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ISSN 1875-418X  
Issue ..... (Provisional)  
Published .....: YVfuary 2009

This article will be published in a future issue of OGEL (2009). Check website for final publication date for correct reference.

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## Oil, Gas & Energy Law Intelligence

### Russian Energy Strategy: Does BP-TNK Represent a Valuable Case Study? by E.S. Burger

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# Russian Energy Strategy: Does BP-TNK Represent a Valuable Case Study?

by Ethan S. Burger<sup>1</sup>

## Introduction

During the 1970s and 1980s, the Soviet government sought to make the European Union member-states dependent on it for their energy supplies (principally natural gas, but to a lesser extent oil). The Russian government has seemingly pursued a similar objective in recent years – be it as a state or through favored individuals and legal entities. Perhaps the struggle for control over the TNK-BP joint venture can only be understood within this context.

## The Strange Case of BP-TNK

In a January 15, 2009 press release, British Petroleum (BP) announced that “the shareholders in TNK-BP have agreed to appoint three independent directors, including former chancellor of the Federal Republic of Germany, Gerhard Schroeder, to the restructured main board of TNK-BP. His fellow independents will be James Leng,<sup>2</sup> the chairman designate of Rio Tinto, and Alexander Shokhin, president of the Russian Union of Industrialists and Entrepreneurs.”

Given Mr. Schroeder long-standing and lucrative relationship with Gazprom, the largest shareholder of which is the Russian government” one would have to be quite credulous to believe that he is truly independent or understand nothing about corporate governance. Thus, it is questionable whether he can serve as an honest broker in the event of shareholder disputes. The same can be said of Mr. Shokhin.

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<sup>2</sup> Mr. Leng is the former Chairman of Corus, a major player in the steel industry.

Financial Times reporters Ed Crooks and Catherine Belton, respected and long-time observers of events in Russia in a recent article posed a series of important questions:<sup>3</sup>

- 1) “Ha[s] BP been outsmarted and outfought and forced into concessions that would fatally undermine its prospects in Russia?”, or
- 2) Did BP make “a skillful compromise in order to retain its strategic position – making the concession it needed to end the dispute with [Alfa Access Renova (AAR)], while retaining the structure that underpinned the joint venture’s success?

I am inclined to believe the former rather than the latter explanation. Mr. Shokhin is not your typical business leader. Apparently, he is to be one of BP-TNK’s three “independent” directors, but that presents the question what would qualify an individual as “independent” under Russian corporate law. At present, he is the President of the Russian Union of Industrialists and Entrepreneurs as well as on the Supervisory Board of Renaissance Capital. In light of his past and present governmental business connections that might present conflict of interest problems.<sup>4</sup>

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<sup>3</sup> Ed Crooks and Catherine Belton, “Venture’s future in hands of board,” *The Financial Times*, at 15, January 16, 2009.

<sup>4</sup> For example, Mr. Shokhin was Deputy Prime Minister of the Russian Federation from 1991-1994 and again in 1998. Apparently, at the same time he held the posts of Minister of Labour and Minister of Economics. As if he were not busy enough, for much of this time he was also the Russian governmental representative to both the IMF and the World Bank.

In addition to his obligations in the executive branch of government, Mr. Shokhin was a State Duma Deputy from 1993 to 2002 and was the Chairman of the Duma Committee on Credit Institutions and Capital Markets. For part of this period he was the First Vice Chairman of the State Duma (1996-97) and subsequently the leader of the Duma party bloc ‘Our Home is Russia’ (1997-98).

During part of this period, he held the post of Head of the Duma's Representation in the Parliamentary Assembly of the Council of Europe and the Vice-Speaker of the Assembly. Later in 2003, he was elected as Chairman of the Expert Council on The Federal Commission for Securities Market (FCSM). See Renaissance Capital website at [http://www.rencap.com/eng/about/executive\\_detail02.asp](http://www.rencap.com/eng/about/executive_detail02.asp).

According to its website, BP is “one of the largest integrated oil companies in the world, with an estimated global market share of around 3% of oil & gas production and 4% of refining capacity in the major global markets . . .” It has in excess of 1.2 million shareholders. In most cases, it is not possible to identify who are these shareholders. BP has a 50% share in TNK-BP.

Last year, BP's struggle with the Russian consortium AAR for control of TNK-BP has received considerable media attention. Allegedly, AAR is controlled by Russian oligarchs Mikhail Fridman, German Khan, Viktor Vekselberg and Len Blavatnik. Whether these individuals indeed are AAR's ultimate beneficial owners is not absolutely certain. Few would dispute that at least some of AAR's owners have close ties to the Russian political leadership.

In the past, the Russian government has not been a neutral bystander in the BP-TNK dispute. It ordered the Russian tax authorities to scrutinize TNK-BP's taxes, imposed fines for alleged labor law violations (albeit not huge) and refused to grant visas to certain BP employees seconded to the joint venture. While coincidence does not prove causation, the Russian political leadership seemed to be using governmental bodies to consolidate its control over the country's natural resource sector

#### The Unexpected Settlement of the BP-TNK Dispute

Late last year, BP unexpectedly entered into a settlement agreement with its Russian partners in TNK-BP's that would allow BP to maintain its 50% interest in the joint venture. BP's Board of Directors approved the compromise after BP's Chief Executive Officer Tony Hayward and its Board Chairman Peter Sutherland convinced their colleagues that the company's investment in the highly profitable Russian entity TNK-BP was in jeopardy. As a result of the compromise, former Denis Morozov formerly with Norilsk Nickel, although only 35 will be TNK-BP's head.

What explains this outcome after the parties engaged in considerable posturing – threatening both arbitration and litigation of aspects of the dispute? Is it possible that BP caved out of a concern of losing its stake in the joint venture? What is the likelihood that the Russians decided to compromise with BP because it recognized that it could gain control over it? What might the consequences for Great Britain if foreign governments/persons controlled BP?

Legally, a company (or corporation) is a “legal” person possessing certain characteristics. For example, it can acquire and own property, transfer property, enter into contracts, sue and be sued in its own name, and unless otherwise provided, can have a perpetual existence. As a legal person, a company is a legal entity that is distinct from shareholders, for whose benefit the directors are required to act.

With small legal entities, typically limited liability companies, it is usually possible to determine who owns the entity. This is less often the case with publicly-traded corporations. In fact, persons can act as the agents of others (both individuals and legal entities). Corporations can be established in jurisdictions where it is not clear who the entities' ultimate beneficiaries are. This can be particularly vexing where governments own shares through intermediaries' legal entities or are represented by individuals who seemingly are acting for their own benefit.

As Russian legal entities or individuals acquire the shares of foreign legal entities (openly or through intermediaries), although the “nationality” of a particular company may be English or German, it can indeed be owned by foreign persons – in this case, by Russians. In a world seemingly dominated by corporations and private capital, the possibility that a foreign state indeed owns a large share (or majority share) of a company cannot be dismissed out of hand. When compromises result in the resolution of matters that seem incapable of settlement – it raises many questions. Most disputes about money can be resolved amicably. Nonetheless, one

should not forget that political factors may play an important, although sometimes overlooked role.

The price of British Petroleum stock has declined recently, after rebounding in October 2008.<sup>5</sup> Since the price of oil is unlikely to rebound in the near-term, it is conceivable that some Russian individuals or legal entities, independently or at the instruction of the Russian government might attempt to obtain a controlling share in BP. Given the make-up of BP-TNK's Board of Directors, this scenario may not be far-fetched.

#### Some Important Questions and Disquieting Thoughts

According to a 2006 Report on outbound Russian investment prepared by Deutsche Bank Research, there are six noteworthy features of Russian foreign investment:

- Russia was the second largest overseas direct investor (ODI) in countries classified as "emerging markets," with 8.9% of total ODI (it was behind Hong Kong (39.1%) and ahead of both the Virgin Islands (7.0%) and Singapore (6.7%). A large share of the funds used for these three countries' investments abroad may have originated in another country);<sup>6</sup>
- Russian investment abroad was concentrated initially in the successor states of the former Soviet Union;
- The three sectors receiving the largest amount of Russian investment abroad were fuel, energy and metallurgy;
- The Russian state favored a policy of encouraging Russian individuals and legal entities to invest abroad. At the same time, the investors benefited in various ways such as gaining access to new markets, acquiring new technologies, obtaining raw materials, and diversifying their sources of financing; and

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<sup>5</sup> See the Findata website at <http://www.findata.co.nz/Markets/StockQuote/LSE/BP.htm>.

<sup>6</sup> According to Sergei Guriev and Aleh Tsyvinski, Russia has fallen to third place in this area, behind Brazil, but the authors note that the top 25 Russian companies hold \$59 billion in foreign assets. Guriev and Tsyvinski note that "[f]ollowing the Russian Georgian war, the West is scared that Russia's government will use its cash not just for economic purposes, but as an aggressive foreign policy tool." *The Japan Times*, October 18, 2008. This number is probably low since Russian individuals and legal entities may establish companies in other countries so as to hide the fact that the beneficial owner of an asset is Russian.

- Russian individuals and legal entities are likely to continue to be major investors in emerging markets.<sup>7</sup>

The Report's authors believed that Russian legal entities invested abroad to (i) "obtain higher profit margins," (ii) "increase their growth potential," (iii) "gain access to technology and management know-how," (iv) "secure access to raw materials," (v) "reduce capital costs through better governance and diversification," and (vi) "benefit from a more [favorable] investment climate." The last reason might be thought of as a tactful way to say to avoid governmental interference in their activities such as the unjustified rejection of licenses, avoid corruption, and the risk of unlawful expropriation.

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<sup>7</sup> Thorsten Nestmann and Dario Orlova, Russia's Outward Investment, Deutsche Bank Research, April 30, 2008, at 1, available at [http://www.dbresearch.com/PROD/DBR\\_INTERNET\\_EN-PROD/PROD000000000224964.pdf](http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000224964.pdf).