

The TNK-BP Deal¹

(The deal closed August 29. Please see our [update on the close.](#))

The final confirmation of a long-rumored deal between BP and Tyumen Oil Company (TNK) in Russia has gotten everyone's attention. And, it should have.

The deal, as we understand it, is discussed below. We are more focused on its implications, and what we think BP is really telling the markets about strategic thinking in the oil business. We look at the deal in the context of a predecessor deal, done in January, wherein BP sold to Apache its North Sea "Forties" properties and some properties on the Gulf Coast of the U.S. When the Apache deal was announced, the market was a little confused and disappointed by the apparent retreat of BP. BP's shares dropped and Apache's shares rose on news of that deal. BP, in hindsight had something more in mind than retreat, but they couldn't very well say to the markets, "wait 'til you see my next act."

But now we have, and the markets liked what they saw. BP's shares rose on the news, as well they might.

The TNK-BP deal is not one that plows entirely new ground. Already, BP was active in Russia, as were Chevron, Conoco, Marathon, Shell, and Exxon. Some of those already had very ambitious projects in Russia.

Rather, it is the two deals taken together that make an important statement. What it says is that one of the world's largest, and arguably one of the most strategically astute, integrated oil companies has instituted a major shift in its focus on upstream activities. Before the TNK deal, BP's reserves were mostly in the U.K. and North America. This deal, combined with the Apache deal, moves that focus to Russia. Subsequent to announcing the TNK deal, BP has announced the disposal of more North Sea assets.

Perhaps it has looked at the future prospects for growth in upstream activities, on the scale that a major oil company needs to find, are no longer positive in the traditional markets. The Forties field is in its declining years, as are prospects in the Gulf of Mexico. BP is having problems in Alaska, and opposition to actions (such as the gas pipeline) to enhance future prospects there is growing. Rather than fight that, go somewhere else.

Perhaps unnoticed in the flurry of excitement over the TNK deal is BP's indication that it was increasing its attention to other areas of the world as well. It has an ambitious capital expenditure program, and none of that expenditure looks to be focused on traditional areas.

In short, BP has taken stock of declining prospects, coupled with "not in my backyard" (NIMBY) social opposition in the traditional, and "safe," markets and decided that fighting that battle further is not in its interests. It has chosen to shift its future developmental activities in exploration and production to new frontiers. If other major oil companies follow suit in leaving the traditional markets, it opens us a lot of opportunity for second tier oil companies who are less likely to have the kind of visibility that stir the passions of organizations like Greenpeace. In short, this may precipitate a major re-alignment of the oil production business.

¹ Updated March 18, 2003 from original version of February 14, 2003

By the foregoing, we do not mean to imply that Russia is not “safe.” The second message of the TNK-BP deal is that Russia’s own risk profile is improving. This, perhaps, is the start of a new resources boom.

What about the deal itself? BP has leveraged off a weak, minority interest in a medium-sized Russian company into a strong partnership position with a Russian major. The new company (called TNK-BP) will be the third largest Russian oil company (after Yukos and Lukoil).

BP has paid, partially now in cash and partially later in stock, \$6.75 billion for a 50% share of TNK-BP. It also contributed certain assets, such as its 25% share of Sidanco, to TNK-BP. Simplistically, this values TNK-BP at \$13.5 billion. An article in the *Moscow Times* on 12 February stated the new company had a value of \$18.1 billion. In either case, this makes TNK-BP a world class oil company.

BP’s commitment is nearly ten times larger than the investments to date of the next largest foreign player in the Russian oil market (Chevron at a reported \$800 million). It also ranks above the first two Sakhalin projects.

It is also interesting to note that the valuation BP placed on the assets seems to break with recent precedents. Conventional wisdom, until February 10th, was that Russian oil reserves were worth \$1-2 per barrel in the ground. The calculation of how much BP actually paid for reserves is complex, leading to different calculations and interpretations. But, other observers and press reports have put that number at somewhere between \$2 and \$4 per barrel, a multiple of the previous market practices. It is, of course, still less than the \$5 to \$6 per barrel paid in traditional markets. This seems to say that perception of Russia as a place to do business is fast improving, and we would agree with that.

The deal also propels BP into half ownership production capacity of 1.2 million barrels per day, half of which (by agreement) will be BP’s to market independently. It also gives them, it seems, a stake in TNK’s own chain of petrol stations in Russia and Ukraine. And, it gives BP refining capabilities (5 refineries) in Russia, all in one stroke. The new company will have oil and gas reserves of 9.5 billion barrels of oil equivalent, which again ranks TNK-BP as a world class company in its own right.

The domestic markets in Russia for refined oil products are growing fast. The introduction of consumer credit in Russia will lead to rapid growth in the sales of major consumer items, such as automobiles. Industry is restructuring with growth in that sector forecast to increase at above the rates in traditional markets.

It also offers BP opportunities to expand its sales of Russian crude and oil products into the world markets. Already, TNK is exporting most of its production. It will be interesting to see how Transneft responds to this new pressure.

In conclusion, we believe that the TNK-BP deal is a landmark for two reasons:

- It marks a major shift in focus away from traditional, developed countries for upstream activities for one of the world’s major natural resources companies; and
- It marks a dramatic shift in perception of the country risk for Russia.

We believe that other companies, and industries, will take note of this and follow. They should.

Deal Specifics

In as far as we know from various public sources here (in very summary form) are the specifics of the deal.

The owners of TNK, a private company, are Access Industries (a private investment group in New York City, not to be confused, we believe, with Access Industries, Inc., a producer of medical safety appliances), the Renova Group of Russia, and Alpha Bank of Russia. Access, Renova and Alpha have formed an entity referred to in the press releases as “AAR” which has contributed certain assets, but no cash, to the formation of the a company: TNK-BP.

BP will pay cash and stock to AAR for a 50% stake in TNK-BP, plus BP will contribute certain assets in Russia to TNK-BP. The cash is reported as “about \$3 billion” and that contribution is immediate upon financial close. The stock will be contributed in three equal, annual contributions of \$1.25 billion each, the number of shares to be calculated on the basis of the market price of the shares at about the time of contribution each year.

The actual closing transaction is likely to be quite complex, but the end result is clear. BP and AAR each will own 50% of the shares of TNK-BP. AAR will appoint the chairman of TNK-BP², while BP will appoint the CEO. Neither AAR nor BP will have control. As with Shell, board decisions will have to be unanimous, which has produced some marathon board sessions, but can be made to work.

According to press releases, AAR is blocked from disposing of its TNK-BP shares until 2007; there is no indication in the press of a similar constraint on BP. The stock payments to AAR will give it an estimated 2.5% share of BP stock. The internal split of shareholdings and proceeds within AAR is not clear.

Table of Asset Contributions

BP	AAR
Sidanco (minority)	Tyumen Oil Company (TNK) Sidanco (majority)
Rusia Petroleum, Eastern Siberian gas fields	Rusia Petroleum, Eastern Siberian gas fields
Sakhalin V exploration licenses	Sakhalin IV and V exploration licenses
Moscow area petrol stations	Rospan gas field, Western Siberia

Not Contributed

LukArco (joint venture with Lukoil)	Slavneft acquisition in partnership with Sibneft (TNK portion offered in March for extra payment by BP)
trading activities in Russia	
Marine businesses in Russia	
Aviation fueling business in Russia	
lubricants business in Russia	

Sources: In preparation of this analysis, Pan EurAsian has used the following sources.

The Financial Times of London

The Moscow Times

The website of TNK; www.tnk.com and the website of British Petroleum; www.bp.com

² In March German Kahn, of TNK, appointed executive director of TNK-BP; Robert Dudley of BP appointed President and CEO.