

Russian Roulette

International Oil Company Risk in the Russian Arctic

May 2013

Introduction

International oil companies (IOCs) face pressure from investors to achieve a positive reserves replacement ratio. In addition to the increasing inaccessibility of conventional oil and gas reserves, IOCs face a threat from the rise of resource sovereignty in Latin America, the Middle East and Russia.

Access to the Russian Arctic is currently restricted to companies with majority state ownership and five years' Arctic experience. The only companies currently satisfying these criteria are Rosneft and Gazprom¹. Accordingly, IOCs can only gain access to Russian offshore reserves through involvement with one or both of these companies.

Beginning with BP's now abandoned 2011 joint exploration deal with Rosneft, the last two years have seen a flurry of announcements of deals between IOCs and one or other of the Russian national oil and gas companies. Exxon Mobil, Statoil and Eni are all in joint ventures (JVs) with Rosneft. BP has since become the holder of 19.75% of the shares in the Russian company². Recently, Shell has taken further steps towards cementing its own strategic Arctic partnership with Gazprom³.

These alliances expose IOCs and their shareholders to risks including poor environmental and safety performance, questionable corporate governance, an unpredictable political, regulatory and fiscal regime and a lack of corporate transparency.

This briefing accompanies a new report published by Greenpeace, Platform and ShareAction focusing on alliances made by an IOC and either Rosneft or Gazprom since 2011. The report: *Russian Roulette: International oil company risk in the Russian Arctic* is available at: http://www.greenpeace.org.uk/sites/files/gpuk/Investor_report_Arctic_risks_2013.pdf. This briefing provides an overview of some of the key findings of the report and suggests questions for investors to ask of those IOCs involved with either Rosneft or Gazprom.

Operational risk

As the IOCs carry the bulk of exploration costs in Russian JVs, they and their shareholders should be particularly concerned about Rosneft and Gazprom's operational capability for successful and safe offshore drilling.

Shell's 2012 Alaskan Arctic multiple operational setbacks, and the company's failure to meet US regulatory requirements on time, serve as a warning about the significant challenges of Arctic oil and gas exploration for even the most advanced of IOCs⁴.

Rosneft

- Has never brought an offshore project to extraction stage as operator.
- Responsible for 2,727 or 75% of spills in Russia's largest oil province Yugra in 2011⁵ while extracting only 25% of the total regional output that year.
- Still lacks sufficient expertise at appropriate levels despite recent appointments.
- In 2006 Rosneft formed a JV with a consortium of Korean companies to explore the West Kamchatka continental shelf. In 2008 Rosneft's licence was revoked. Its Korean partners claimed to have spent \$300 million on the project⁶.

Gazprom

- The Kolskaya rig sank, killing 53 of its 67 crew⁷ after Gazprom's subsidiary Gazflot continued drilling outside of the approved season⁸ and without carrying out all necessary assessments⁹.
- No member of the board of directors has specific offshore experience or with special responsibility for offshore projects¹⁰.
- Has taken no steps to address the lack of offshore drilling expertise or oversight at board level.
- Gazprom's headline Arctic JV with Total and Statoil, which was to operate the massive Shtokman field in the Barents Sea, fell apart in 2012 after years of delays, a cost rise from \$20bn to \$40bn¹¹ and lack of clarity over fiscal conditions made extraction economically unfeasible.

Gazprom's reporting on injuries and fatalities in its 2010-2011 sustainability report¹² omits entirely the Kolskaya incident in which 53 of 67 crew died.

Lack of transparency

Reporting on environmental performance and safety practices at both Rosneft and Gazprom is incomplete. Rosneft's sustainability reports only provide a figure for the number and volume of oil spills incidents resulting from pipeline ruptures, but not for spills arising from other causes. Gazprom provides the total volume of oil spilled but not the number of individual spills. Gazprom's reporting on injuries and fatalities in its 2010-2011 sustainability report¹² omits entirely the Kolskaya incident in which 53 of 67 crew died. Neither company will disclose its oil spill response plans for offshore projects.

Dependence on favourable political conditions

Leaving aside the probability of delays, the earliest final investment decision on the recently announced alliances will be in 2016-2017 for the Exxon/Rosneft deal while the other JVs are unlikely to begin exploratory drilling until the 2020s. The IOCs' strategic decisions are predicated in large part on the current regulatory structure which grants Gazprom and Rosneft exclusive access to the Russian Arctic and offers an attractive tax regime. Accordingly, to profit from their Russian ventures, IOCs need to maintain stable relationships over a long period of time not only with their Russian corporate partners but also with the Russian government.

Currently Russia's policy on energy, as well as practical control of the energy companies, appears to be subject to a doubling up of policy structures. It is contested between the cabinet of ministers and Arkadaii Dvorkovich (vice PM for energy) on the one hand, and Igor Sechin (Rosneft CEO, chairman of its state majority shareholder and secretary of the presidential commission on energy strategy) on the other hand¹³.

In this context, an understanding of the Russian political landscape, the key corporate and political personalities and the tensions between them together with stated government policy on the privatisation of Gazprom and Rosneft are essential in evaluating the risks of an IOC investing in Russia.

Key questions for IOCs

- In working on projects with either Rosneft or Gazprom, are you expecting to retain operational and subcontracting control? If not, how will you ensure the application of your health and safety and environmental policies by your Russian partner and its subsidiaries?
- In working with Gazprom/Rosneft and their subsidiaries, how will you maintain transparency to shareholders about the operation of joint projects?
- Is the company worried about the tight timelines contained in the licences? What is the contingency plan if delays arise?

Operational risk - Questions for IOCs in JVs with Gazprom

- What steps are being taken to address a lack of offshore experience at board and senior management level in Gazprom?
- Who on Gazprom's board of directors and management board has responsibility for offshore projects?
- What is the role of Gazprom's 'Administration for Offshore Projects Technology' about which there is very little public information and where does it fit within Gazprom's corporate structure and reporting lines?
- Will Gazprom's environmental and health and safety reporting be improved to reflect best international practice? Why did Gazprom exclude the loss of 53 lives on the Kolskaya rig from its health and safety reporting in 2011?
- What changes have been made to Gazprom's corporate practices since the Kolskaya incident to prevent the occurrence of a similar incident?

Operational risk - Questions for IOCs in alliances with Rosneft

- What is being done in addition to recent appointments to improve offshore experience at senior management and operational levels in Rosneft?
- Will Rosneft's environmental reporting be improved to reflect best international practice?

Key questions for IOCs on political risk

- Does the company anticipate that the currently promised fiscal and other incentives for Arctic offshore drilling will remain in place after any privatisation of Rosneft and/or Gazprom? What is the contingency plan if they do not?
- Has the company carried out a risk assessment of a change in political power in Russia?

Additional questions for BP as a significant shareholder in Rosneft

- As the company's largest minority shareholder what role, if any, does BP anticipate having in overseeing the privatisation of Rosneft?
- Does BP know if the Russian government intends to retain a "golden share" in Rosneft and what rights would attach to that share?
- What impact would the liberalisation of access to the Russian Arctic have on Rosneft's Arctic operations? What is BP's contingency plan if the Russian government's disposal of its majority shareholding in Rosneft results in a change to its current access to the Russian Arctic seas?
- What steps are being taken to improve corporate governance standards in Rosneft on issues such as conflicts of interest and transparency?
- Will BP report on CO² emissions, oil spills and health and safety incidents in Rosneft's operations to its shareholders?
- What steps will BP take to bring Rosneft's policies and practices in line with BP's own Operating Management System and Safety and Operations Risk policies and practices? Does BP agree that failure to do so would negatively impact on its efforts to rebuild trust in the company?

Conclusion

Arctic oil and gas exploration presents new and unique challenges to the oil industry. These challenges are compounded in the Russian Arctic by Gazprom and Rosneft's lack of experience of offshore projects at senior level, poor environmental and health and safety track records, a lack of transparency in company reporting and questionable corporate practices at board level. These unpredictable and risky corporate practices are compounded by a complex political regime that is currently divided over the future of the Russian energy sector. In this context, the rush to gain access to the Russian Arctic seas through JVs with and/or share acquisitions in Russian oil and gas giants, Gazprom and Rosneft, is worthy of investor scrutiny.

ENDNOTES

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About ShareAction

ShareAction (Fairshare Educational Foundation) is a registered charity that promotes responsible investment practices by pension providers and fund managers. ShareAction champions greater transparency and accountability to the millions of people whose long-term savings are managed by institutional investors and other professional agents. ShareAction believes that responsible investment helps to safeguard investments as well as securing environmental and social benefits.

ShareAction is supported financially by a number of leading charitable foundations and counts amongst our member organisations a growing number of globally recognised NGOs and trade unions. Over 8,000 individuals support our work both by taking action directly to advance responsible investment and through personal donations.

Further information:

Louise Rouse

louise.rouse@shareaction.org

shareaction.org

0207 403 7812

The opinions expressed in this publication are based on the documents specified in the end notes. We encourage readers to read those documents. Those documents which are only available in Russian have been reviewed by a native Russian speaker.

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