

# RUSSIAN ROULETTE: International oil company risk in the Russian Arctic



A dramatic landscape featuring dark, jagged rock formations in the foreground and middle ground. The sky is filled with heavy, grey clouds, creating a somber and atmospheric setting. The lighting is low, highlighting the textures of the rocks and the density of the clouds.

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# Introduction

The 2012 report 'Out in the Cold: Investor Risk in Shell's Arctic Exploration'<sup>1</sup> explored how the end of easily accessible oil from conventional sources is driving international oil companies (IOCs) to ever more extreme forms of oil and gas extraction – with the Arctic Ocean representing the last frontier. 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. Governments are increasingly asserting control over the natural resources located in their territories. In the case of Russia, IOCs have entered a number of joint ventures (JVs) with Russian national oil and gas companies Rosneft and Gazprom. BP has additionally become Rosneft's largest independent shareholder. These alliances aim to trade western capital along with technical capability and expertise for access to oil and gas concessions in the Russian Arctic and continental shelf.

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.<sup>2</sup> Shell's experience in the Alaskan Arctic has had a knock on effect on the exploration plans of ConocoPhillips<sup>3</sup> and Statoil.<sup>4</sup> However, at the same time, yet more alliances with Russian companies are being announced.

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 report:

- ⊞ provides an overview of the Arctic exploration deals that have been made between an IOC and either Rosneft or Gazprom since 2011;
- ⊞ examines Rosneft and Gazprom's environmental and safety performance records, along with their experience of offshore drilling at an executive and senior management level;
- ⊞ provides information on the complex and shifting political landscape in Russia, which will have a direct impact on the future of the Russian oil and gas industry and its western participants;
- ⊞ proposes questions that shareholders in IOCs should ask of those companies to clarify how such risks are being mitigated and managed.

# Executive summary

IOCs face pressure from investors to achieve a positive reserves replacement ratio (RRR) – the amount of proven reserves added to a company’s reserve base during the year, relative to the oil and gas extracted.<sup>5</sup> These companies are now targeting Russia’s continental shelf, with its government estimated reserves of 76bn tonnes oil equivalent.<sup>6</sup> Access to the Russian Arctic is currently restricted to companies with majority state ownership and five years’ Arctic experience and the only companies currently satisfying these criteria are Rosneft and Gazprom.<sup>7</sup> Accordingly, IOCs can only gain access to Russian offshore reserves through involvement with one or both of these companies.

## ALLIANCES

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 (see Table 1, p8). Exxon Mobil stepped in to replace BP with Rosneft, and Statoil and ENI are also in JVs with the Russian company. Meanwhile, BP arranged the sale of its existing Russian venture (50% in TNK) to Rosneft in return for cash and shares. Post completion of this deal, BP will hold 19.75% in Rosneft.<sup>8</sup> Recently, Shell has taken further steps towards cementing its own strategic Arctic partnership with Gazprom, including a JV for Arctic exploration,<sup>9</sup> featuring the “same terms” as Rosneft’s international JVs.<sup>10</sup>

In these JVs, the IOC provides the majority of the capital while Rosneft retains the majority stake, and to date its subsidiaries have acted as the operator. This exposes the IOC to Rosneft’s lack of offshore management experience and questionable operational practices (see Section 2). Investors in IOCs should seek clarification as to which company has operational control.

BP is currently unique among IOCs in holding a significant minority stake in Rosneft, exposing the British company and its

shareholders to all of Rosneft’s operations and not just specific projects. In addition to this shareholding, the companies have recently announced that they are in talks about potential Arctic collaborations.<sup>11</sup>

## OPERATIONAL RISK

As the IOCs carry the bulk of the JV exploration costs, JV partners and their shareholders should be particularly concerned about Rosneft and Gazprom’s operational capability for successful and safe offshore drilling (see Section 2, p12). Shell’s 2012 Alaskan Arctic programme has shown that the extreme environment makes it beyond the capability of even the most advanced of IOCs.

Rosneft has never brought an offshore project to extraction stage as operator. While its subsidiaries had historical experience of exploring offshore blocks around Sakhalin, it has been reported that, in 1998, Rosneft disposed of its entire fleet and laid off its entire offshore exploration staff.<sup>12</sup> Rosneft has recently sought to address the lack of offshore experience at management board level by appointing to it the former Exxon Russia head, Zeliko Runje.<sup>13</sup> And as part of the BP share acquisition, BP CEO Bob Dudley will join the board of directors.<sup>14</sup> However, while these appointments show Rosneft attempting to build capacity for offshore projects, the company has some way to go in ensuring sufficient expertise at appropriate levels. This should be of particular concern to BP shareholders and IOC shareholders where Rosneft retains operational control in any JV.

Rosneft was responsible for 2,727 or 75% of spills in Russia’s largest oil province Yugra in 2011<sup>15</sup> while extracting only 25% of the total regional output that same year<sup>16</sup> (according to the results of a report by the environmental regulator Rosprirodnadzor published by the business paper *Vedomosti*). Of the four companies featured in the report, Rosneft had the lowest overall environmental safety budget: \$563m compared to TNK-BP’s budget of \$897m.<sup>17</sup>

Gazprom’s subsidiary Gazflot has drilled exploratory wells for Gazprom in the Pechora, Kara and Okhotsk seas. In 2010 as part of the Okhotsk Sea drilling programme, Gazflot continued drilling outside of the approved season<sup>18</sup> and without carrying out all necessary assessments.<sup>19</sup> The Kolskaya rig sank, killing 53 of its 67 crew<sup>20</sup> (see Box 4, p18).

Currently no member of the Gazprom board of directors has specific offshore experience. No director of Gazprom has specific responsibility for offshore projects. The head of its exploration and production department, and a member of the management board, is Vsevolod Cherepanov, a geologist with 15 years’ experience at Gazprom’s Yamal-based (onshore) subsidiary.<sup>21</sup> Unlike Rosneft, Gazprom has shown no sign of addressing the lack of offshore drilling expertise or oversight at board level. The company has no senior managers with experience of managing offshore drilling and has not made clear who at management board or director board level oversees its offshore exploration projects.

In addition to a lack of expertise at board level, wider corporate governance concerns have been raised about Gazprom including its handling of contracts with related parties (see Section 4, p28).

## LACK OF TRANSPARENCY

Reporting on environmental performance and safety practices at both Rosneft and Gazprom is incomplete. Rosneft’s sustainability reports only provide an overall number of oil spill incidents resulting from pipeline ruptures but not the volume of oil spilled or spills arising from other causes. Gazprom provides the total volume of oil spilled but not the number of individual spills. In comparison, Shell and BP report both. Gazprom’s reporting on injuries and fatalities in its 2010–2011 sustainability report<sup>22</sup> entirely omits the Kolskaya incident in which 53 of 67 crew died. Neither Gazprom nor Rosneft will disclose their oil spill response plans for offshore projects (see Section 2.4, p20).



*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*

This lack of public transparency has also extended to shareholders in Rosneft or its subsidiaries. Most recently, Rosneft has come under criticism from minority shareholders in TNK-BP subsidiaries (including BNP Paribas Partners) unhappy about Rosneft's decision to use \$10bn from company accounts to help pay for the acquisition of TNK-BP.<sup>23</sup>

#### **DEPENDENCE ON FAVOURABLE POLITICAL CONDITIONS**

Frontier projects in icy waters are likely to have even longer development times than large scale extraction projects elsewhere. Leaving aside the probability of delays, the earliest final investment decision 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.

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 (see section 3, p22).

Currently Russia's policy in 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 the state majority shareholder Rosneftegaz and secretary of the presidential commission on energy strategy) on the other hand.<sup>24</sup> Complex industrial negotiations on the future of a key extractive industry have also become a proxy personal war between these powerful political figures, which in turn can influence the relevant fiscal and regulatory regimes – upon which the success of IOC partnerships will in large part depend (see Section 3, p22).

# 1. The alliances

Over the past two years, starting with Rosneft's abortive tie-up with BP in 2011, a number of different alliances have been announced between Rosneft or Gazprom and a Western IOC to explore Russia's Arctic continental shelf. Rosneft and Gazprom currently have exclusive access to licences in this area, but lack the expertise and the capital to invest in difficult offshore Arctic projects. Offshore drilling in Arctic conditions is characterised by delays and cost rises, as the histories of Shtokman and West Kamchatka concessions show (see Boxes 1 and 2, p10). It is dependent on high prices and political support.

The majority of the new alliances are based on a JV between the western and Russian partner, with the western partner (Eni, Exxon, Statoil) providing all or most of the investment while the Russian partner holds the majority stake (normally 66.7%). As of the time of writing, there has not been an official company announcement regarding the terms of Shell and Gazprom's JV, but business daily *Kommersant* claims that Shell will receive a 33.3% stake in the JV while covering "the bulk of the exploration costs."<sup>25</sup> The Russian minister for natural resources and environment Sergei Donskoi has been quoted in the press as saying the planned JV would be "the same as with Rosneft."<sup>26</sup>

These terms expose the Western partner to all risks associated with the Russian company's management and safety culture. The companies' public announcements do not specifically disclose the extent of either company's operational control in a JV, however Rosneft's subsidiaries have been subcontracting work on all of the fields to be explored by its JVs.

Furthermore, the agreements tie the companies to dates by which exploratory wells have to be drilled: 2014 for Exxon and Rosneft, 2016–2021 for Statoil and Rosneft, and 2020 for Eni and Rosneft. The Russian government's previous decision to revoke Rosneft's West Kamchatka licence for not drilling enough wells is indicative that the companies are under pressure to drill fast, exacerbating operational risk along with the risk of licences being revoked and investments in exploration lost (see Box 2, p10 and Section 3.3, p25).

BP, as a 19.75% shareholder in Rosneft, will be further exposed to risk from Rosneft's other operations.

Table 1 provides an overview of the new Russian offshore exploration partnerships. It highlights key dates and outlines how the risks discussed in this report may affect each alliance. Information on other existing alliances between these companies (including abroad, trade, and onshore) is provided for context. This includes two offshore projects at extraction stage (Sakhalin-1 for Rosneft-Exxon and Sakhalin-2 for Gazprom-Shell). These projects are not discussed in the rest of the report as they are not operated by Rosneft or Gazprom and their contractual arrangements are different (Production Sharing Agreements rather than JVs operating on a licence held by the Russian partner).

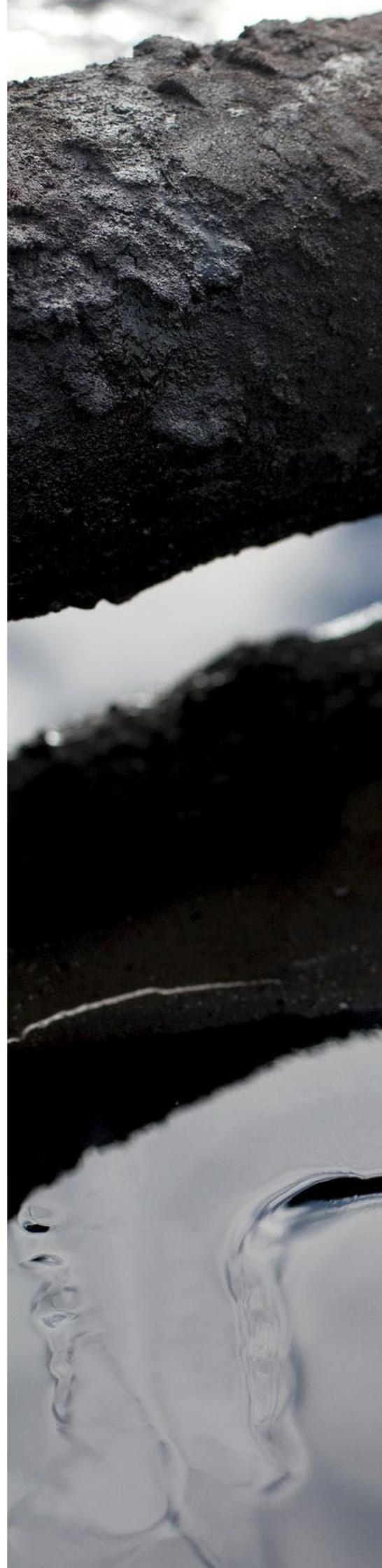




Table 1. Alliances between IOCs and Rosneft or Gazprom

Partners	Share acquisition	Russian exploration alliance		
		Stakes	Fields, reserves	Operator
BP and Rosneft	BP acquired 19.8% shares in Rosneft	BP had previously played down chances of possible direct exploration partnerships, but recently announced they are in talks on potential Arctic collaborations. <sup>27</sup>		
Exxon and Rosneft	–	66.67% Rosneft, 33.33% Exxon	<b>Offshore:</b> East Prinovozemelsky field (Kara Sea, Arctic sea ice 270–300 days a year. Estimated reserves 35.8 bbl oil, 10.3tn m <sup>3</sup> gas) <sup>28</sup> <b>Offshore, not Arctic:</b> Tuapse block (Black Sea, 9 bbl oil)	Rosneft? <sup>29</sup>
Shell and Gazprom	–	Not yet signed, reported 66.67% Gazprom, 33.33% Shell. <sup>31</sup> Existing JV: Salym Petroleum Development (50% Shell, 50% Gazprom)	<b>Onshore:</b> Salym field tight (shale) oil deposits (reserves undisclosed) <b>Offshore:</b> in discussion, proposed North Vrangell (Chukchi Sea) and North-West (Pechora Sea) prospects. Reserves estimates undisclosed, Gazprom does not hold licences yet	Salym Petroleum Development (50–50 JV). Potential offshore projects – suggested “same terms as Rosneft’s partnership”
Statoil and Rosneft	–	66.67% Rosneft, 33.33% Statoil <sup>33</sup>	<b>Offshore:</b> West Barents Sea: Perseevsky licence block Okhotsk Sea: The Magadan 1, Lisyansky and Kashevarovsky licence blocks. (estimated 14.66 bbl oil and 1.8tn m <sup>3</sup> gas) <sup>34</sup> <b>Onshore:</b> Ongoing joint technical evaluation of tight oil deposits at the North Komsomolsk field in Western Siberia and the Khadumsky formation fields in the Stavropol Territory	Rosneft? <sup>35</sup>
Eni and Rosneft	–	66.67% Rosneft, 33.33% Eni	<b>Offshore:</b> Fedynsky and Central Barents blocks in the Barents Sea (estimated 2bn tonnes oil and 1.9tn m <sup>3</sup> gas) <b>Offshore, not Arctic:</b> Western Chernomorsky block in the Black Sea (estimated 1.36bn tonnes oil)	Rosneft? <sup>38</sup>

				Other ongoing alliances (extraction, onshore, elsewhere, trade)	Key relevant risks
	Financed by	Timeline			
				–	Policy uncertainty and privatisation of Rosneft (Section 3.2), poor safety culture and environmental reporting (Sections 2.3, 2.4), corporate governance (Section 4)
	Exxon at initial stage, at least \$1.5bn. Overall \$3.2bn over 3 years <sup>30</sup>	2013 seismic exploration 2014 exploratory drilling 2016–2017 final investment decision		<b>Extraction, US:</b> Rosneft bought out 30% in Exxon's operations: 20 GoM blocks, La Escalera Ranch project in West Texas, Harmattan acreage in Alberta, Canada. <b>Extraction, offshore Russia:</b> Sakhalin-1. Long-running PSA-based project. Operated by Exxon (30% stake) with Rosneft holding 20% and other partners 40%.	Operational control and poor safety culture in Rosneft (Sections 2.3, 2.4), lack of offshore drilling expertise in Rosneft (Section 2.1), dependency on tax breaks and political support (Sections 3.3, 3.4)
	Shell reported to carry "the bulk of exploration cost" <sup>32</sup>	Undisclosed		<b>Extraction, offshore Russia:</b> Sakhalin-2. PSA-based project. In 2006 Gazprom took over a 50% + 1 share stake with pressure from Russian government (section 4). Currently Shell remains main operator, holds 27.5% minus 1 share, other partners 22.5%.	Gazprom's access to concessions (Section 3.3), operational control and lack of safety culture within Gazprom (Sections 2.2, 2.3, 2.4), policy uncertainty (Section 3.1), dependency on tax breaks and political support (Section 3.4)
	100% by Statoil for exploration phase (sum unknown, with bonuses to Rosneft for each commercial discovery) <sup>36</sup>	2016–2021 six wildcat wells to be drilled		<b>Bidding, offshore Norway:</b> JV (66.67% Statoil, 33.33% Rosneft) bidding for concessions in the Norwegian part of the Barents Sea in 2012–2013 <sup>37</sup>	Operational control and poor safety culture in Rosneft (Sections 2.3, 2.4), dependency on tax breaks and political support (Sections 3.3, 3.4)
	ENI for licence obligations; 33.33% Eni 66.67% Rosneft for works outside of licence obligations <sup>39</sup>	2015–2016 two exploration wells in the Western Chernomorsky block in the Black Sea 2020 first exploration well drilled in the Fedynsky block 2021 first exploration well drilled in the Central Barents block		<b>Trading:</b> Eni Trading and Shipping is one of the largest buyers of Rosneft's Urals crude. Eni and Rosneft signed a strategic agreement to develop logistics opportunities on 24 February 2013. <sup>40</sup>	Operational control and poor safety culture in Rosneft (Sections 2.3, 2.4), dependency on tax breaks and political support (Sections 3.3, 3.4)



### **BOX 1: SHTOKMAN: ABORTIVE FLAGSHIP JOINT VENTURE**

The Shtokman gas field, discovered in 1988, was for a long time considered to be Russia's flagship offshore extraction project, and the first JV based Arctic extraction alliance between a Russian national oil company (NOC) and IOCs. In 2008, licence holder Gazprom formed a JV with Total (25%) and Statoil (24%) to carry out the first phase of extraction. At this point, it was expected that extraction on the project would start in 2013.<sup>41</sup> However, the estimated costs of the project rose from \$6bn in 1994 to \$20bn to 2007 reaching \$40bn in 2011.<sup>42</sup> The partners shifted back the date of the final investment decision several times between 2010 and 2012.<sup>43</sup> The Russian government made a series of announcements promising large-scale tax breaks for the project, however their final form was never agreed. Following the beginning of large-scale shale gas extraction in the US, extraction at Shtokman became uneconomical.

The JV agreement was coming up for renewal in July 2012, and some news reports indicated that new partners including Shell would join the project.<sup>44</sup> However, the agreement was not renewed and the project effectively halted. Statoil wrote off the \$340m spent on the project and handed its shares back to Gazprom.<sup>45</sup>



### **BOX 2: JOINT VENTURE WITH ROSNEFT COSTS KOREAN PARTNERS**

In 2006 Rosneft formed a JV to explore the West Kamchatka offshore licence block with KKC (a consortium of Korean National Oil Company (KNOC) and six others – with KNOC holding a 50% stake). Rosneft held 60% in the joint venture and KKC 40%, but KKC, like Eni and Statoil in current Rosneft JVs, carried all of the costs of the project at exploration phase.<sup>46</sup> KNOC says it spent over \$300m on the project.<sup>47</sup>

Rosneft had planned to start drilling exploratory wells on the prospect in 2007, but failed to get regulatory approvals in time. In 2008 the resources regulator RosNedra decided to revoke Rosneft's licence due to the company's failure to fulfil its licence obligations.<sup>48</sup> Gazprom, who received the licence as a result, had publicly stated that it would invite KNOC back into a JV for the project,<sup>49</sup> but this deal was never finalised and Gazprom carried out its exploration of West Kamchatka by itself.



## 2. Operational risk

Shell's summer of setbacks in the Alaskan Arctic,<sup>50</sup> along with Statoil<sup>51</sup> and ConocoPhillips<sup>52</sup> decisions to delay their Alaska offshore drilling, show that no IOC to date is confident enough in its expertise and technology for the challenging conditions of Arctic waters. Rosneft and Gazprom's operational capacity for offshore exploration and extraction, as well as their accountability for the safety of these operations, should concern investors in their JVs where Rosneft and Gazprom have any operational control. In particular, Statoil<sup>53</sup> and Eni<sup>54</sup> bear the entire costs of exploration within licence obligations in their JVs with Rosneft, while Exxon bears more than half of the costs. Rosneft is currently carrying out preliminary works on the projects but has not disclosed who the JV operator is on any of the projects (see Section 1, p6). A statement by the Russian minister for natural resources suggests that Shell will have "the same conditions" as Rosneft's partners, i.e. bear financial responsibility for drilling.<sup>55</sup>

Rosneft has never brought an offshore project to extraction stage as operator. Gazprom's offshore drilling projects are notorious for their delays and disregard for safety. The Kolskaya platform capsized during towing, leading to deaths of 53 drilling crew,<sup>56</sup> and the Prirazlomnaya platform (assembled initially by Rosneft) has failed to start drilling for a second year citing safety problems.<sup>57</sup> These high-profile failures point to the following deeper problems within Gazprom and Rosneft:

1. **A lack of experience of running offshore projects at the top level of the companies.** Rosneft appears to be addressing this by appointing a new and experienced top manager for offshore projects, but this appointment does not in itself guarantee the necessary expertise or a change in corporate culture around safety.
2. **The pervasive corporate culture of disregard for environmental safety norms and reliance on dangerous or outdated equipment.** Rosneft is

responsible for the largest number of oil spills in Russia's main oil province.

3. **The lack of regulatory powers to prevent harmful practices.** In the case of the Kolskaya rig, Gazprom had been taken to court for commencing drilling without necessary approvals, but drilling proceeded anyway despite the onset of the ice season.
4. **The poor quality of both companies' environmental reporting.** Rosneft does not report on total volumes of oil spilled, and Gazprom's reporting on health and safety in 2011 entirely omits the Kolskaya incident.
5. **The lack of transparency and independent oversight.** Both companies have refused to disclose project documentation including oil spill response plans for projects.

This section provides details on the above problems and suggests questions for investors in Rosneft and Gazprom's Western partners regarding operational risk in offshore JVs.

### 2.1 ROSNEFT – ARCTIC READY? Experience

Although technically Rosneft passes the Russian government's requirement of the necessary five years' experience to bid for offshore licences, its actual expertise in offshore drilling is slim. The only offshore field Rosneft has operated by itself and extracted oil from so far is Odoptu-More, located several kilometres off the coast of Sakhalin. But this field is accessed by using a horizontal drill set up on land,<sup>58</sup> a very different technology from offshore drilling proper.

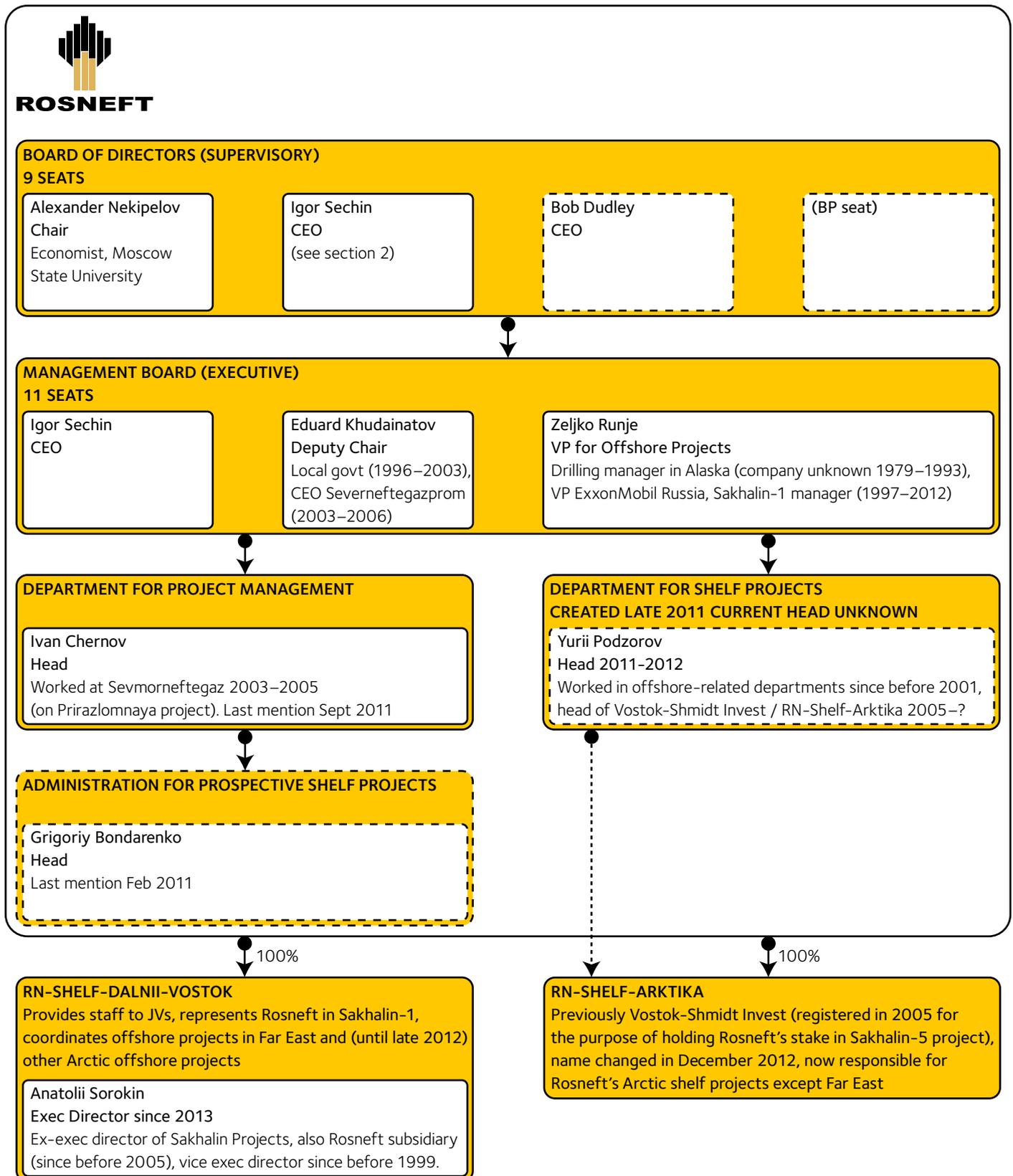
Rosneft owns stakes in several large licence blocks located further offshore around Sakhalin. Sakhalin-1, the only one of these in the extraction stage, is fully managed by Exxon despite Rosneft's dominant 30% stake. The other projects are in various exploration drilling stages.

BP exited<sup>59</sup> its JV with Rosneft to explore Sakhalin-4 and -5 (financed entirely by BP<sup>60</sup>) due to the small scale of reserves discovered.<sup>61</sup> Rosneft has an exploration JV with Chinese company Sinopec for the Venin field (part of Sakhalin-3), where it has drilled two exploratory wells confirming a gas and condensate find.<sup>62</sup> It has also been exploring by itself the smaller Lebedinskiy block next to Sakhalin-1.<sup>63</sup>

Between 2003 and 2008 Rosneft held an exploratory licence on the West Kamchatka shelf, operated from 2006 in a 60–40% JV with a consortium of Korean companies.<sup>64</sup> However, following the resources regulator Rosnedra's dissatisfaction with the company's progress, Rosneft was forced to hand back the licence. The company had failed to acquire the necessary regulatory approvals for drilling and so could not drill its first exploration well in the timeline posited by the licence. Rosneft's partner KNOC carried the full financial risk and lost its investments.<sup>65</sup>

Rosneft's Sakhalin-based subsidiary RN-Sakhalinmorneftegaz (previously Sakhalinmorneftegaz) had decades of experience (since 1975) of exploring offshore blocks around Sakhalin.<sup>66</sup> However, according to business daily *Kommersant*, "In 1998, when the world market price for drilling equipment went up, Rosneft's subsidiaries sold off their whole fleet: 6 floating drilling rigs and 25 ships. The same year saw the whole of the company's offshore exploration staff laid off – about 2500 professionals from RN-Sakhalinmorneftegaz. They now mainly work for foreign operators."<sup>67</sup> According to a comment by an industry insider published online, Rosneft's then new CEO "Bogdanchikov sold off his own [drilling] equipment and fleet for a pittance. Out of all the specialists working at DMURB [the Far East Oil and Gas Exploratory Drilling Expedition], those who explored the oil and gas fields off the coast of Sakhalin between 1977–2000 and in Vietnam between 1984 and 2003, [Bogdanchikov] brought no-one to Moscow except accountants."<sup>67</sup>

Diagram 1: Rosneft's relevant top managers, departments, and subsidiaries (previous, future or unconfirmed connections shown in dotted lines)<sup>68</sup>  
 Percentages refer to shareholdings



### Board members

Russian corporations have a two-tier board system: the board of directors is elected by shareholders and supervises the management board comprised of the top executives. Rosneft's board of directors does not include anyone with specific upstream management experience, though BP expects to control two out of nine seats on the directors board following the completion of the share purchase. BP CEO Bob Dudley has been nominated for one of the seats, the other candidate is unknown.<sup>69</sup>

In October 2012, Rosneft hired American Zeljko Runje, previously head of Exxon Russia and Sakhalin-1 manager, to oversee its offshore projects.<sup>70</sup> Runje's profile was widened to cover all of Rosneft's upstream operations in December 2012.<sup>71</sup> Apart from Runje, there is no one on Rosneft's management board with experience in managing offshore drilling, and only one other person with experience of managing upstream operations (Eduard Khudainatov, currently deputy chair and CEO of Rosneft 2008–2012).

### Departments

A specialised department for shelf projects was created in Rosneft in late 2011,<sup>72</sup> headed by Yurii Podzorov who has worked in various positions related to Rosneft's offshore projects since 2001.<sup>73</sup> Prior to 2011 the only high-level manager in Rosneft with any offshore experience was Ivan Chernov<sup>74</sup> who was responsible for overseeing the construction of the notorious Prirazlomnaya platform in a JV with Gazprom in the early 2000s (see Box 3). It is unclear who currently leads the department for shelf projects.

### Subsidiaries

Until late 2012, the management of Rosneft's new Arctic offshore concessions was the responsibility of Rosneft's Sakhalin-based subsidiary RN-Shelf-Dalnii-Vostok (RN-Shelf-Far-East),<sup>75</sup> under the leadership of long-time Sakhalin projects manager Lev Brodskii.<sup>76</sup> The company's publicly listed tenders indicate that it controlled seismic surveys in the Far East and on licence blocks in the Arctic to be explored with ENI and Statoil, as well as more general offshore policy such as setting standards in oil spill response plans.<sup>77</sup> In late 2012, following Runje's appointment, a new Moscow-based subsidiary RN-Shelf-



## BOX 3: PRIRAZLOMNAYA: DELAYS AND FAULTY EQUIPMENT

Between 2001–2004, Rosneft took the lead role in preparing a drilling platform for the Prirazlomnoye field in the Barents Sea, in a 50–50 JV with Gazprom.<sup>79</sup> Rosneft purchased an 18-year-old retired North Sea platform under suspicious circumstances (see Box 8, p29) and combined its topsides (living quarters and machinery) with supports constructed in Russia. However, in 2003 the topsides were held up due to awaiting regulatory approval related to the presence of nuclear isotopes. In 2004 the topsides were found to be in poor condition and not compatible with local requirements.<sup>80</sup> In late December 2004, Rosneft sold its stake in the JV to Gazprom for \$1.7bn.<sup>81</sup>

When Gazprom finally put the platform in place for drilling in the Barents Sea in 2011, subcontractors working on its construction were quoted in the press as declaring it "94.2% ready for use."<sup>82</sup> However an anonymous source involved in the construction told Nord-News agency that in reality the platform was no more than 50% ready.<sup>83</sup> Gazprom had refused to send representatives to public consultations on the project in 2011, and was continuing to refuse to publish any of the platform's safety documentation, its environmental impact assessment, or the oil spill response plan for the project.<sup>84</sup>

At a press conference on 6 December 2011, Gazprom's head of department for offshore extraction technology Vladimir Vovk admitted that project documentation was not complete at the time of the start of construction of Prirazlomnaya. He also acknowledged that the use of the retired platform Hutton was a mistake: "the attempt to speed up the construction of the platform by using old equipment had the opposite result."<sup>85</sup>

As the platform was being taken out to sea in 2012, a leaked video showed the platform's gangway falling off during a storm.<sup>86</sup> An anonymous industry source explained the state of the platform to Nord News Agency:

*The thing is that from 2012 the exploitation of platforms like Prirazlomnaya will be forbidden, for technical reasons: a platform which took 15 years to build may simply have become outdated. Therefore Sevmash [construction company] needed to put Prirazlomnaya into exploitation before the end of the year, regardless of how ready it is. And that's what is happening: the unfinished platform is being transported to the Prirazlomnoye oil field where it will be "brought into order."<sup>87</sup>*

Following a series of information leaks concerning poor safety onboard, as well as a targeted campaign by Greenpeace, Gazprom cancelled plans to drill that year.<sup>88</sup> As of early 2013, Gazprom has not begun extraction from Prirazlomnaya. It has published only a summary of its oil spill response plan<sup>89</sup> and has not produced any evidence of testing its oil spill response capabilities in icy waters around the platform.

Arktika has taken over managing at least some of the Arctic offshore projects.<sup>78</sup>

Runje's appointment and the new activity of RN-Shelf-Arktika are signs of Rosneft attempting to build up capacity for managing and running offshore projects. But given the history of very little expertise of offshore drilling in the company, investors and partners of Rosneft should pay close

attention to RN-Shelf-Arktika (for Arctic projects) and RN-Shelf-Dalnii-Vostok (for Far East projects). Despite the appointments of Runje and Dudley, Rosneft still lacks board and senior management expertise to provide sufficient reassurance for investors about high risk projects, especially given the intention for Rosneft to start exploratory drilling in the Kara Sea in 2014.



МЛСП «П. РАЗЛОМНАЯ»

МЛСП «ПРИРАЗЛОМНАЯ»

## 2.2 GAZPROM – ARCTIC READY?

### Experience and subsidiaries

Gazflot, Gazprom's longest running subsidiary dedicated primarily to offshore Arctic exploration and construction of drilling platforms designed to withstand Arctic conditions, was founded in 1994. This subsidiary has drilled exploratory wells for Gazprom in the Pechora and Kara Seas and since 2009 in the Okhotsk Sea.<sup>90</sup> It was for Gazflot's Okhotsk Sea drilling programme that the ill-fated platform Kolskaya was used. The details of its sinking reveal alarming disregard for safety in Gazflot's operations (see Box 4, p18).

Like Rosneft, Gazprom has a large but non-operator stake in one of the older large-scale offshore projects near Sakhalin: 50% plus one share in Sakhalin-2. This stake was acquired in 2006, when the project operator Shell was accused of inflating costs from \$10bn to \$22bn, as well as environmental violations. Despite the takeover of the majority stake, Shell has retained operational control of this project.<sup>91</sup>

Gazprom's other offshore projects have not reached the extraction stage:

- ⊖ Shtokman: stalled due to loss of JV partners (see Box 1, p10), to be overseen in phases 2 and 3 by Gazprom Dobycha Shelf (100% subsidiary created in 2008<sup>92</sup>).
- ⊖ Sakhalin-3: Kirinskoye deposit, currently "building extraction infrastructure,"<sup>93</sup>

operated by Gazprom Dobycha Shelf, drilling platform installed by Gazflot.

- ⊖ Prirazlomnoye field (see Box 3, p14): operated until 2012 by Gazprom Neft Shelf (100% subsidiary created in 2009), sold to Gazprom Neft (95.68% subsidiary).

Gazprom Neft is by itself Russia's fifth largest oil company<sup>94</sup> and to an extent independent of Gazprom with its own refineries and downstream department. In his letter to the minister of natural resources, Rosneft deputy board chair Nikolai Laverov contends that Gazprom Neft is insufficiently controlled by the state to have access to offshore concessions (see also section 3.3).<sup>95</sup> Shell's onshore extraction JV Salym Petroleum Development is with Gazprom Neft, rather than Gazprom directly. Gazprom Neft will be conducting its own exploratory drilling on the Dolginskoye deposit in the Pechora Sea in 2013.<sup>96</sup> According to company statements, Salym Petroleum Development will be providing services to the new JVs, but the Arctic offshore exploration JV will be with Gazprom, rather than Gazprom Neft.<sup>97</sup>

### Boards

Gazprom has no board of director members with specific offshore experience, or with special responsibility for offshore projects.<sup>98</sup> On its management board, the head of the company's exploration and production department is Vsevolod Cherepanov, a geologist with 15 years' experience

at Gazprom's Yamal-based (onshore) subsidiary.<sup>99</sup> Cherepanov also sits on the board of Gazprom Neft and is the only director with upstream experience there.<sup>100</sup> Gazprom Neft has no management board members with stated responsibility for, or experience of, upstream operations.<sup>101</sup> Unlike Rosneft, Gazprom has shown no sign of addressing the lack of offshore drilling expertise or oversight at board level.

### Management

Gazprom has an 'Administration for Offshore Projects Technology,' whose head Vladimir Vovk has been quoted in the media in relation to various offshore projects since 2008, but there appears to be no public information on where this administration fits into the corporate structure, how large it is or what its remit is.<sup>102</sup>

Neither Gazprom nor Gazprom Neft have any senior managers with experience of managing offshore drilling (or, in Gazprom Neft's case, any upstream operation at all). Gazprom has not made clear who oversees its offshore projects at management board or directors board level. Gazprom has limited experience in offshore extraction, but longer experience in exploratory drilling, through its subsidiary Gazflot. However, its record suggests an alarming disregard for safety (see Box 4, p18).

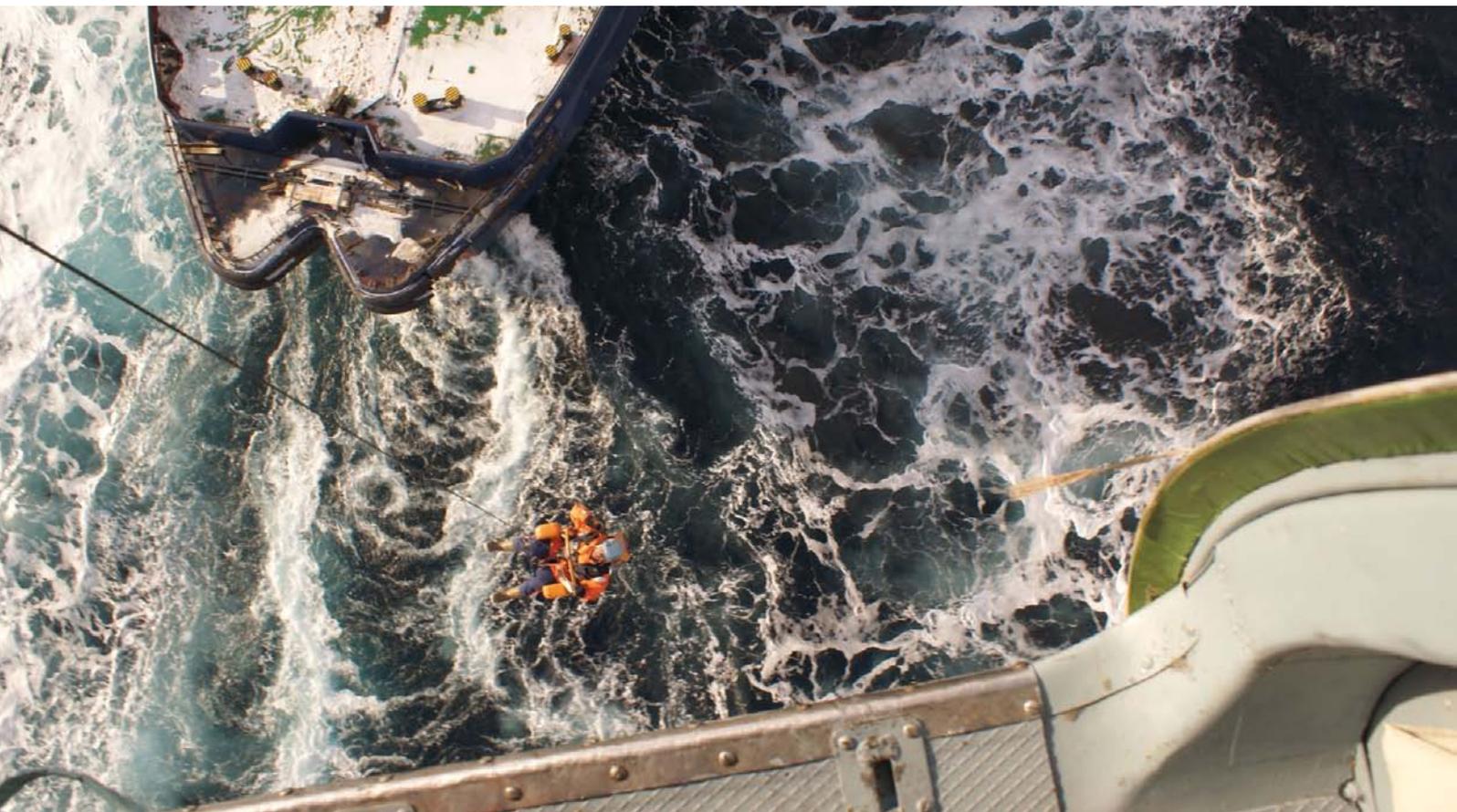
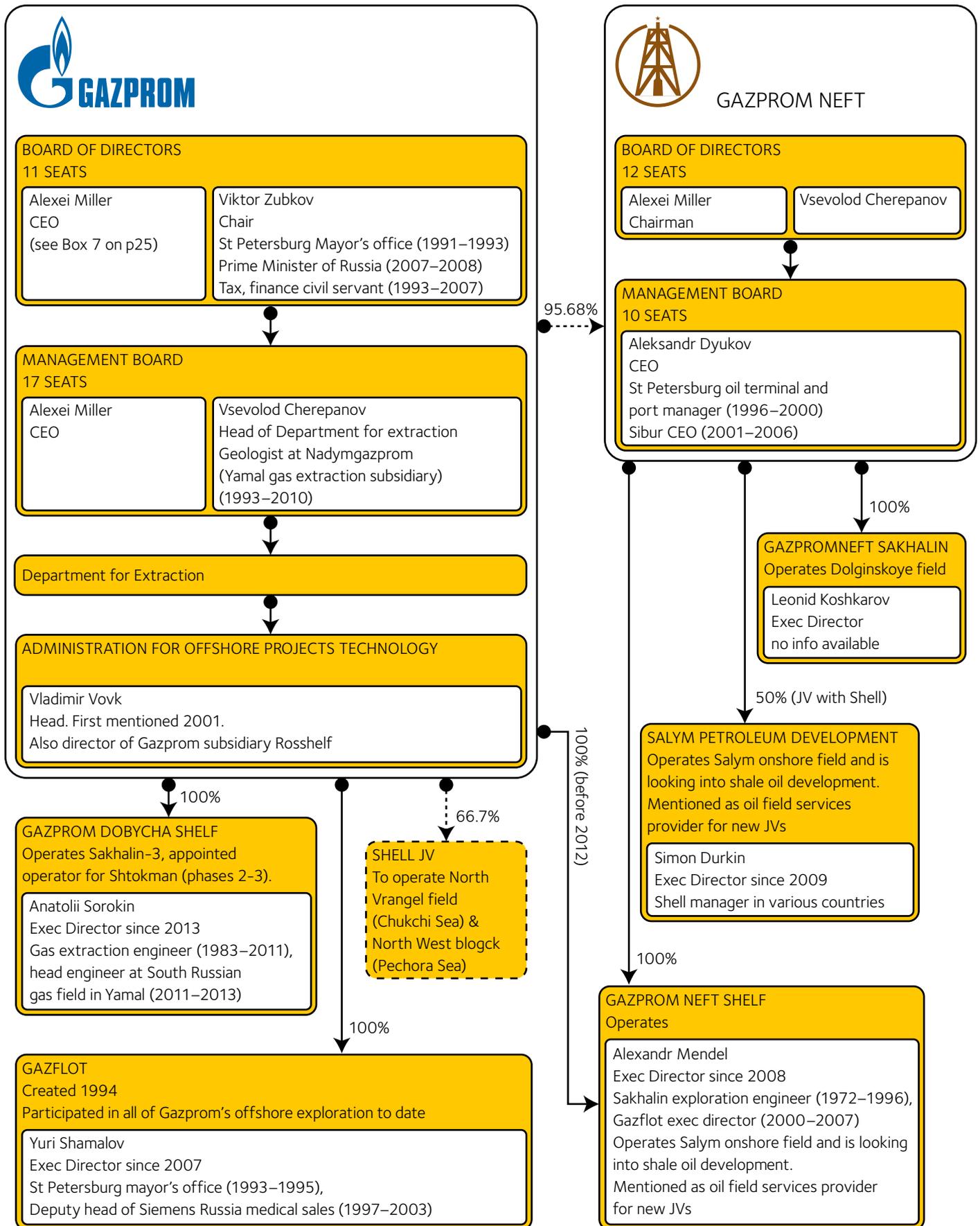


Diagram 2: Gazprom's relevant top managers, departments, and subsidiaries (previous, future or unconfirmed connections shown in dotted lines)  
 Percentages refer to shareholdings





## BOX 4 KOLSKAYA: FATAL ATTEMPT AT ILLEGAL DRILLING, REGULATORY FAILURE

The Kolskaya rig, commissioned by Gazprom subsidiary Gazflot capsized and sank on its way back from drilling in the Okhotsk Sea on 18 December 2011, killing 53 of the 67 crew.<sup>103</sup> The history of the exploratory drilling project reveals clear disregard by Gazprom's management for safety and environmental regulations.

Gazprom received the licence for the West Kamchatka shelf area in June 2009. Previous to this, Rosneft had held the licence between 2003 and 2008, and failed to complete its exploration programme (see Box 2, p10). Gazprom conducted a seismic survey in 2009–2010<sup>104</sup> and began the process of getting regulatory approval for drilling.

In early September 2011, a state environmental impact assessment commission found Gazprom's exploration drilling project "not compliant with the relevant environmental regulations." Specifically:

- ⊖ parts of the documentation were found to be inconsistent with each other;
- ⊖ Gazprom had not conducted an oil spill risk assessment;
- ⊖ Gazprom had not assessed the project's impacts on sea birds and mammals;
- ⊖ the project fell short of legal requirements on preventing the discharge of drilling fluid and waste.<sup>105</sup>

Despite being declared as unprepared by the environmental regulator's evaluation, Gazflot commenced drilling in September 2011. On 20 October 2011 the Kamchatka regional prosecutor's office filed a case in the Cheremushki district court in Moscow, demanding that Gazprom and Gazflot's drilling operation be halted on the basis that they were drilling without the necessary permits.<sup>106</sup> Subsequently, the company's webpage announcing the drilling operation was deleted, and the conclusions of the state environmental assessment were removed from the environmental regulator's online register of drilling projects.<sup>107</sup>

At the end of September 2011 Gazflot sent its project documentation to be re-examined by the state environmental assessment authority, and a month later the project received approval. However, this time the full text of the assessment was not published and no public consultation was carried out.<sup>108</sup> Later (in February 2012) a district court fined Gazflot 400,000 roubles (£8,000) for drilling without the regulator's approval.<sup>109</sup>

On 18 December 2011 the rig Kolskaya capsized and sank while being towed across Okhotsk Sea to Sakhalin in stormy weather. According to the business daily *Kommersant* (referencing anonymous sources familiar with the criminal investigation that followed the incident), the rig was not designed to withstand the height of the storm waves.<sup>110</sup>

Surviving crew members pointed out that multiple technical faults in the platform and deficiencies in the towing plan had been raised by the crew to the management, which had ignored the warnings. Elena Kartashenko, widow of the rig's drilling mechanic, said in an interview that her husband had believed the drilling season was supposed to finish in October, but due to a late start the company had decided to keep the rig in operation through November.<sup>111</sup>

The rig's full crew was onboard during towing because the company did not hire an additional ship to transport them, despite being legally required to. Most of the survivors of the accident were the towing crew who were on the deck for their shift.<sup>112</sup> The rig's captain Alexandr Kovalenko said in an interview that he had requested for at least part of the crew to be moved off the rig during towing, but Gazflot refused. He also said the rig's insurance agent Zhivko Zhekov (who died in the accident) had been concerned that the two ships towing the rig were not powerful enough.<sup>113</sup>

Criminal investigation of the incident is ongoing.<sup>114</sup> Gazprom's sustainability report for 2010–2011 fails to mention problems with the Kolskaya rig, and does not include its crew in reporting on fatalities, although Gazflot is a 100% subsidiary of Gazprom.

### 2.3. DISREGARD FOR SAFETY AND ENVIRONMENTAL IMPACT

Rosneft is reputed to be Russia's most polluting company. There is no regular overall reporting at government level to enable comparison. But a one-off report by the environmental regulator Rosprirodnadzor, whose results were published by the business paper *Vedomosti* in 2012, concludes that Rosneft was responsible for 2,727 or 75% of spills in Russia's largest oil province Yugra in 2011<sup>115</sup> while only extracting 25% of the total regional output that same year.<sup>116</sup> (Yugra, or Khanty-Mansiysk Autonomous Region accounts for 51% of Russia's overall oil extraction volumes,<sup>117</sup> and for 54% of Rosneft's.<sup>118</sup>) Of the four companies featured in the report, Rosneft had the lowest overall environmental safety budget: \$563m compared to TNK-BP's budget of \$897m.<sup>119</sup>

According to an anonymous industry source commenting to *Vedomosti* on the 2012 Rosprirodnadzor report, the main reason for Russia's world record in terms of numbers of oil spills is the worn out state of pipelines. The source states that companies are not incentivised to improve or replace old equipment – they receive no benefits for doing so, and the price of liability is negligible.<sup>120</sup> Because Rosneft's sustainability reports only provide figures on pipeline ruptures, not other oil spills (see Table 2, p20), it is difficult to assess the scale of the problem at other points, including points of extraction.

Rosneft's harmful emissions from oil processing amount to 24.4% of country-wide emissions, according to Ministry of Natural Resources statistics,<sup>121</sup> larger than the company's share of 18.8% of the country's refining capacity.<sup>122</sup> *Nezavisimaya Gazeta* suggests that at a time of high debts, the company is unwilling to invest in replacing outdated equipment.<sup>123</sup> The decision to build the platform Prirazlomnaya from a decommissioned North Sea rig (see Box 3, p14) is indicative that Rosneft's reluctance to invest in updating equipment for use in offshore extraction, at least in the early 2000s, was no different.

Appendix 1 presents a review of five years (2007–2012) of environmental infringements at Rosneft's Sakhalin operations. Most of the cases are related to aging or faulty equipment – including 1,100 barrels of oil that seeped from a filtering station into river Ekhabi in 2009, resulting in estimated damages of 82m roubles (£1.64m). The company eventually had to pay out 22m roubles (£440,000).<sup>125</sup> The majority of the cases were documented and brought to the attention of regulators by the local civil society group Sakhalin Environment Watch (SEW). The key infringements related to offshore operations were:

- ☐ In 2009 the Ministry for Emergencies, following a request from SEW, verified that Rosneft had not prepared any oil spill response plans for its ongoing small-scale drilling operations on Sakhalin's north shore.<sup>126</sup>
- ☐ In September 2012 RN-Sakhalimorneftegaz (Rosneft's operating subsidiary in Sakhalin) was fined 800,000 roubles (£16,900) for flaring 50% of associated petroleum gas from Odoptu-More (offshore field operated by horizontal drilling from onshore). The project's permits allow for flaring only up to 4% of the gas. The regional prosecutor associates the flaring with "significant damage to ... the environment and public health."<sup>127</sup>

Gazprom did not feature in the regulator's Yugra report; its overall figures on oil spilled are significantly lower than those of Rosneft (see Table 2, p20) as oil represents less of the company's extraction. However, the Kolskaya incident, as well as the operation of the Prirazlomnaya platform, indicate a similar lack of safety culture within Gazprom (see Boxes 3 and 4, p14, 18).

Gazprom Neft failed to clean up several, including some large scale, oil leaks on the Yamal peninsula in the past three years:

- ☐ In January 2013, the Yamal regional prosecutor opened five criminal cases

against Gazprom Neft for ignoring its responsibility to clean up oil spills in the region. Six spills from the company's pipelines during February and March 2012 resulted in polluting nearly 7,000m<sup>2</sup> of forest. The prosecutor valued damages at 11m roubles (£220,000). The court ordered the company to complete clean-up by October 2013; criminal proceedings are ongoing.<sup>128</sup>

- ☐ In July 2012 the same prosecutor brought 13 criminal cases to court against Gazprom Neft and RN-Purneftegaz (Rosneft subsidiary) for failing to clean up a number of leaks that occurred throughout 2010 and 2011. The total damage was estimated at 30m roubles (£644,350).<sup>129</sup>
- ☐ In 2009 the same prosecutor sued Gazprom Neft for 12.53m roubles (£265,000) for failing to clean up a spill that had contaminated a river and marshland.<sup>130</sup>

#### Weak regulatory oversight affecting both companies.

In the case of Kolskaya, the regional Kamchatka prosecutor had taken Gazflot to court to stop illegal drilling, and the regulator issued a fine several months after the rig sinking. However, these government departments were unable to effectively stop unsafe practice. The regulator's environmental assessment declined Gazprom's project documentation because of its multiple problems, but approved it only a month later without going through the same consultation process. Fines imposed by the environmental and safety regulator for small scale oil spills (Appendix 1, p32) are in the region of £1,000 and therefore insufficient to motivate action by companies.

Although routine fines and liabilities are unlikely to be financially significant, the lack of sufficient regulatory oversight should concern Rosneft and Gazprom's JV partners because of the high safety risks of drilling in icy waters.

## 2.4. UNRELIABLE REPORTING

Reporting on environmental performance and safety practices at company level at both Rosneft and Gazprom is incomplete. We compare several key indicators from their sustainability reports in Table 2.

Rosneft's sustainability reports only provide a figure for the overall number of oil spills resulting from pipeline ruptures, but not their total volume. Nor do they provide the number or volume of any other oil spills. Gazprom provides total volumes of oil spilled but not the number of incidents. Shell and BP report on both these indicators. TNK-BP – now part of Rosneft – does not report on the actual number or volume of oil spills, but only on volume of oil spilled per volume extracted.

Gazprom's reporting on injuries and fatalities in its 2010–2011 sustainability report entirely omits the Kolskaya incident, and the report makes no mention of the capsized rig. (BP's 2011 sustainability report omits the Deepwater Horizon spill volume from its reporting due to ongoing investigation on the volume of the spill and mentions this prominently.)<sup>131</sup>

Both companies have refused to publish their oil spill response plans for offshore projects. Following pressure from Greenpeace and other NGOs, Gazprom made available a shortened version for Prirazlomnaya (see Box 3, p14). Rosneft has, to the best of our knowledge, not made any of its oil spill response plans available online and, in 2009, admitted to not having prepared any for its shoreline operations in North Sakhalin.<sup>132</sup>

It should be noted that company and government figures are likely to be underestimated. With regard to Rosneft's oil spills on Sakhalin (see Appendix 1), a number of spills documented by SEW were underestimated or denied by the company and/or regulator:

- ⊗ The regulator estimated damage from a pipeline leak in February 2007 at 30m<sup>2</sup>. A much larger area can be seen in SEW's photographs and the group estimate the actual damage at 1 hectare.
- ⊗ Rosneft claimed it had completely rectified the same spill by October, but the damaged pipeline was left lying in place, along with some spilled oil. The regulator's inspector "failed to notice" the leftover spill but it was confirmed by the prosecution's inspector.

Table 2. Rosneft, Gazprom, TNK-BP, and Gazprom Neft environmental reporting compared

Company	Total volume oil spilled (barrels)		Number of oil spills		Casualties or days away from work (cases/fatalities)		CO <sub>2</sub> emissions, from operations / from burning products (million tonnes)
	2010	2011	2010	2011	2010	2011	
Rosneft	3,737 (pipelines only) <sup>133</sup>	1,066 (pipelines only) <sup>134, 135</sup>	7,187 (pipelines only) <sup>136</sup>	7,134 (pipelines only) <sup>137</sup>	63 / 7 <sup>138</sup>	56 / 8 <sup>139</sup>	43.8 / 137.1 <sup>140</sup>
TNK-BP	N/R	N/R	N/R (only reported reduction on 2005 level) <sup>141</sup>	N/R (only reported reduction on 2005 level) <sup>142</sup>	68 / 9 <sup>143</sup>	70 / 6 <sup>144</sup>	28 / N/R <sup>145</sup>
Gazprom	670 <sup>146</sup>	483 <sup>147</sup>	2467 (pipelines only) <sup>148</sup>	N/R	231 / 19 <sup>149</sup>	226 / 21 <sup>150</sup>	245.5 / N/R <sup>151</sup>
Gazprom Neft	646 <sup>152</sup>	425 <sup>153</sup>	N/R	N/R	57 / 3 <sup>154</sup>	60 / 2 <sup>155</sup>	1.8 <sup>156</sup> / N/R <sup>157</sup>
BP	10,692 <sup>158, 159</sup>	3,773 <sup>160</sup>	142 <sup>161</sup>	102 <sup>162</sup>	408 / 14 <sup>163</sup>	168 / 2 <sup>164</sup>	70.8 / 539 <sup>165</sup>
Shell	21,256 <sup>166</sup>	43,978 <sup>167</sup>	195 <sup>168</sup>	208 <sup>169</sup>	N/R / 12 <sup>170</sup>	N/R / 6 <sup>171</sup>	84 / 570 <sup>172</sup>



- ⊖ A number of instances of contamination discovered jointly by SEW and regulator Rostekhnadzor in 2008 were not investigated or taken to court after they passed from Rostekhnadzor's competency to environmental regulator Rosprirodnadzor.
- ⊖ A 2012 underwater pipeline leak documented by SEW was denied by both the regulator and the company.

If Rosneft and Gazprom's partners are to understand the operational risks associated with Rosneft and Gazprom's lack of safety culture, these companies' reporting needs to improve significantly both in consistency and substance.

## 2.5. QUESTIONS FOR COMPANIES

### 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?

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 international best 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?

### Question 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 international best practice?

### Questions for BP as a significant shareholder in Rosneft

Will BP report on CO<sub>2</sub> 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 operations 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?

# 3. Political risk

Frontier projects in icy waters are likely to have longer development times than large scale extraction projects elsewhere. The earliest final investment decision announced on the Arctic exploration projects is 2016–2017 for Exxon and Rosneft,<sup>173</sup> but this date is unlikely considering the years of delays on previous offshore projects including Shtokman (see Box 1, p10) and Prirazlomnaya (see Box 3, p14). The other JVs are not expected to even start exploratory drilling until the 2020s, meaning extraction would be expected closer to 2030. To profit from operations in icy offshore conditions in Russia, the IOCs would need to maintain both stable terms with their Russian partner companies and government support in the form of tax breaks and renewed licences for extraction, for several decades.

The Russian government has a history of taking over or reshuffling major oil companies and projects, most famously by breaking up Yukos, the country's largest oil company in 2004 (see Box 5).<sup>174</sup> Shell experienced the takeover of a majority stake in its Sakhalin-2 project by Gazprom in 2006. While currently Rosneft and Gazprom's Western partners are protected from experiencing anything similar by their state ownership, the long-term timelines of Arctic oil and gas extraction and the planned privatisation of Rosneft and Gazprom make political risk more pertinent.

In the short term, a lack of clarity over political control of Rosneft and Gazprom creates the following uncertainties:

1. **Short- and medium-term regulatory uncertainty.** Russia's energy policy and control of energy companies is subject to a conflict between policymakers.
2. **Uncertainty over plans for privatisation.** Rosneft is scheduled to be privatised by 2015 and Gazprom in the longer term, this may affect their privileged access to licenses and other political support.
3. **Risk of losing access to Arctic exploration and extraction licences.** Pre-privatisation, the two companies are in competition with each other for licences.
4. **Changes in tax breaks.** Tax breaks are critical to enable Arctic oil extraction and the Russian tax regime is subject to change.

This section reviews the Russian government's influence over the direction of Rosneft and Gazprom, outlines the implications for the longer term and suggests questions that investors in IOCs should ask regarding these uncertainties.

## BOX 5: THE GROWTH OF ROSNEFT, YUKOS ASSETS, AND POLITICAL CONTROVERSY

In 2004 Igor Sechin was appointed as chairman of what was then a relatively small state-controlled oil company, Rosneft. Rosneft's growth into one of Russia's largest oil companies corresponds directly to the demise of Yukos. Owned by Mikhail Khodorkovsky since its privatisation in 1995, Yukos had been one of Russia's two largest oil producers in 2003 (591.5m barrels per year against Lukoil's 597.4).<sup>175</sup>

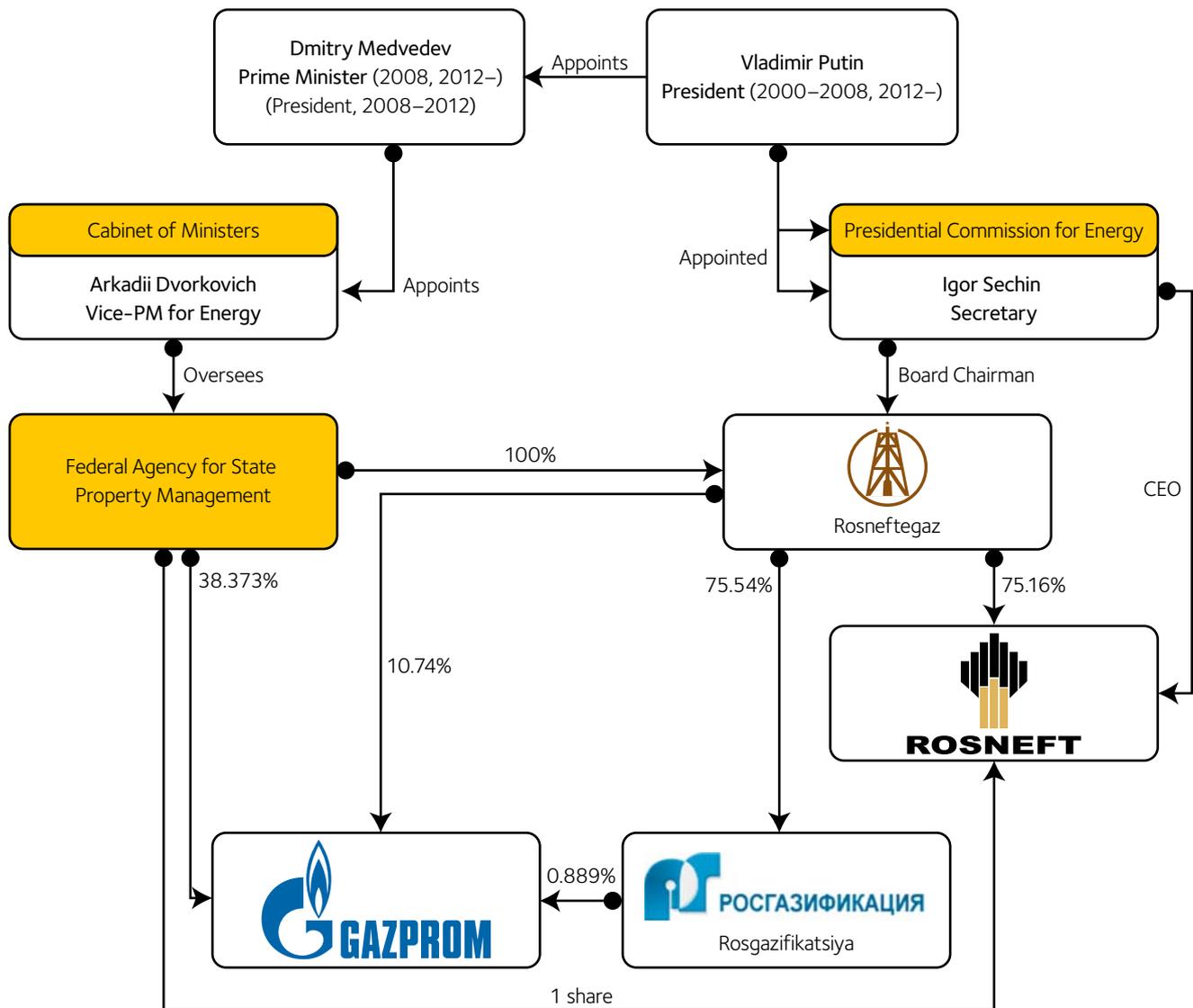
In 2003, Khodorkovsky was arrested and subsequently convicted of tax evasion and fraud. For many years it has been alleged that his conviction was 'selective targeting' motivated by his open financial backing of political opposition<sup>176</sup> and his vocal criticism of Rosneft. It was reported that in a televised February 2003 meeting with Putin, Khodorkovsky criticised Rosneft's purchase of Northern Oil, a small oil company, for a premium price that according to him indicated "kickbacks to Rosneft's leadership."<sup>177</sup> Yukos's assets were frozen and auctioned off to pay outstanding tax liabilities.<sup>178</sup>

A number of UK MPs including former foreign secretaries David Miliband and Sir Malcolm Rifkind have publicly condemned the trial against Yukos's former owners, believing it to be politically motivated.<sup>179</sup>

Its largest subsidiary was sold at auction in 2004 to a previously unknown company called Baikalfinansgroup. The ultimate beneficiaries of Baikalfinansgroup are unknown, but this company was purchased by Rosneft two days later for a rumoured sum of 10,000 roubles (£200).<sup>180</sup>

Following the purchase, the value of Rosneft's total assets increased from \$6.8bn in 2003 to \$25.99bn in 2004,<sup>181</sup> and Rosneft's earnings quadrupled between 2004 and 2005.<sup>182</sup>

Diagram 3: Rosneft and Gazprom control  
Percentages refer to shareholdings



### 3.1. WHO CONTROLS RUSSIA'S NATIONAL OIL COMPANIES?

Currently Russia's policy on energy, as well as the practical control of the energy companies, appears to be subject to a double structure. It is contested between the cabinet of ministers and Arkadii Dvorkovich (vice PM for energy) on the one hand, and Igor Sechin (Rosneft CEO, Rosneftegaz chairman, and presidential commission on energy strategy secretary) on the other hand (see Diagram 3).<sup>183</sup>

Between 2008 and 2012, while Vladimir Putin was prime minister, Sechin had the rank of vice prime minister with special responsibility for energy policy, and Dvorkovich was a special economic advisor to President Dmitry Medvedev. With Putin's re-election as president in 2012, Medvedev became prime minister and appointed Dvorkovich to coordinate energy

policy. Meanwhile Sechin received a new post in President Putin's administration: secretary of the presidential "commission for the development of the fuel and energy complex,"<sup>184</sup> colloquially known as "the oil club".<sup>185</sup> a body comprised of top managers of the country's oil companies designed to give strategic direction to the industry. In effect Dvorkovich and Sechin now have parallel portfolios – to the point where the same oil executives had separate round table meetings with Sechin and Dvorkovich in the same day.<sup>186</sup>

Since the reshuffle after Putin's re-election, Sechin and Dvorkovich have been publicly in deadlock over a number of issues, including Rosneftegaz paying its dividends,<sup>187</sup> the possible privatisation of Rosneft and Gazprom, and the companies' exclusive access to concessions on Russia's continental shelf.<sup>188</sup> Putin has intervened

several times on Sechin's side, to give him extra powers (including by putting him in charge of Rosneftegaz, the state holding company). However, Putin does not always support Sechin's proposals. Notably, in late 2012 Putin overruled Sechin's argument that the privatisation of energy company RusHydro should be controlled and financed by holding company Rosneftegaz (which Sechin heads), instead ruling in favour of Dvorkovich's suggestion that financing should come from Rosneftegaz dividends to the state.<sup>189</sup>

In terms of direct shareholding control of Rosneft and Gazprom, tables 3 and 4 show that the bulk of the state's stake in Rosneft, as well as part of its holding in Gazprom, is held via Rosneftegaz. This company holds shares in over 70 energy related enterprises on behalf of the state as of 2010.<sup>190</sup>

Table 3. Rosneft's shareholding structure as of 1 April 2013<sup>191</sup>

State-controlled shares	Rosneftegaz (100% state-owned)	69.5%
	Federal Agency for State Property Management	1 share
Independent shareholders	BP (shares currently held by National Settlement depository)	19.45%
	Other shares held by National Settlement Depository (nominal shareholder)	10.24%
	Other legal entities & individuals	0.51%

Table 4. Gazprom's shareholding structure as of 31 December 2011 (most recent report)<sup>192</sup>

State-controlled shares (50.002%)	Federal Agency for State Property Management	38.373%
	Rosneftegaz	10.740%
	Rosgazifikatsiya (gas supply networks company 74.5% owned by Rosneftegaz) <sup>193</sup>	0.889%
Gazprom subsidiary	Gazprom Gerosgas BV <sup>194</sup>	2.930%
The Bank of New York Mellon (nominal shareholder for publicly traded securities)		28.350%
Other shareholders (holdings less than 2%)		18.718%

In August 2012, President Putin appointed Igor Sechin to the post of chairman of the board of Rosneftegaz. According to sources surveyed by business paper *Vedomosti* within the cabinet of ministers, and an unnamed other director of Rosneftegaz, this appointment came as a surprise and had not been cleared by anyone in the cabinet of ministers.<sup>195</sup> Rosneftegaz's current CEO is Larisa Kalanda, also Rosneft's vice president and according to *Vedomosti* a long-time colleague of Igor Sechin.<sup>196</sup>

Since Sechin's appointment there have been several indications that Rosneftegaz is to an extent independent of government control. Rosneftegaz has repeatedly refused to pass on Rosneft and Gazprom's dividends to the

state. In September 2012 it was reported that the holding company had only paid dividends once in its existence, in 2007.<sup>197</sup> In November 2012, Igor Sechin had reportedly negotiated for a pending dividend payment to be delayed another month in order for Rosneftegaz's banking obligations to be fulfilled.<sup>198</sup> *Vedomosti* reported that Russia's state property management agency does not have a shares management agreement or any formal contract with Rosneftegaz on how it ought to use its rights as shareholder of Gazprom and Rosneft.<sup>199</sup>

**Implications for Gazprom:** Rosneftegaz holds less than half of the state's shares, therefore the lack of a shareholding agreement does not mean

a loss of control.<sup>200</sup> However, in case of a disagreement between Rosneftegaz and the cabinet of ministers, the company in effect does not have a controlling shareholder.

**Implications for Rosneft:** According to lawyers surveyed by *Vedomosti*, the lack of a shareholding agreement between Rosneftegaz and the state could result in a temporary loss of control over company decisions.<sup>201</sup> Putin's appointment of Sechin, and the apparent difficulty of the working relationship between Rosneftegaz and the cabinet of ministers, mean that Sechin is in a position of extraordinary power in Rosneft, as both its CEO and chairman of its controlling shareholder.

*Sechin is in a position of extraordinary power in Rosneft, as both its CEO and chairman of its controlling shareholder.*

## BOX 6: ROSNEFT CEO: UNOFFICIAL POWER

Igor Sechin, the current CEO of Rosneft, has stayed in this position, or close to it, since 2004. He is widely reputed to be one of the most influential political figures in Russia today. *The Financial Times* profiled him as “the third man” (i.e. third in command to Putin and Medvedev)<sup>202</sup> and *Forbes* as the “Darth Vader” of Russian politics.<sup>203</sup> A brief search on Sechin in the US diplomatic cables published by Wikileaks reveals that the Moscow embassy staff regarded him as a powerful, corrupt<sup>204</sup> and shadowy figure. “Like many of Prime Minister Putin’s close allies, Sechin emerged from the security services. The [US Government] has had virtually no interaction with him.”<sup>205</sup> “During much of Putin’s first term, Sechin was so shadowy that it was joked he may not actually exist but rather was a sort of urban myth, a bogeyman, invented by the Kremlin to instil fear.”<sup>206</sup>

Born in 1960, Igor Sechin began his career in Mozambique and Angola in Soviet diplomatic and trade organizations. According to media commentators, Sechin’s actual role in these missions was military intelligence-gathering for the KGB, which may explain his later weight among the “siloviki”, or security service men, in Russian government.<sup>207</sup> From 1988 Sechin worked for the Leningrad Soviet (council), alongside Vladimir Putin and closely followed him as a deputy throughout his future career: in the St Petersburg city hall, President Yeltsin’s administration in Moscow, and finally as prime minister and president.<sup>208</sup>

## BOX 7: GAZPROM CEO: LINKS TO PUTIN, CONFLICT WITH SECHIN?

Gazprom CEO Alexei Miller is likewise a long-time colleague of President Vladimir Putin, having worked directly under his leadership in the St Petersburg city hall from 1991 to 1996. When Putin became president in 2000, Miller got the post of deputy energy minister and a year later was appointed Gazprom CEO, in a decision that was reportedly a surprise to the company’s top management.<sup>209</sup> In this position he worked alongside Dmitry Medvedev (Russia’s President 2008–2012, current prime minister, and Gazprom chairman of the board 2000–2001 and 2002–2008).<sup>210</sup>

A 2008 Wikileaks cable from the US embassy in Moscow refers to “Sechin’s well-known personal animosity toward Gazprom’s leadership, especially its chairman Alexey Miller.”<sup>211</sup> Referencing a source, the diplomat continues, “Sechin “hates Miller,” but more importantly sees Gazprom and its leadership as threats to, rather than the source of, Russia’s future prosperity.”<sup>212</sup>

During 2012 and 2013, Miller and Sechin together sent a number of public appeals to Prime Minister Dmitry Medvedev to voice their opposition to letting non-state-controlled companies access the Arctic continental shelf.<sup>213</sup> However, that alliance appears to have been temporary. Currently the two companies and the two top managers appear to be competing with each other for offshore Arctic licences (see Section 3.3).

## 3.2. AMBIGUOUS PRIVATISATION PLANS

Current government policy is to sell off the Russian state’s stake in Rosneft. The company is to be fully sold off before 2016 except for one (possibly “golden”) share, and Gazprom is to be privatised in the longer term.

In August 2011, the state’s entire stake in Rosneft appeared on the government’s list of companies to be privatised by 2015.<sup>214</sup> With his return to the presidential seat in May 2012, Vladimir Putin signed a decree striking out a number of energy-related

stakes from the privatisation list, including one share in Rosneft. Commentators surveyed by the news outlet *Gazeta.Ru* all agreed that this is to become a “golden share,” i.e. a nominal share that gives the state veto power over the other shareholders of a company.<sup>215</sup> Commenting upon this decree to BBC Russia, consultant Mikhail Krutikhin suggests that the inclusion of the one Rosneft share in the protected list is a concession to Igor Sechin’s keenness to keep state control over Rosneft.<sup>216</sup>

In April 2013, another announcement was made by the energy minister saying the

state was preparing to sell a 19% stake in Rosneft, which would leave it with a 50.5% stake.<sup>217</sup> No further details were disclosed on whether the shares would be sold in one chunk (as they were to BP last year) or through a public offering.

Putin also decreed that until 2015, Rosneftegaz should act as investor in relation to the companies scheduled to be privatised, i.e. that this holding company can take control or use its existing control of state shares in energy companies for the purpose of recapitalising them, to finance their privatisation.<sup>218</sup>

Gazprom is not part of the government’s current privatisation list.<sup>219</sup> However, a number of commentators in the media suggest that more of Gazprom’s shares may end up held by Rosneftegaz as part of Rosneftegaz’s mission as “investor” for companies destined for eventual privatisation.<sup>220</sup> In 2012 Putin talked about privatising Gazprom alongside Rosneft as a “long term” ambition for his government.<sup>221</sup>

In the long term, a new ownership post-privatisation for both companies may affect the conditions of operation of JVs, including their access to licences.

## 3.3. RISK OF LOSING ACCESS TO LICENCES

According to current legislation, Rosneft and Gazprom are de facto the only companies allowed to bid for exploration or extraction concessions on the Russian oceanic continental shelf (to be able to bid for concessions, a company has to be at least 50% owned by the Russian government and to have at least five years’ experience in drilling offshore).<sup>222</sup> Arkadii Dvorkovich had voiced proposals to change this regime to allow companies without majority state capital to access the shelf, and PM Dmitry Medvedev has held cabinet meetings dedicated to developing these proposals,<sup>223</sup> but so far the policy has remained unchanged. Currently the cabinet of ministers is discussing options for private (i.e. not state-owned) companies to explore the licences that Gazprom and Rosneft have not taken up or done insufficient exploration on.<sup>224</sup> This means that both companies are under pressure to complete as much exploration in the shelf as they can.

By mid-March 2013, Rosneft received 43 licences to drill on the Arctic continental shelf and is applying for eight more. Gazprom applied for 20 concessions, some of which overlap with Rosneft’s

applications.<sup>225</sup> On 25 April 2013 Gazprom was granted four new licences in the Barents Sea.<sup>1</sup> Russian business press commentators interpret this as Rosneft attempting to win over some of the continental shelf concessions from Gazprom, as it is currently in a stronger position politically.<sup>226</sup> *Kommersant* cited a letter from Rosneft non-executive director Nikolai Laverov to resources and environment minister Sergei Donskoi, asking for Rosneft to receive additional concessions including those 'pegged' for Gazprom, as Rosneft had successfully carried out its outstanding tasks on existing licences. The letter further expresses concern that Gazprom's subsidiary Gazprom Neft (see Section 2.2) is not sufficiently controlled by the state.<sup>227</sup>

#### Implications for both companies.

It is clear that if the privatisation of the two companies goes ahead, the regulations will have to change and Gazprom and Rosneft may lose the privileged access to the continental shelf that they currently enjoy. As for finds on existing exploration licences, the cabinet of ministers grants both exploration and extraction licences on resource extraction areas deemed to be "of federal significance," including offshore licences. If a find is made during extraction, it is up to the cabinet of ministers to decide whether to grant an extraction licence.<sup>228</sup> Therefore both of the companies' access to Arctic fields will be at risk if they lose political support as a result of privatisation, or if the balance of power shifts in favour of Medvedev and Dvorkovich.

#### Implications for Gazprom.

The company may get fewer exploration licences than it applied for due to competition from Rosneft and the reputed conflict between the top managers of the companies. According to *RBC-Daily*, Rosneft's application for additional licence blocks includes the areas that Gazprom is reported to have offered to explore with Shell.<sup>229</sup>

#### Implications for Rosneft.

The company is under pressure to complete as much exploration as it can before planned privatisation in 2016. This means it may lose licences where it has not completed sufficient drilling (as it had done with West Kamchatka, see Box 2, p10), and makes operational risk (Section 2, p12) particularly prominent.

#### 3.4. TAX BREAKS

Offshore Arctic oil and especially gas extraction in any of the Arctic countries, including Russia, would be unviable without significant fiscal incentives in any of the Arctic countries.<sup>230</sup> It is too early to assess the scale of tax breaks necessary for the new Russian Arctic licences (as they will depend on the scale and kind of the oil or gas fields found), however the scale of tax breaks was discussed as a sticking point for the Shtokman project (see Box 1, p10).

According to recent announcements from an official at Russia's ministry of finance, a regime of tax breaks for offshore and 'tight' oil is expected to come into effect on 1 January 2014, including, for offshore concessions, "scrapping export duty and a sharp reduction of mineral extraction tax."<sup>231</sup> This concerns state-owned companies specifically. A report made at a January 2013 cabinet meeting by resources and environment minister Sergei Donskoi<sup>232</sup> proposes a separate set of tax conditions, based on a higher value added tax (i.e. a lesser subsidy) for any private companies extracting oil and gas from the continental shelf in the future.

If the tax regime will be differentiated between state-owned and privately-owned companies (with more incentives for the former), this poses the question of what regime will apply to Rosneft and Gazprom when privatised. If by the stage of extraction, Rosneft or Gazprom are privatised, the tax regime under which they and their JVs operate may have been revised.

#### 3.5. QUESTIONS FOR IOCS

Is the company worried about the tight timelines contained in the licences? What is the contingency plan if delays arise?

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 on a potential change in political power in Russia?

#### Additional questions for BP

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?



# 4. Risks for minority shareholders

The governance standards and shareholder accountability of Rosneft and Gazprom should concern investors in those companies who have acquired shares in these companies as part of their alliance (currently only BP has a shareholding in Rosneft), or are considering doing so (reportedly, Shell was considering a share swap with Gazprom). Both companies have refused to disclose documents to activist minority shareholder Alexei Navalny; and both are known for concluding controversial deals that commentators claim go against the interests of their shareholders.<sup>233</sup>

## 4.1. ROSNEFT: QUESTIONABLE CONTRACTS AND DISREGARD FOR MINORITY SHAREHOLDERS

Alexei Navalny, now better known for his visible role in the movement against election fraud in Russia, acted as an activist shareholder within Rosneft for several years previously, probing the legality of a number of Rosneft's corporate practices.<sup>234</sup>

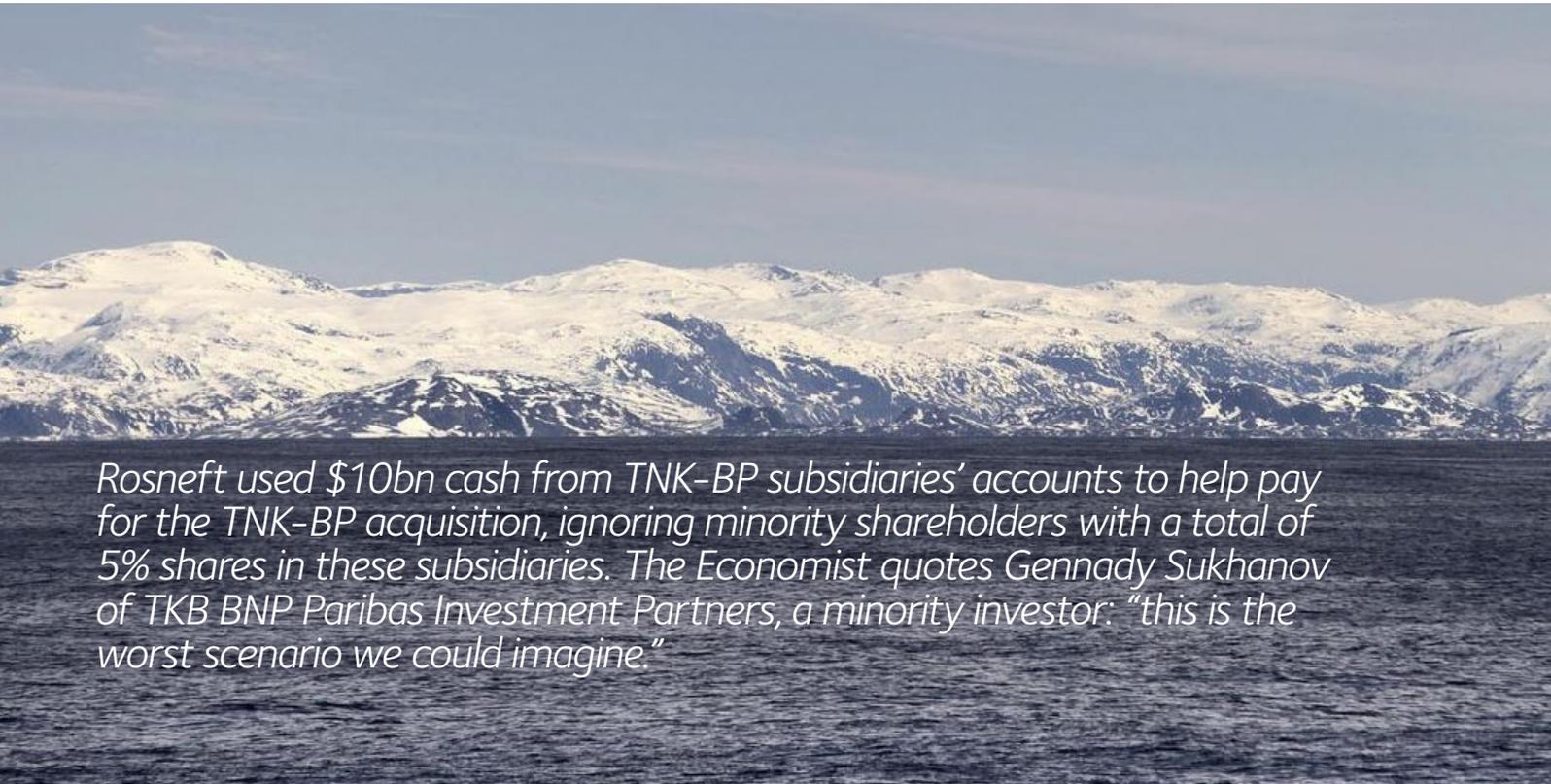
As a minority shareholder, Navalny requested Rosneft's board minutes for 2009, as well as its contract for sales of

oil to China. Sealed in 2009, this contract has Rosneft supplying oil to China at a rate of 110m barrels a year for 20 years in exchange for a loan of \$10bn.<sup>235</sup> The contract came under criticism in Russia for locking Rosneft into supplying oil for no more than \$60 per barrel, while current market price exceeds \$100 per barrel.<sup>236</sup> Detailed terms of the agreement have not been made public; Rosneft also refused to disclose them to its shareholder Navalny.

Refusing Navalny's request for board minutes and copies of the contract, Rosneft's representatives argued in court that the size of his holding did not merit the disclosure (i.e. that shareholder rights are differentiated by size of holding), that he did not vote in the 2010 AGM, and that he is known for his activist stance on corporate governance.<sup>237</sup> The court case went through several appeals, where the Federal Service for Financial Markets supported Navalny's position, but Rosneft won in the ninth court of appeals in August 2012.<sup>238</sup>

Rosneft's attitude to minority shareholders came under criticism from minority TNK-

BP investors when Rosneft used \$10bn cash from TNK-BP subsidiaries' accounts to help pay for the TNK-BP acquisition, ignoring minority shareholders with a total of 5% shares in these subsidiaries. *The Economist* quotes Gennady Sukhanov of TKB BNP Paribas Investment Partners, a minority investor: "this is the worst scenario we could imagine." Timo Rossi of Northern Star, a Finnish investment fund with shares in TNK-BP, called Mr Sechin's decision a "huge embarrassment."<sup>239</sup>



*Rosneft used \$10bn cash from TNK-BP subsidiaries' accounts to help pay for the TNK-BP acquisition, ignoring minority shareholders with a total of 5% shares in these subsidiaries. The Economist quotes Gennady Sukhanov of TKB BNP Paribas Investment Partners, a minority investor: "this is the worst scenario we could imagine."*



**ROSNEFT**

### **BOX 8: CORRUPT SALE OF PRIRAZLOMNAYA PLATFORM?**

In 2002 Rosneft purchased a retired North Sea oil platform to operate in the Prirazlomnoye field. The platform Hutton appears to have been retired from the North Sea in 2002 after 18 years of service for Kerr-McGee. It was sold to a firm called Monitor TLP Ltd (apparently dissolved the next year)<sup>240</sup> for \$29m.<sup>241</sup> According to Russian newspaper *Pravda* referencing a sales agreement seen by the journalist, Monitor then sold the platform for \$67m to Sevmorneftegaz, earning \$37m on the spot for its unknown beneficiary.<sup>242</sup>

#### **4.2. GAZPROM: QUESTIONABLE SALES**

Unlike Rosneft, Gazprom disclosed its board minutes to Navalny without going to court.<sup>243</sup> According to Navalny, Gazprom Board minutes for 2009 showed that a number of Gazprom's directors voted on approving deals with companies where they have interest.<sup>244</sup> According to Chapter 11 of Russia's law on joint-stock companies,<sup>245</sup> decisions on this kind of "deals with interest" are to be taken by a majority vote of directors without interest and the discussion of the deal should include a clear indication of what the interest is.

Navalny started a court case against Gazprom, asking the court to compel the company to abide by this regulation. He also requested that the court annul 16 deals approved by Gazprom's board with companies including Gazprombank, Sogaz insurance company, and Rosselkhozbank (Gazprom CEO Alexei Miller chairs the boards of both Gazprombank and Sogaz). The arbitration court in Moscow refused Navalny's suit.<sup>246</sup>

A series of "surprising"<sup>247</sup> deals with gas extracting company Novatek indicate that Gazprom's handling of contracts with related parties should be of concern to investors. First, according to *Vedomosti* with reference to investigation documents seen by the paper, in 2008 the Moscow Home Office Investigations unit was conducting a probe into a deal between Gazprom and Transinvestgaz (TIG), a gas trading company. TIG acted as an intermediary, buying gas from extracting company Novatek and selling it on to Gazprom in the exact same locations, with a mark up of 70% in 2005 and of 44% in 2006. Altogether Gazprom bought 4.5bn m<sup>3</sup> of gas from TIG and lost 1.49bn roubles (£31.68m) on the price difference, according to the investigation documents. Officials conducting the fraud investigation claimed to *Vedomosti* that they had approached Gazprom to act as the victim of the crime but the company had refused, saying it had "suffered no financial damage" from the deal.<sup>248</sup> Investigation documents also indicated that Gazprom itself gave TIG a loan in order to purchase the gas from Novatek.<sup>249</sup> In August 2009 the investigation was transferred between

Home Office departments and shut down.<sup>250</sup>

Second, in December 2010, Gazprom sold a 9.4% stake in Novatek itself to Gazprombank for 57.5bn roubles (£1.223bn), which was nearly 30bn roubles (£640bn) cheaper than market price. The bank then sold the stake for 80bn roubles (£1.706bn) to companies owned by millionaires Leonid Mikhelson and Gennadii Timchenko.<sup>251</sup> Timchenko is known as a long-time associate of President Vladimir Putin, and his estimated wealth has grown fourfold over the past four years to \$9.1bn according to Forbes.<sup>252</sup>

Third, in November 2011, Gazprom sold to Novatek its Urals-based gas trading subsidiary Gazprom Mezhhregiongas Chelyabinsk, for 1.55bn roubles (£31.16m). This subsidiary recorded a pre-tax profit of 1.3bn roubles for 2011, from takings of 12.1bn roubles (£251.2m), so Novatek practically earned back its purchase money over a year. According to UBS and Nomos-bank analysts surveyed by *Vedomosti*, a fair price for the gas trader ought to have been six or even eight times higher than the price paid by Novatek.<sup>253</sup>

In the early 2000s, Gazprom was subject to several probes for similarly suspicious deals with the gas company Itera.<sup>254</sup>

#### **4.3. QUESTION FOR COMPANIES ACQUIRING A SHAREHOLDING IN ROSNEFT OR GAZPROM**

What steps are being taken to improve corporate governance standards on issues such as conflicts of interest and transparency?



# Conclusion

Shell's experience in 2012 in the Alaskan Arctic serves as a warning about the significant challenges of oil and gas exploration in such an extreme environment. It also highlights that not even the most advanced of companies has current capability to undertake Arctic exploration safely and successfully. In this context, the rush to gain access to the Russian Arctic seas through joint ventures (JVs) with and/or share acquisitions in Russian oil and gas giants, Gazprom and Rosneft, is worthy of investor scrutiny.

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 governance 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.

This report is intended to inform investors of the specific risks facing international oil companies (IOCs) as those companies expand their Arctic operations into Russia. It suggests a number of questions investors in such IOCs should ask in order to understand whether the companies have adequately assessed the various risks they face and are taking appropriate steps to mitigate and manage them.

## KEY QUESTIONS TO 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?

### Political risk

Does the company anticipate that the currently promised fiscal and other incentives for Arctic offshore drilling to 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 CO<sub>2</sub> 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?



# Appendix 1.

## Rosneft's environmental liabilities on Sakhalin island

Date	Field or pipeline	Documented incident	Regulator and company's response
2007 February	Pipeline near port Kaigan	Pipeline leak due to corrosion. A regulator press release recorded a 2.255m <sup>3</sup> contaminating 3x10m of soil, <sup>255</sup> but SEW photographs <sup>256</sup> estimate the total contamination area at 1 hectare.	Rostekhnadzor initiated administrative liability proceedings for unauthorised discharge of petrochemicals and failure to notify, <sup>257</sup> and charged company 842,000 roubles (£16,840) in damages. <sup>258</sup> According to SEW, this is the first ever instance of a damages charge for oil spills on Sakhalin. <sup>259</sup> Rosneft claimed the leak was completely rectified, but by October the damaged pipeline was still lying in place, with an oil pool nearby. <sup>260</sup> Regulator's inspector "failed to notice" the spills during an inspection with representatives of the company; prosecution's inspector confirmed the spills. <sup>261</sup>
2007 June	Piltun	Two abandoned, unsealed boreholes were found to have been used to steal oil using domestic hoses. 1 hectare and 1.5 hectares of forest around each borehole respectively were contaminated, with oil leaking into river Piltun.	Rosneft cleaned up the spills and sealed the boreholes but denied responsibility for their maintenance. Regional prosecutor opened a criminal case on the oil theft. <sup>262</sup>
2007 August	Odoptu, Vostochnoye Ekhabi, Ekhabi, Centralnaya Okha	Leaks from worn out equipment resulted in contaminated soil around the installations. Contamination had not been removed. <sup>263</sup>	Regional prosecutor initiated administrative liability proceedings and demanded clean-up. <sup>264</sup>
2007 October	Katangli field	Leaking pipelines and boreholes; filter equipment overloaded; oily patches found on nearby river and lake. Largest patch was 150m <sup>2</sup> , within 100m of residential area. <sup>265</sup>	Regional prosecutor initiated administrative liability proceedings and demanded clean up.
2007	Paromai	SEW found two abandoned boreholes, both of them under pressure and with equipment still in place. One of the boreholes was surrounded with a 20m radius pool of oil. <sup>266</sup>	Unknown.
2008	Katangli	River Katangli contaminated with oil due to run-off from filtering equipment.	Rostekhnadzor fined the company and demanded clean up. <sup>267</sup>
2008		Joint inspection by Rostekhnadzor and SEW finds a number of instances of contamination.	Rosneft limits the list of the installations open to inspection. The functions of pursuing environmental damage was passed from Rostekhnadzor (industrial H&S regulator) to Rosprirodnadzor (environmental regulator), and the case initiated by Rostekhnadzor was closed. <sup>268</sup>
2009	North Sakhalin shoreline	SEW requested the ministry for emergencies and regional prosecutor to verify whether Rosneft had approved oil spill response plans for its minor offshore operations north of Sakhalin. The company did not.	Regional prosecutor demanded that Rosneft rectify the lack of oil spill response plans. <sup>269</sup>

Date	Field or pipeline	Documented incident	Regulator and company's response
2009 February	Ekhabi	At least 150 tons of oil seeping from a water filtering station contaminated the river Gilyako–Abunan. SEW and the press were notified of this in April by locals. <sup>270</sup> In 2009 a local oil spill management company head told visiting US embassy officials that “there had been a “fairly big spill” earlier this year at Rosneft’s onshore project. He said this spill was “kept quiet” by the authorities, despite NGO attempts to publicise it.” <sup>271</sup>	Some unsuccessful attempts at clean up had been made by Rosneft, including setting the oil on fire. <sup>272</sup> Rosprirodnadzor initially estimated damages at 82m roubles (£1.64m) but eventually charged the company 22m roubles (£440,000) which it refused to pay. Fifth court of appeals in 2010 ruled in favour of Rosprirodnadzor, requiring Rosneft to pay. <sup>273</sup> According to SEW, the damages payment is significantly underestimated, as the calculation was based on a thickness of less than a mm rather than the actual thickness of several cms. <sup>274</sup>
2009 April	Katangli	SEW found several leaks from boreholes and dumping of polluted water from filtering station into river Katangli.	Regulator confirmed the facts, demanded clean up and fined Rosneft 50,000 roubles (£1000). <sup>275</sup>
2010	Mongi	Oil spilled into river Tomi and Nyiski Bay, damaging the local fishing industry.	Rosprirodnadzor initiated administrative liability proceedings and calculated damage at 364,668 roubles (£7293). <sup>276</sup>
2010 April	Odoptu	Internal gas pipeline burst, releasing approximately 900 litres of contaminated water and gas condensate which then caught fire.	Fire was put out within hours, clean up was carried out within a week. Rosprirodnadzor fined the company 12000 roubles (£240). <sup>277</sup>
2010 August	Odoptu, East Ekhabi, Ekhabi, Central Okha	Joint Rosprirodnadzor and prosecutors’ inspection found leaks from worn out equipment on boreholes on each of these fields. <sup>278</sup>	Prosecutor initiated administrative liability proceedings and demanded clean up. <sup>279</sup>
2010 August	Lebedinskaya prospect	Rosneft began night-time seismic testing on 20 August in violation of their adopted environmental standard.	SEW complained to Rosprirodnadzor who confirmed the testing and contended it was a violation of a voluntary commitment not of the law. <sup>280</sup>
2011 May, September	Vostochnoye Ekhabi, Central Okha, Katangli	Several boreholes found to be leaking, one of them contaminated 600m <sup>2</sup> of forest.	Regulator initiated administrative liability proceedings and demanded clean up. Chief ecologist at Okhaneftgaz (operating subsidiary) was fired. <sup>281</sup>
2011 November	Pipeline Mongi – Dagi	Pipeline that had been in service 29 years rusted through, spilling oil into Dagi river. <sup>282</sup>	Upon SEW’s request regulator initiated administrative liability proceedings for unauthorised discharge of petrochemicals and failure to notify. <sup>283</sup>
2012 February	Odoptu–More (offshore)	Underwater pipe damaged by a bulldozer caused an oil leak.	Regulator and company failed to find fault. <sup>284</sup>
2012 May	Mongi, Kauranani, Nabil, Vostochnoye Dagi	Variety of minor breaches including illegal construction and industrial waste dumping and spills around boreholes.	Rosprirodnadzor issued fines of a total of 44,000 roubles (£880) for industrial safety and environmental breaches. <sup>285</sup>
2012 July	Mainline pipeline Okha – Komsomolsk	Pipeline fault resulted in a leak that contaminated an area of 60m <sup>2</sup> and seeped into a fish spawning river (Kamulan). <sup>286</sup>	Regional prosecution investigated the spill. Company claimed the leak was into a drain rather than the river. <sup>287</sup>
2012 July	Nizhneye Dagi, Zapadnoye Sabo, Vostochnoye Ekhabi, Shkhunnoye	Variety of minor breaches, mainly contaminated water around boreholes. SEW carried out an inspection and informed Rosprirodnadzor and prosecutor. <sup>288</sup>	Unknown.

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