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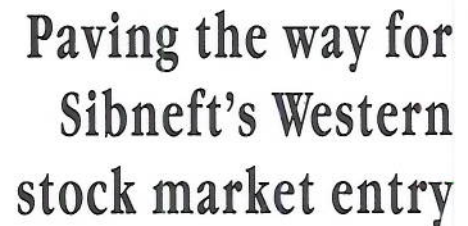

Paving the way for Sibneft's Western stock market entry

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With the decision to create a national oil company taken in early May, economics expert Andrei Konoplyanik examines the next steps

Energy Charter Treaty may hold fair solution for creating the national oil company

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The 'political' decision to merge Rosneft, Slavneft and ONAKO to create a national oil company has been made and now the choice of mechanisms for forming a new holding company is the talking point.

But if it is impossible to do that by appropriate economic methods and in the framework of the international law, the idea should be totally forgotten.

Means do exist. Nationalisation of part of the assets of the merged companies' subsidiaries in line with the provisions of the international Energy Charter Treaty (ECT) — signed by Russia but still awaiting ratification by its parliament — could be used at one of stages of a national oil company's formation.

One of the main relevant provisions is the 'Hull formula' observed by the ECT. It stipulates that nationalisation is possible in the event that adequate, prompt, and effective compensation is paid.

The state has many times stated the need to strengthen its role in the economy. The formation of a unified national oil company should be regarded in this context, proceeding from the assumption that the political decision to merge three companies — Rosneft, Slavneft and ONAKO — has been made in principle and it will be realised in line with the government-proclaimed and State Duma-backed intention to strengthen the state's role.

Moreover, let us also assume that the planned merger is targeted at maximising the 'investment effect', rather than the 'privatisation effect' — let alone the interests of oligarchs **(see Why merge?)**. The goals of that merger would include:

- reducing operating costs of a unified company ('concentration effect');
- the company's fully-fledged participation in PSA projects and its management of the state's share in those projects and organisation of their financing;
- forming a strategic reserve of oil and petroleum products and its management, including for oil supplies to consumers financed from the state budget;
- acting as the state's agent ordering state-financed geological exploration and prospecting activities.

It is necessary to decide whether it would be expedient to form a state oil company or a national oil company.

If a state oil company is formed, it should be, exclusively, a matter of consolidation of state-owned blocks of shares — that is, the creation of a company with the state having a domineering stake, involved in business activities on equal terms with other companies. Besides, it would deal — by purely economic methods — with a number of special tasks determined for it by the state.

If the state sets tasks for its company that are unreasonable in economic terms, its ability to compete will be lower and it will lose markets and sources of revenues. As a result, rather than being a mechanism for effectively replenishing the federal budget, the state company's role will be reduced to redistribution of funds allocated from the budget. The company itself can only generate losses in that case.

If a national oil company is formed, it will not only mean consolidation of state-owned stakes. That will require the newly formed company being given some special status. Fears that this may happen explain resolute opposition to the planned merger of state-controlled companies on the part of Russia's largest privatised oil companies.

It goes without saying that a proper declaration of goals and a proper choice of a unified company's status as a state oil company (SOC) would substantially reduce the number of opponents.

Having decided on the status of a unified company, authorities will face the problem of choosing a most effective mech-

anism for the realisation of their merger plans.

Opponents of a SOC's formation claim that the task cannot be resolved in principle or its solution would cost too much — $400m-$450m — for the cash-strapped state, which it cannot afford. They then arrive at the conclusion that a new company should not be created.

Instead, a logical step should be made, they say, and the previously rejected plans of merging Rosneft, Slavneft and ONAKO in to private Russian oil majors should be revived.

That viewpoint is based on the opponents' expediency reasons. In fact, they do not even try to hide their interests.

But looking at the problem from a different point of view, the SOC formation project should be regarded, substantiated and implemented as a self-repaying project carried out exclusively on 'project financing' principles, with costs covered by financial flows generated by the project itself.

Therefore, the new company's ability to work normally and generate the required financial flows would be a prerequisite for the project's success.

In turn, that is impossible unless uniform shares are introduced.

Until the transition to uniform shares is completed, a state oil company will inevitably have to work for quite some time with a quite unstable — in management terms — organisational structure as a 'three-tier holding company'.

Certainly, that transition period should be made as short as possible to make the company's formation effective. That, in turn, will depend on how promptly and adequately the problem of minority shareholders is resolved — to shift to uniform shares, the interested party (the state in this particular case) will have to concentrate in its hands at least 75 per cent of voting shares of merged vertically integrated oil companies and their subsidiaries. (What may happen to plans to introduce uniform shares, if minority shareholders own more than 25 per cent, was clearly shown by Kenneth Dart's companies in YUKOS and Sibneft in 1997 and 1998. **(See, for example, Paving the way for Sibneft's Western Stock market entry, p. 10)**.

Unfortunately, the merged oil companies have lost controlling stakes in most of their subsidiaries. Therefore, the state now faces a key task of developing an effective mechanism that would be in line with international law and would let the state increase state-owned stakes in the planned oil company's subsidiaries to at least 75 per cent.

In my opinion, nationalisation (forced buyout of shares) in line with international legal norms can be the only effective mechanism for the state's concentration in its hands of 75-per cent stakes in a state oil company's subsidiaries.

From the state's viewpoint, nationalisation and privatisation are contrary, but equally applicable mechanisms making it possible to change the ownership structure with the purpose of increasing the efficiency of management. Therefore, the mode of their application could give rise to objections, but certainly not the very fact that those mechanisms are applied.

Just one mechanism for nationalisation of private (including foreign-owned) property is now believed to be acceptable from the point of view of international law. It is known as the Hull formula and fixed in numerous bilateral agreements on the protection

Why merge?

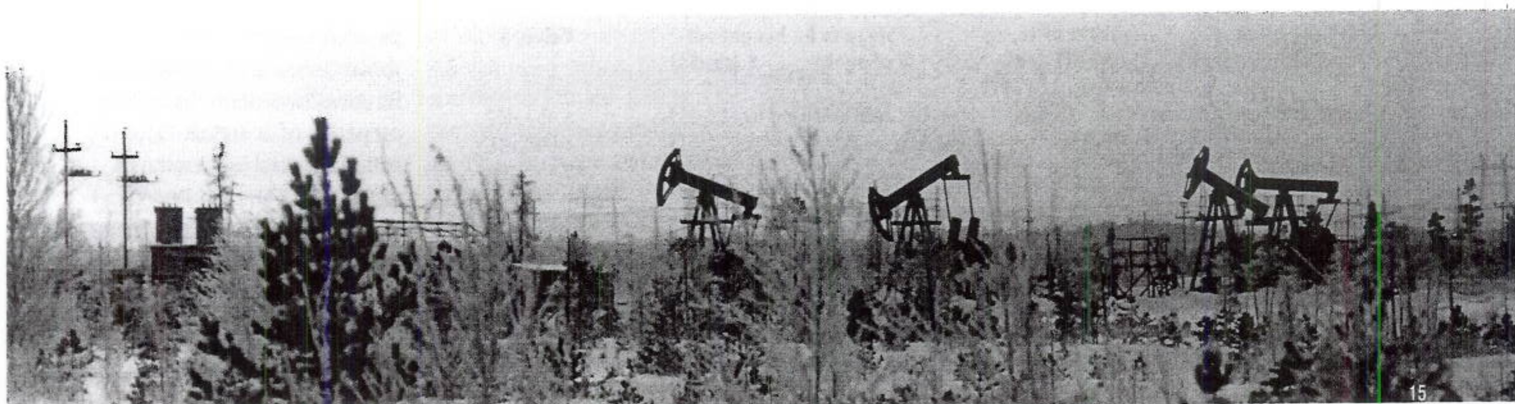
Merging oil companies to form a single state oil company can have three different 'real' goals.

First (described as the 'privatisation effect'), a merger with the purpose of increasing a unified company's financial attractiveness for its subsequent privatisation. The purpose is preparing its for sale. In that case, that merger will have a one-time direct effect and will be equal to the margin between the expected additional proceeds from the company's privatisation and the cost of its preparation for sale. In turn, expected additional proceeds from privatisation will amount to a unified company's higher capitalisation as a result of its privatisation less total capitalisation of separate companies, if they are privatised separately. There have been more than enough statements that this is the real purpose of a planned merger.

Second (described as the 'investment effect'), a merger with the purpose of forming an effective and workable vertically integrated oil company embracing the whole production cycle, able to compete both in the domestic and world markets. In that case, the effect of a merger will not be of a one-time nature. That effect will be permanent and will steadily grow with time in the form of financial flows generated with the help of new investment and operational potential acquired by the unified company as compared to the potential of separate companies.

Third (described as the 'oligarch effect'), a merger with the purpose of forming a big and steadily operating donor to the budget – the task especially pressing on the eve of election campaigns. That idea may proceed from the assumption that the oil sector still has sources of super profits so thoroughly concealed by non-state companies or may have occurred to those seeking to resolve immediate political tasks at any rate. In that case, consolidation of the merged companies' financial flows and a state oil company's work in conditions of a never-ending drain on its funds are the real purposes of its formation.

It is impossible to totally rule out the existence of such goals – even though deputy prime minister Vladimir Bulgak has firmly stated that the "ideological component (of a merger) should be forgotten once and forever."



of investment and in the Energy Charter Treaty (ECT). The ECT's Article 13, Expropriation, outlines four terms to be observed simultaneously to make expropriation possible where such expropriation is:

- for a purpose which is in the public interest;
- not discriminatory;
- carried out under due process of law; and
- accompanied by the payment of prompt, adequate and effective compensation.

FACT FILE

What price?

The critics of the state oil company project often note that the buyout of shares from minority shareholders in the merged companies cannot be regarded as a means of avoiding confrontation with them today – the state just does not have enough money.

They offer no costing methods.

We have computed, even if approximately, the cost of a forced buyout of shares required by the state to have at least 75 per cent of voting shares in the subsidiaries of the three merged vertically integrated oil companies.

Several costing methods could be used. We have used three for the beginning (estimates have been prepared by A. Gans, a postgraduate student in the fuel and energy business management with the State University of Management).

Method 1. The price of the block of shares required by the state was estimated on the basis of average offered prices on the over-the-counter market in August 1998, as reported by the AK&M agency (unless stocks were quoted in August, data was taken for other months and adjusted to the AK&M stock index for oil and gas production). For enterprises whose stocks were not quoted in the market, capitalisation of the required blocks of shares was estimated as of August 1998 proceeding from the shares of enterprises with stocks quoted and not quoted in the market in the authorised capital of their parent company as of the date of its formation. The result is $376.6m.

Method 2. The buyout price of the required block of shares of six companies whose shares are quoted in the Russian Trading System (RTS), was calculated proceeding from the price of the latest deal made before August 17, 1998 (see the Table). The share of those six companies in the total capitalisation of the required block was determined as in Method 1. The buyout price for the six companies ($72.8m) was then divided by the above share (57.5%). The result is $126.6m.

Method 3. For the six companies with stocks quoted in the RTS, the price was determined in line with Method 2. For companies whose stocks were not quoted anywhere, Method 1 was used. For other enterprises, the price of the blocks required by the state was determined on the basis of average offered prices in the over-the-counter market (AK&M data for August 1998), multiplied by a coefficient determined as the ratio of prices of actual RTS deals to offered prices in the over-the-counter market for the six companies indicated in the table (0.336). The result is $150.3m.

Therefore, the usually mentioned range of nationalisation costs – $400m-$450m – seems an overstatement. It is also worth noting that the closer valuation methods approach the real market and real deals, the lower is the estimated cost. It is obvious that the 'fair market value' of the nationalised assets should be based on the prices of actual deals. In other words, the valuation of nationalisation costs in line with Methods 2 and 3 seems to be more reliable.

As a result, according to our estimates, nationalisation of the required blocks of shares in line with the Hull formula may cost the state $125m to $150m. Given that from August 1998 to May 1999 the stock index has gone down by 33 per cent, revaluation to take account of the current stock quotes reduces the price to $80m to $100m.

A unified company can undoubtedly raise that amount.

Estimated buyout price of shares the state requires to have 75 per cent (of voting shares) in companies whose stocks are quoted in the Russian Trading System

Company	Share price, last RTS deal before Aug. 17, 1998, $	Stake to be bought out % of equity	Stake to be bought out # (stocks)	Value, $
Megionneftegaz	0.51	10.8	10,695,299	5,454,602
Orenburgneft	0.4	18.3	12,022,416	4,808,966
Purneftegaz	1.52	18.3	15,243,084	23,169,488
Sakhalinmorneftegaz	2.85	18.3	11,130,296	31,721,344
Yaroslavnefteorgsintez	0.01	18.3	170,039,813	1,700,398
Stavropolneftegaz	35	46.9	169,264	5,924,237
Total				72,779,036

De-privatisation carried out strictly in accordance with the Hull formula and on the terms fixed in the ECT would be effectively protected by international law and, as a result, would not raise any well-grounded objections on the international community's part.

Key issues the state will have to resolve to carry out de-privatisation in line with the Hull formula include the size and source of compensation payments.

According to Article 13 of the ECT, "such compensation shall amount to the fair market value of the investment expropriated at the time immediately before the expropriation or impending expropriation became known in such a way as to affect the value of the investment (hereinafter referred to as the 'valuation date'). Such fair market value shall at the request of the investor be expressed in a freely convertible currency on the basis of the market rate of exchange existing for that currency on the valuation date. Compensation shall also include interest at a commercial rate established on a market basis from the date of expropriation until the date of payment."

As for the valuation mechanisms used for expropriated investment, the ECT, being a multilateral treaty, just refers to appropriate national legal procedures.

Existing Russian legislation fails to address nationalisation proper.

The closest analogy is reorganisation of a joint stock company in line with the *Law on Joint Stock Companies*. Besides, two drafts have been prepared of a federal law on nationalisation (both submitted to the State Duma in December 1998) — *On the Bringing of Property under the Ownership of the Russian Federation* (proposed by deputies led by

Pavel Bunich) and *On the Bringing of Property under the State's Ownership* (proposed by leftist deputies Igor Bratishchev, Vasily Shandybin and others).

But only the former draft stipulates a mechanism that is in the international legal framework and is acceptable in principle for valuation of nationalised property by an independent valuer determined through open tenders.

Naturally, the federal budget could be the source of compensation payments (including proceeds from the sale of state-owned assets). Or, if an investor agrees, compensation could be made through swapping government assets for investment subject to expropriation.

The former variant seems unrealisable today and the latter is unlikely, because it calls for swapping assets between various sectors.

As an alternative, compensation from anticipated financial flows to be generated by the assets of a unified oil company would be possible. A unified company's incremental revenues, rather than lump sum payments from the budget, would be a source of compensation payments in that case.

That approach would allow extending compensation payments and making them from total proceeds from a number of separate projects. For example, with proceeds from the government take in the state oil company's projects. That variant seems to be the only possible way to a compromise between the interests of investors whose assets are to be expropriated, and the state consolidating its blocks of shares.

Therefore, the Energy Charter Treaty, on the one hand, guarantees investors maximal protection of their rights during nationalisation and, on the other, ensures that expropriation is flawless in legal terms. That means that the ECT is a very useful document for Russia.

Russia, along with other countries, signed the ECT in December 1994. But the Russian parliament has not ratified the treaty thus far. The Duma's Committee for Industry, Construction, Transport and Energy turned down a government-proposed draft law on the ECT's ratification in May 1998, and the State Duma has scheduled another debate on the draft law for next June.

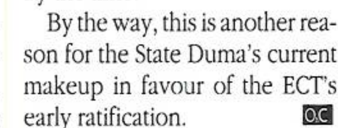
In what concerns a state oil company's formation, the ECT's ratification would make the observance of the Hull formula mandatory during nationalisation.

But laws are not passed quickly in Russia, and it would be senseless to delay the nationalisation of the blocks of shares required for establishing full control of companies — the lower the stock market rates, the less compensation is to be paid. Therefore, it cannot be ruled out that the state may decide to begin nationalisation before the ECT is ratified.

Comparison of the Energy Charter Treaty and Russian draft laws on nationalisation shows that the Hull formula is only observed if nationalisation is carried out in line with Article 13 of the ECT. Russian draft laws do not fully comply with the Hull formula, which means that they cannot guarantee Russian authorities against claims in connection with their violation of international legal norms.

In this connection, even though nationalisation in line with the ECT principles will not be obligatory — under Russian legislation — when a state oil company is formed, it should be carried out in accordance with the ECT, even if it is not ratified by the time.

By the way, this is another reason for the State Duma's current makeup in favour of the ECT's early ratification.



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