TNK-BP a “Done Deal”

On August 29, 2003 it was announced that the owners of Tyumen Oil Company (TNK) and BP had finalized the deal to establish and operate their new joint venture company: TNK-BP. This deal, originally announced in February, was described on the Pan EurAsian website in some detail.

The appearance of TNK-BP on the scene has significant impact in Russia and in the world. Giving BP credit for its half of TNK-BP, BP becomes the second largest oil company in the world, only exceeded in size by Exxonmobil. In Russia, TNK-BP will be the third largest oil company following Yukos and Lukoil. Even by itself amongst world oil companies TNK-BP is a significant new player at about 7th largest in the world in terms of daily production and proven reserves (amongst private sector companies).

The owners of TNK were two companies: Alfa Bank and the Access/Renova Group (AAR). The deal combines most, but not all, of the oil businesses of AAR and BP in Russia into a new company called TNK-BP. The ownership is a strict 50/50 arrangement. The chairman of the board of TNK-BP is Mikhail Fridman of Alfa Bank, while the President and CEO of TNK-BP is Robert Dudley, a BP secondee. German Khan, executive director of TNK, continues in that position with TNK-BP. The company is registered in the British Virgin Islands. TNK-BP commenced operations effective August 29.

There were two major changes to the deal made during the last months of due diligence and preparation. They were:

- BP withdrew its Sakhalin project from the deal; and
- TNK added its 50% interest in Slavneft to the deal.

These changes had the net effect of adding about $1 billion to the payments to be made by BP over what had originally been expected.

The original deal contemplated the following structure:

- BP and AAR would contribute defined assets to a new company – TNK-BP;
- In addition to contributing defined Russian assets, BP would make an initial payment of $3 billion in cash to AAR, plus 3 payments in BP stock of $1.25 billion each on the first, second and third anniversaries of the closing of the deal. This was necessary if BP were to obtain a 50% share of the new company.
- Thus, the total cost to BP was about $6.75 billion plus contributed assets.

However, subsequent to February, TNK took on additional debt, also to be assumed by the new company. This had the effect of reducing BP’s initial payment to $2.4 billion. Then, because of opposition from Rosneft, BP’s partner in the Sakhalin project, BP withdrew that project from the assets it had obligated itself to contribute. This, plus some other adjustments, increased the initial payment to $2.6 billion. The stock payment obligation remained the same: 3 payments of $1.25 billion each over three years. The increase in cash payment was to make up for the value represented by the Sakhalin project and maintain a 50% share in TNK-BP for BP.

An open issue in February was TNK’s interests in Slavneft. Sibneft and TNK had acquired Slavneft from the Russian government in December 2002 for a total price of $1.86 billion. Sibneft and TNK agreed to divide the company up between them rather than try to manage it jointly as a distinct entity. In March, TNK and BP agreed to include TNK’s interests in Slavneft into the deal, subject to the division of Slavneft being agreed with Sibneft, probably at the end of this year. When that addition is closed, BP will make a further payment to AAR of $1.35 billion. Indications are that AAR and Sibneft will complete negotiations on dividing up Slavneft by the end of this year.

In summary, the total cost of the transaction for BP appears to be about $7.7 billion, setting aside the time value of money and the value of the assets that were contributed[1].

Summary of Payments
BP to AAR

	million USD
Initial Cash payment	2,600
August 2003	
Slavneft payment	1,350
December 2003?	
TOTAL 2003	3,950
Stock payments	
August 2004	1,250
August 2005	1,250
August 2006	1,250
Grand Total	**7,700**

According to one report, the total cost to BP is about $3.43 per barrel of proven reserves acquired, which is considerably less than the cost of proven reserves in more established oil operating areas such as the North Sea or North America. (We presume that this estimate of $3.43 includes some estimate of the value of the assets that BP has contributed as well as the cash and stock payments.) Part of this price differential represents the Russian risk discount. Previous estimates of Russian risk put oil at around $1 per barrel of proven reserves, so BP's judgment seems to be that Russia is improving rapidly as a place to do business. Recent statements about the deal by the Chairman of BP have said just that. Since BP has been in Russia for some years already, and had its share of difficult moments, it would seem that BP's revaluation of Russian risk is worth paying attention to.

The table to the right summarizes the new company's assets. We have arbitrarily added one-half of the information regarding Slavneft to the TNK-BP data simply for the sake of comparison. There is no indication at present that the Slavneft assets would be divided in such a way or that the final impact on merging those assets into TNK-BP would look anything like what is implied here. The Slavneft transaction still awaits approvals from the European Union, Russia and Belarus.

Quick Look

TNK-BP: August 2003		**Slavneft ½**
Employment (people)	113,000	
Total proven reserves (million boe)	5,200	800
recoverable during existing lease lifetimes	3,200	500
Production (bopd)	1,200,000	147,000
West Siberia	*800,000*	
East Siberia	*400,000*	
Refineries (million tonnes per year)	25	7
(barrels per day)	500,000	147,000
Petrol stations in Russia and Ukraine (number)	2,100	285

There remain some important items to complete, each of which is dependent on negotiations with other parties before TNK-BP can absorb their value:

- The division of Slavneft assets between TNK and Sibneft;
- Negotiations between BP and Rosneft regarding transferring BP's interests in the Sakhalin project to TNK-BP, which Rosneft is opposing at the moment;
- Negotiations between BP and Gazprom regarding the Kovykta gas field project.

All of this is unfinished business from forming the new company, and will have a significant impact on the company when resolved.

Already, TNK-BP has announced that it is on the hunt for acquisitions outside Russia, mostly in nearby areas such as Turkey and Central Europe.

It is most interesting to note that this merger has occurred in Russia, and not been derailed, by the dispute between the Russian government and Yukos.

[1] According to the *Financial Times* the value of the TNK debt assumed by the new company is about $1.9 billion.