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Lvovgazodobycha gas industry administration. Lokachi gas field.

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# How Russia is Nationalized: The Oil Sector

The processes of nationalization in the oil sector are more visible than others and filled with more drama. Still, the state's desire to capture an ever larger slice of the industry's income seems logical. But often the methods and appetite of the state companies contradict this logic.

### The Creativity of Capitalism

Looking back at the history of the Russian oil industry we find its initial privatization had taken place that by the end of 1997. The state retained about as many companies as it sold, although it often controlled larger and better shares. At the time, the only national company among them was Rosneft with enterprises dispersed across the entire country, from the Far East (Sakhalinmorneftegaz, with an interest in Sakhalin-1 and Komsomolsky oil refinery) to the Southwest (oil production in the Krasnodar and Stavropol regions and Tuapsinskiy oil refinery). But with only one sizable production plant (Pumeftegaz in western Siberia). In addition, the government owned Tatneft, Bashneft, Bashneftekhim, which all had connections to the regional elite; company ONAKO Slavneft, created as a Russian-Belarusian project with production in Siberia and refinement in Belarus, which was limited to Russian shares as a result of Belarus' refusal to offer a stake in the Mozyrsky oil refinery. This was all poorly managed and obviously a project left uncompleted.

The state paid no regard to the situation until 1999. Primakov's administration put forward a plan to unite Rosneft, ONAKO and Slavneft, the result of which would be a state company comparable to a private enterprises. However, this idea failed to garner support and was never realized. Low oil prices and domestic issues didn't help either.

Privatization began again in 2000. It's likely that lobbying by the most active private oil companies – Yukos, Sibneft and TNK – had more than a little to do with this. In any case, in 2000 ONAKO was auctioned off to TNK and in 2002 Slavneft was purchased by a TNK-Sibneft alliance. This was the first time that the sale price of oil shares were determined by the market. In 2002, in a fanciful sales scheme, Bashneft and Bashneftekhim were privatized and for all practical purposes ended up in the hands of the son of the Bashkortostan president, Ural Rakhimov.

The climax of Russian oil's "private era" was in 2003 during the creation of TNK-BP. After a few years of animosity and struggling over the shares of SIDANKO, TNK, the de facto victor, offered to merge with the Russian shares of the transnational BP. The Russian shareholders of TNK received 50% of the combined company and ... \$6 billion. The agreements to create TNK-BP were signed twice, in both Moscow and London, both times in the presence of the Russian president and prime minister of Great Britain.

By the end of 2003 the distribution of power in the oil industry was such: the primary shares were divided between four private companies (Lukoil, Yukos, TNK-BP and Surgutneftegaz), secondary players were represented by the formidable private company Sibneft, and the tertiary "left-overs" were held by the state.

### Revenge of the State

It so happened that at precisely this moment in time fuel prices rose to a level that, in the eyes of both the state and society, the oil industry began to (be super-profitable) (In 1998 oil cost less than \$9 a barrel and the average price for 2003 was \$26 per barrel, and by the end of this year is predicted to surpass \$60 a barrel.)

By the second half of 2003 three tendencies had merged together: a desire by the officials to strengthen the state's role in the oil industry, resentment towards Yukos and societal confidence in the justice of nationalizing profitable industries. A radical decision was made: to return Yukos to state property. The means was found immediately: unpaid taxes. Formally, Yukos had been using tax minimization as allowed by current law. And they were not alone in doing so. The judges had to apply maximum flexibility and refinement in order to legally validate the political decision.

No one doubted that realizing this decision would be a long and hard process. One can't just take a controlling packet as payment for debt: the threat of trials by foreign owners or their heirs would hang over the deal like the sword of Damocles. It was decided to take the main oil-producing subsidiary, Yuganskneftegas, as payment for the debt. Without Yuganskneftegas Yukos wouldn't be able to manage with the rest of its back tax claims and eventually go bankrupt and have to be liquidated.

Completing the task took four years. Yuganskneftegas was sold in late 2004 and Yukos was liquidated in August of 2007. All significant shares were purchased by Rosneft, which turned into the undisputed industry leader by all volume indicators (reserves, production, processing). Its important to point out that ...

In 2004 not only Rosneft was competing for Yuganskneftegas, but Gazprom as well. Gazprom, however, was denied. The reason (or the excuse) is perfectly respectable. Gazprom has too many shares abroad; lawsuits by upset American stockholders of Yukos could put them under attack. On the other hand Rosneft had no foreign shares and therefore any lawsuits against it would stand little chance. After this defeat the gas monopolist became even more insistent on acquiring oil shares. Their explanation is logical: all large energy companies in the world (ExxonMobil, BP, Shell) have both gas and oil production units.

Its general knowledge that at one time Gazprom was looking to Rosneft to be its "second leg". Chairman of Gazprom's board Dmitry Medvedev voiced a suggestion to merge, paying the state in shares of a supposed additional placement and thereby increase the state's stake up to a control figure. This option never materialized. The complaints of Gazprom were, in our opinion, justifiably considered excessive.

Fortunately for Gazprom, its decision to acquire oil assets coincided with the wishes of Sibneft's owner Roman Abramovich to leave the oil business. Perhaps they consulted with him. But whatever happened, the purchase of Sibneft by Gazprom please everyone. This took place in the middle of 2005 by real market prices – about \$13 billion.

With a Rosneft drunk from Yukos and a Gazprom beefed up on oil, the state has become the key player in the domestic oil industry, able to dictate its conditions to private traders by way

of the market, without resorting to state regulation, which is frowned upon by developed countries.

#### Dialectics... Gazprom Style

In the gas industry we can see two separate ways by which the state is increasing its influence. The first is that Gazprom is acquiring new assets. The second is by increasing its share in the joint stock of Gazprom. The latter was declared over several years to be the main state policy toward energy companies. Nevertheless its purpose is not clear. Here's why.

The state has always had real control over Gazprom. The federal stake held 38.373%, more than 10% was owned by complete subsidiaries of the monopoly, about another 5% was held by Rurgas, the most loyal consumer to the current government in Russia. Then why bring the federal stake a controlling one? Furthermore, the state, we feel, has chosen a strange path to accomplish its goals. In the current state of government finances you could just purchase the shares from Gazprom's subsidiaries and buy the remainder on the market. An even cheaper option would be to seize the shares from the subsidiaries and liquidate them. As a result the state's share would rise to almost a controlling stake and the rest could be bought on the market, domestic or foreign. A third option, integrating Gazprom and Rosneft, as discussed earlier, would give the same result.

Nonetheless we have once again set out on our own path. FGUP Rosneftegas was created in early 2005 and was given 100% of Rosneft's stock. A few months later Rosneftegas, under the aegis of Rosneft's stock, received a loan from foreign banks and by the summer of 2005 had purchase 10.74% of Gazprom from its subsidiaries. Taking into account the 0.889% stake belonging to FGUP Rosgasifikatsiya, this gives the government its sought-after 50.002%.

Awhile back the bureaucrats got to thinking about how they could transfer FGUP stock directly to federal property. But apparently it remains a matter of talk; the task turned out to be too difficult from a technical-judicial point of view.

Immediately after receiving a controlling packet the state fulfills its promises and removes the barriers between foreign and domestic markets of Gazprom stocks and limitations on the amount that can belong to foreigners. But that is not the whole of it. Loans need to be repaid and Rosneftegaz places 15% of its shares, which used to be completely state-owned, on an IPO. But therein lies the point that "marketeers" protest: Gazprom is not the object of nationalization, but its subject. The scale of its expansion surpasses rational limits. In the last three years Gazprom, in addition to Sibneft, has acquired controlling packets of Sakhalin Energy (Sakhalin-2), Rusia Petroleum (the Kovyktin deposit), Nortgaza, Salavatnefteorgsintez, Mosenergo and 19.9% in Novatek, the largest independent producer of natural gas. Two other Wholesale Generating Companies (WGCs) and the largest producer of carbon fuels, Siberian Carbon Fuel Company, are preparing to be taken over by Gazprom. Complaints have been filed against Toliattiazot, other enterprises in the nitrate industry, Chayninskoye natural gas deposit and one of the Sakhalin-3 projects

Moreover Gazprom is actively using its authoritative resource. Too often a buyout will be preceded by ecological or tax complaints, threats to withdraw licenses etc.

#### Results

The results of nationalization in the oil sector can be summed up in the following: state shares in the oil industry have become comparable to private shares and Rosneft is its biggest company. The situation is not a joke for the rest of the world and, in our opinion, has not changed the market quality of the industry. It has retained its previous competition among several large, vertically-integrated oil companies and as before has room for structures of a smaller scale. It is difficult to guess the government's future plans; the signals are too contradictory. The situation in the gas sector looks less optimistic. Gazprom has yet to cope with the tasks given to it, but expansion, in our mind, cannot help but to bring with it managerial problems. There is no other company in the world that owns all of the gas produced in a country and simultaneously was the largest provider of carbon fuels and among the top five producers of oil and electricity. The growth of Gazprom's stock, hailed by the company and the government, is not something to be proud of. Currently what the market values most is a growing administrative resource and the willingness to use it unabashedly. It would be nice to see "high economic efficiency" added to the list, but that's doesn't seem to be in the cards for the time being.

**Yakov Pape, Ekaterina Drankina**

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