6 million, at least twice its fair value. Khodorkovskiy cited this deal as the example of corruption in the state authorities.<sup>41</sup> Putin's reaction was tough: “It is a state company that needs to increase

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<sup>35</sup> *Oil and Capital*, 2002, # 10.

<sup>36</sup> *Vedomosti*, 08.10.05.

<sup>37</sup> *Vedomosti*, 09.06.06.

<sup>38</sup> *Oil and Capital*, # 5, 2002.

<sup>39</sup> Its oil production grew from 1.0 million tons in 2001 to 4.8 million tons in 2005.

<sup>40</sup> *Oil and Gas Eurasia*, March 2004, p. 60.

<sup>41</sup> *Oil and Capital*, # 10, 2004, p. 131.

its insufficient reserves,” he said, and added that “other oil companies” have excessive reserves, while “we still have to investigate” how they obtained them.<sup>42</sup>

Soon after the RF President publicly supported Rosneft, Platon Lebedev and then Khodorkovskiy himself were arrested, and the destruction of YUKOS began. Bogdanchikov triumphed over his rival: the former owner of YUKOS got a long sentence, and Rosneft acquired its best asset.

Having bought Yugansk and increased its production from 21 to 75 million tons of oil, Rosneft was transformed into an oil heavyweight, and in terms of recoverable reserves of 3.4 billion tons of oil<sup>43</sup> it became number two in the world among public companies, second only to LUKOIL.

In 2004, Igor Sechin, the number two person in the country according to Renaissance Capital,<sup>44</sup> was appointed Rosneft’s BoD chairman. Such strengthening of the state interference in the oil sector of Russia caused serious concern of the global investment community.<sup>45</sup> Sechin, widely considered to be the initiator of the “YUKOS case”<sup>46</sup> launched a new attack against the beleaguered company: Rosneft that has already arrested some 180 enterprises of YUKOS<sup>47</sup> began to lead the process of its bankruptcy by buying out its debts from creditor banks.<sup>48</sup>

It is noteworthy that Yuganskneftegas has been enjoying exceptional luck in his litigations with fiscal authorities after it was consolidated into Rosneft.<sup>49</sup> Besides, some analysts comment that Rosneft is buying oil from its subsidiary at transfer prices,<sup>50</sup> though it forced Yuganskneftegas to start court proceedings against its former parent company accusing it of this very crime.

Meanwhile, in September 2004 experts had serious grounds to believe that Rosneft would cease to exist as an independent entity. The RF President announced that Rosneft would be consolidated into Gazprom so that the state could get the controlling interest in the gas giant. Vladimir Milov, the leading energy expert, commented that “the state intends to get rid of the oil company that is worth several billion dollars, in exchange for the legal confirmation of the status quo.”<sup>51</sup>

However, Rosneft managed to repulse this new attack. And it is likely to continue its triumphant march: Bogdanchikov promised to Putin that the company would produce 135 million tons by 2015 versus its current 75 million tons. Since it will hardly be able to implement these plans using its current production potential, the natural question arises: whom will the newly emerged “global major” acquire next?

### **A Special Purpose Company** ***On his Majesty's Social Service***

Today, Rosneft positions itself as the vehicle for promoting strategic interests of Russia in the oil and gas sector of the country,<sup>52</sup> i.e. as the national oil company *de facto*.

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<sup>42</sup> *Vedomosti*, 20.02.03.

<sup>43</sup> [www.rosneft.ru](http://www.rosneft.ru)

<sup>44</sup> *Vedomosti*, 24.12.04.

<sup>45</sup> [www.gazeta.ru](http://www.gazeta.ru), 28.07.04.

<sup>46</sup> *The Moscow Times*, 05.08.05.

<sup>47</sup> *Kommersant*, 07.07.05.,

<sup>48</sup> *Vedomosti*, 16.03.06.

<sup>49</sup> *Vedomosti*, 11.10.05.

<sup>50</sup> *Vedomosti*, 22.02.06.

<sup>51</sup> *Vedomosti*, 24.03.05.

<sup>52</sup> [www.rosneft.ru](http://www.rosneft.ru)

Sergei Bogdanchikov was always regarded as one of the key supporters of the national oil company in Russia. In an interview given in 1999 he explained his vision: “If the government needs a rescue team that can be relied on even under conditions of financial shortage that it will cope with supplies [to the Northern regions] and won't permit people to freeze in winter than it is logical to commission the state company to do it. It is difficult to order private companies to do something to their own detriment, but it is possible to order such a company.”<sup>53</sup> All actions of Bogdanchikov were aimed at establishing Rosneft as the powerful national company. However, his actual deeds sometimes contradicted his publicly expressed sentiments, as the situation with fuel supply to Kamchatka definitely showed.

In spring 2001, Rosneft, the sole supplier of fuel to Kamchatka, notified the governor that it would stop delivering mazut (black oil) to the peninsula because of non-payments of Kamchatskenergo, the local power generating subsidiary of RAO UES Russia, which in turn was not paid by its customers. In April, the governor announced that the region was on the verge of a complete energy disaster. To “persuade” the debtors, Kamchatskenergo started to disconnect consumers, even such “untouchables” as schools and hospitals. Meanwhile, the tanker with 15 thousand tons of Rosneft's fuel oil on board was anchored in the port; Rosneft did not permit to unload it until Kamchatskenergo started repaying its debt. Vice-Premier Victor Khristenko had to interfere and develop a schedule for debt repayment of Kamchatskenergo.

Furthermore, in 2001, Rosneft was charged with gasification of Kamchatka by a special ordinance of the government and had to build a pipeline to Petropavlovsk-Kamchatskiy. This gas pipeline could have eliminated the need to deliver huge quantities of fuel oil to the peninsula, and thus resolve energy problems of the region.<sup>54</sup> There is information that Sergei Bogdanchikov got involved in the project only under pressure of the authorized representative of the RF President in the Far-Eastern Federal District, Konstantin Pulikovskiy. Later, in 2003, analysts of Rosneft submitted a paper to the RF Government where they questioned the profitability of the project of gas supplies to Petropavlovsk-Kamchatskiy. Rosneft believed that its participation in gasification would undermine its financial stability and investment attractiveness.<sup>55</sup> The company negotiated with the Ministry of Economic Development reimbursement of its expenses, either through direct compensation, or through allowing Rosneft participate in another, more profitable venture.

So, the right for the exploration of the West Kamchatka shelf might have been such a consolation prize since its forecast resources are comparable with Sakhalin-1 and Sakhalin-2 projects. YUKOS competed with Rosneft for the 5-year license for geological studies of the shelf; however, in August 2003, Rosneft was declared the winner.

Recently, Rosneft managed not only to reestablish control over its subsidiaries, but also to return its special functions of the national oil company that it lost in the past.

First, together with Zarubezhneft it was reappointed authorized organization in preparing and implementing PSAs. A relevant agreement was signed in August 2001 with the RF Ministry of Economic Development and Trade. The authorized companies were supposed to provide scientific, technical and advisory support to the Ministry in preparing and implementing PSAs, help to speed up the process of developing the agreements, and strengthen the state's position in contests and negotiations.<sup>56</sup> This role created a certain controversy between Rosneft and its peers, because the former simultaneously acted as a commercial entity in these agreements

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<sup>53</sup> *Oil and Capital*, # 1, 1999.

<sup>54</sup> *Oil and Capital*, # 7-8, 2001.

<sup>55</sup> *Oil and Capital*, # 11, 2003.

<sup>56</sup> *Oil and Gas Vertical*, # 2, 2002, p. 84.

(namely, Sakhalin-1) and also got additional privileges that conveyed competitive advantages to it.

However, at first the new status did not always automatically ensure victory over rivals. In the sphere of PSAs, Rosneft suffered a crushing defeat from YUKOS. Production-sharing agreements were an area where Rosneft as the authorized company of the state, and Bogdanchikov, as its boss, could have drastically improved their status and authority. Vladimir Putin was always publicly proclaiming his commitment to the idea of PSAs, and Bogdanchikov was supposed to implement this idea in practice. But in reality the president did not provide necessary support to Rosneft. As a result, Bogdanchikov lost in his struggle with Mikhail Khodorkovskiy who was a vehement opponent to PSAs and conducted a very effective PR campaign against it. Khodorkovskiy was saying that the agreements damaged the state budget, created preferences to certain companies, bred corruption and limited the upside potential of Russian corporations. His arguments seemed convincing to the State Duma that passed a law in his favor in 2003.

In this respect, Mikhail Subbotin, a leading Russian expert on PSAs, believes that YUKOS's victory "cut off oxygen supply" for the companies such as Rosneft that tried to launch new major investment projects.<sup>57</sup> This view is confirmed by the unambiguous statement of Sergei Bogdanchikov, who said "Let's have a look at who is interested in burying PSAs in Russia. These are two companies [YUKOS and Sibneft] that got the most productive fields in the period when the oil pie was divided. Hence, they have the lowest lifting costs; they secured competitive advantages for themselves at this stage, and want to maintain them for the next 15-20 years. It is clear that the expenditures for the development of a new region that entails construction of roads, pipelines and electricity transmission lines will always be uncompetitive versus the already developed areas..."<sup>58</sup>

However, views do change: today it is Rosneft itself that is claiming that the practice of transferring the subsurface plots to non-residents under PSA terms damaged Russia's interests. It is developing the arguments of Khodorkovskiy, but with a new slant: according to some government officials, Rosneft together with Gazprom convinced Vladimir Putin and Mikhail Fradkov that "it is the state companies that should write out entry tickets to the best fields."<sup>59</sup>

Rosneft is officially in charge of two more special functions. One of them is the restoration of the oil industry of Chechnya that was destroyed by the war. To this end, Rosneft established in the late 2000 a subsidiary Grozneftegas. Over the early 2000s, the company managed to rebuild more than 250 facilities destroyed by war and significantly increased oil production: from 0.7 mln tons in 2001 to 2 mln tons in 2004.<sup>60</sup>

Also, Rosneft supplies petroleum products for the state needs, to the agricultural sector of Russia, the RF Ministry of Defense and the Ministry of Transportation. Rosneft's representatives claim that the fulfillment of the state tasks does not bring it any commercial benefits. However, as the above-mentioned situation with Kamchatka showed, the state can find ways to reward its faithful vassal for additional efforts undertaken on its behalf.

In addition to the social function, Rosneft is turning into an instrument of the domestic policy, which the federal authorities unofficially use for strengthening the vertical of power, particularly in the "troubled regions." In 2004, Bogdanchikov said that Rosneft would consist of four major regional divisions (the Far East, Siberian, North-Western and Southern), and that first it would

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<sup>57</sup> Mikhailov A., Subbotin M., Yabloko and PSA. Moscow, 2004, p. 124.

<sup>58</sup> *Vedomosti*, 20.03.03.

<sup>59</sup> *Vedomosti*, 25.05.06.

<sup>60</sup> *Oil and Capital*, # 9, 2004.

join together its producing assets in Krasnodar in order to cut administrative and operating costs. The Southern region is strategically important for Russia, and, therefore, the state company might be putting its house in order there to meet the state objectives.

### ***Extraordinary and Petropotentiary***

Powerful national oil companies often serve as an instrument of the state foreign policy or act as a counterbalance to foreign oil companies. Rosneft, which should have logically been such an instrument because of its state ownership, until recently was not strong or influential enough to perform this function. However, now the situation is changing and it is gradually evolving into a state agent in the foreign policy realm.

Rosneft is active in the CIS states, implementing, in particular, an important project in Kazakhstan: it develops the Kurmangazy located on the shelf of the northern part of the Caspian Sea together with KazMunaiGaz. The subsidiary of Rosneft, RN-Kazakhstan, was authorized by the RF government in 2003 to participate in the Kurmangazy project and finance the Russian share of expenses. On July 6, 2005, a relevant PSA and Agreement on Joint Activities were signed in Astana in the presence of Russian and Kazakh Presidents. It is noteworthy that Kurmangazy was one of many spheres where Rosneft crossed swords with YUKOS. The Caspian Oil Company that was founded by YUKOS, LUKOIL and Gazprom also hoped to become the Russian envoy in the project. However, Rosneft was chosen for this role, and YUKOS complained that Rosneft took unfair advantage of its special status.

Efforts of Rosneft in the “far abroad” are now mainly focused on Algiers where it established a joint operating company with Stroitransgas. Bogdanchikov was saying that he was driven by purely economic considerations, since it is profitable to invest in oil production in the North Africa. However, the date of Rosneft's arrival in Algiers in spring 2001 coincided with the intensification of Russia-Algiers political dialogue. Therefore, participation of Russian companies in Algiers' petroleum projects might contribute to the development of political and economic cooperation between the countries.

Recently, the political weight of Rosneft in Asia has increased considerably. Thus, the Russian-Japanese summit held in November 2005 confirmed the role that Rosneft as the current master of East-Siberian oil will play in Russian-Japanese relations. Sergei Bogdanchikov admitted in Tokyo that he was discussing with JNOC the establishment of a JV dealing with the development of fields in East Siberia.<sup>61</sup>

In addition, during the latest visit of Putin to Beijing an agreement on establishing a JV between Rosneft and CNPC and on cooperation in Russia and China was signed. Rosneft is also implementing joint projects with the Korean National Oil Company on the West Kamchatka shelf and within the framework of Sakhalin-3. Therefore, Rosneft carved for itself an important niche in the relations with the three key countries of the region. Besides, India is involved in Sakhalin-1 project: in 2001, Rosneft sold to the Indian ONGC half of its share in the project, and this deal helped to execute a major contract for the deliveries of Russian weapons to India.

Nowadays, the Russian government is concerned not only with the development of international cooperation and attraction of foreign investors to the domestic energy sector. It is increasingly focused on limiting the role of international corporations in the development of strategic reserves. These limitations were formalized in the draft Law on the Subsurface, and recently they have been toughened even further.

<sup>61</sup> *Vedomosti*, 22.11.05.

Bogdanchikov has started thinking in this direction long ago. He said in February 2004: “I believe we should give an even more careful consideration to the issue of foreign involvement in our oil industry. It might even make sense to think about limiting the acquisition of major stakes in Russian companies by foreigners. Let them invest in production sphere rather than in the stock market: let them win a license under general terms and work.”<sup>62</sup>

Not surprisingly, his tough stance reflects the general sentiment of “oil and gas patriotism” that is getting increasingly stronger in Russia. The usual Russian xenophobia is particularly visible in the case of the oil and gas sector: according to the recent public opinion polls made by Levada-center, 67% of population believes that foreigners should not be allowed any form of control in the oil sector of Russia versus only 2% that accepts foreign involvement without any limitations.<sup>63</sup>

Bogdanchikov’s thoughts about the role of foreign companies in the oil sector of Russia were reflected in his deeds. In 2003, Rosneft won a war for the Vankor oil field when it defeated both YUKOS and TOTAL. Eniseineft created in 1992 won a license for Vankor in a tender held in 1993.<sup>64</sup> In 2000, YUKOS joined the game by acquiring the controlling interest of East-Siberian Oil and Gas Company, a parent company of Eniseineftegasgeologiya and Eniseigeophysica.

In the early 2002, TotalFinaElf conducted negotiations with the administration of the Krasnoyarsk region, Eniseineft and Anglo-Siberian Oil Company (ASOC) about its participation in the development of the field. A year later, TOTAL reached an agreement on buying 52% out of 59% of Eniseineft owned by ASOC. In February 2003, TOTAL said that it was ready to invest \$2.5-3 bln in the development of Vankor over two years. However, soon after that, Rosneft bought ASOC for \$80 million and became owner of a 59% stake in Eniseineft.

Wishing to secure its control over the field TOTAL tried to use “the administrative resource,” i.e. its friendly relations with the Krasnoyarsk Region administration. However, it discovered to its chagrin that Rosneft possessed “administrative resource” of the federal level.<sup>65</sup> Some experts believe that the lengthy negotiations between Rosneft and TOTAL on joint projects were unsuccessful mainly because TOTAL was insisting on a 50% shareholding. Also, to the annoyance of Rosneft, the French major tried to put pressure on the Russian company by sending letters to the RF Government, including to the Ministry of Foreign Affairs.<sup>66</sup>

After Rosneft bought ASOC, disputes with YUKOS continued; to resolve them, Rosneft had to turn to the General Prosecutor Office for assistance accusing Khodorkovskiy of stealing 19% of shares of Eniseineftegas (shareholder of Eniseineft). Having gotten rid of the rivals, Rosneft started drilling at Vankor field in March 2004.

Rosneft fought so hard for Vankor not only to expand its reserve base. By buying ASOC it did not permit Vankor to pass under the control of a foreign major. Had it happened, a new channel of oil export not controlled by Transneft (read - the state) could have emerged. Vankor, in contrast to other oil and gas projects of East Siberia, is not irreversibly linked to the Pacific Rim markets. Liquid hydrocarbons of the Krasnoyarsk region could be shipped along the Northern Sea Route, which would permit to avoid Transneft’s bottlenecks and diversify markets for

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<sup>62</sup> *Oil and Gas Vertical*, # 16, 2004, p. 21.

<sup>63</sup> *Vedomosti*, 29.08.05.

<sup>64</sup> Eniseineft's Russian founders were state enterprises Eniseineftegasgeologiya (22%) and Eniseigeophysika (15%), as well as the administration of the Turukhansk region (4%). The foreign investor of Eniseineft was Anglo-Siberian Oil Company.

<sup>65</sup> See in greater detail N.Simonia, *Russian Energy Policy in East Siberia and the Far East*. Baker Institute Publications, 2004.

<sup>66</sup> *NefteCompas*, April 24, 2003, p.4.

Vankor crude: it could be delivered to Europe, America, Pacific Rim and China. Also, Vankor's oil is light and sweet; therefore, it makes sense not to blend it with Urals in Transneft's system.

The situation with Vankor showed that the national oil company sometimes has to sacrifice its commercial interests for the state needs. It seems that Rosneft had to change its plans for transporting the Vankor oil after the decision was made to build the Eastern Oil Pipeline through which oil can be pumped to China. (And Rosneft has to deliver there 48 million tons of oil over 10 years to repay the debts it incurred while acquiring Yugansk).

In summer 2005 Bogdanchikov pleaded with the president “to ask the government and regional authorities to pay more attention to this pipeline, otherwise many billion dollars of ours will be frozen.”<sup>67</sup> Since without Vankor it will be difficult to fill the Eastern Pipeline, Bogdanchikov put forward the idea to redirect Vankor oil from Dixon (as he intended earlier) to Nakhodka; it will mean pumping crude for the distance of over 5 thousand kilometers.<sup>68</sup>

Pursuing the goal of limiting foreign presence in the oil sector, Russian authorities did not even hesitate to break the previously signed contracts, though these actions seriously undermined the investment climate. In January 2004, the government denied ExxonMobil and ChevronTexaco the right to work on the Kirinskiy block within the Sakhalin-3 project not only under PSA terms, but under the ordinary licensing terms as well, and the block was returned to the undistributed fund of the subsurface plots. (Rosneft was the third equal partner). The government used a formal pretext that international investors did not have documented rights for the relevant plot of the shelf. Probably, the stronger Rosneft no longer wanted to play a second fiddle to foreign partners, and the state was not satisfied with the role that companies under its control had in the most significant petroleum projects. Now Rosneft wishes to bid for the Kirinskiy block when it will be auctioned again,<sup>69</sup> and, if it wins, it might invite the world majors to participate – but on new terms.

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Vladimir Putin very unambiguously shows his approval of Rosneft and personally Sergei Bogdanchikov. He invited head of Rosneft to his residence on Bogdanchikov's birthday (August 10, 2005). In September 2005 Putin visited Tuapse refinery owned by Rosneft, and praised Bogdanchikov to the sky saying that “over the last 5 years the company's capitalization grew by a factor of five. It is a significant contribution to the capitalization of the whole country.”<sup>70</sup>

In the time when Rosneft is preparing its IPO, the benevolent attention of the country's leader becomes an important value driver, since it protects investors from political risks and enhances the company's attractiveness. However, the pending IPO provoked many questions abroad. Western analysts are worried about its huge debt burden (after all the recent acquisitions, its debt exceeds \$11 billion). George Soros raised ethical and global energy security issues.<sup>71</sup> Other international experts are concerned that Rosneft is an instrument of the state policy and will pursue political objectives of Russia to the detriment of shareholders.

Russian citizens who were offered to participate in the so-called “people's placement” of Rosneft's shares within the country should also ask some questions. Whom does this placement really target since the minimal investment for the public was fixed at 15,000 rubles while the

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<sup>67</sup> *Vedomosti*, 24.10.05.

<sup>68</sup> *Oil and Gas Vertical*, # 14, 2005, p. 63).

<sup>69</sup> [www.interoil.ru/news](http://www.interoil.ru/news), 27.02.06

<sup>70</sup> *Vedomosti*, 07.09.05.

<sup>71</sup> *FT*, 26.04.06.

average salary in April 2006 was 10,000 rubles?<sup>72</sup> But the key question is: in whose interests will the national oil company work - in the interest of its own management, of the state or in the national interests of Russia?

<sup>72</sup> Vedomosti, 30.06.06.