Balance of power in Russian partnerships

By **James Henderson**, Oxford Institute for Energy Studies and **Alastair Ferguson**, Former Head of Gas, TNK-BP

The recent joint ventures between Rosneft, Gazprom, Novatek and a number of international oil companies (IOCs) over the past two years have highlighted a return to the partnership strategy that had been in decline during the 2000s but is part of a long-term cyclical trend. The history of foreign company participation in the Russian oil and gas industry goes back almost 150 years, but has often been one of unfulfilled potential. In the earliest years of the industry, companies such as Royal Dutch Shell and Nobel Oil founded their dynasties on the back of oilfield developments in the Caucasus region, only to be stripped of their investments in the 1917 revolution. During the Soviet era foreign contractors were occasionally welcomed when the need for new technology became urgent, but essentially domestic players dominated the industry until the start of the 1990s, when the end of the Soviet Union catalysed a sharp decline in what then became the Russian oil and gas industry.

TNK-BP was Russia's largest international joint venture until it was absorbed into Rosneft

This collapse, caused by a lack of funds for investment in increasingly mature and dilapidated fields and infrastructure, offered the potential for significant co-operation between Russian and international oil companies in a region containing 12 per cent of the world's proved oil and gas reserves. Foreign oil companies had the capability to provide technology, management expertise and capital, while the domestic players had access to reserves as well as an understanding of how to operate within the emerging Russian commercial environment. The potential contribution of foreign companies was recognised by the political elite at an early stage, with President Yeltsin welcoming companies such as Shell, Exxon and Total into the first (and ultimately, only) Production Sharing Agreements (PSAs) granted in Russia, while numerous smaller joint ventures were also formed. However, the subsequent privatisation of the Russian oil industry, and the resulting fight among domestic entrepreneurs for cheap assets, undermined the investment opportunities for IOCs, as they were often regarded as competitors for assets rather than potential partners in their development.

The arrival of President Putin in 2000 brought an end to an era of somewhat anarchic politics and domination by the business elite known as the "oligarchs", and suggested that more stable times would herald increased foreign investment. The formation of Russia's largest international joint venture, TNK-BP, in 2003, prompted a resurgence in IOC interest, but then the bankruptcy of Yukos and the consequent rise of Russia's national oil company, Rosneft, introduced a period of state consolidation in the energy sector that once again limited significant foreign involvement.

Renewed relevance of IOCs

However, the natural progression of the Russian oil industry from the exploitation of Soviet-era assets, which have continued to produce wealth for the country and its oil entrepreneurs for the past 20 years, towards more remote and challenging new fields has created a new opportunity for foreign oil companies. Suddenly their technical experience and financing capability are relevant to Russia again, as is their long experience of managing large oil and gas developments in the global arena, especially offshore. Joint ventures (JVs) between Rosneft and Exxon, Statoil and Eni have focused on Arctic development and unconventional oil assets where domestic companies have little previous experience, while BP's position as a 19.75 per cent shareholder in Russia's national oil company is a further example of the evolving foreign involvement in the country's oil sector.

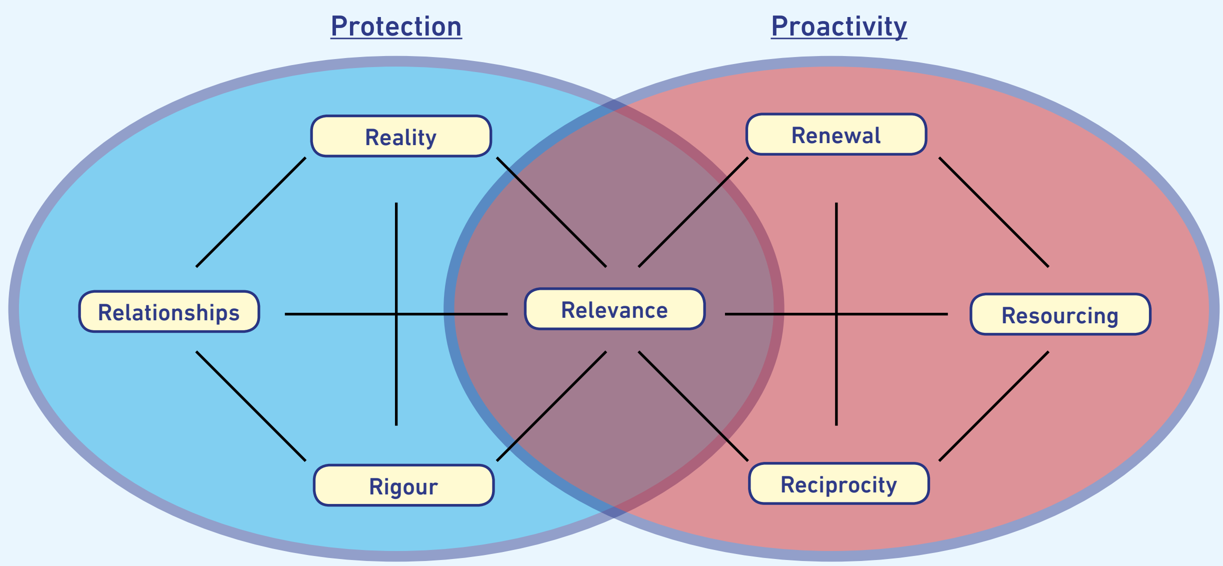
However, Russia is not an easy place for foreign companies to operate. Although there have been notable success stories, many international partnerships have failed, particularly among the JVs formed in the oil and gas industry over the past 20 years. As a result, at a time when JVs are again emerging as a key platform for international investment in the oil and gas sector, we believe that important lessons can be learned to increase the chance of future success.

An extensive review of the history of JVs in Russia, which we have carried out via a number of case studies and interviews with foreign and domestic actors in the oil and gas industry, has led us to conclude that the concept of local knowledge is a vital part of the relationship between the two partners. All the foreign partners whom we interviewed, whether successful or not, acknowledged that an understanding and ability to deal with local political, operational, and business issues in an 'asymmetric environment' was vital to the ongoing development of their business in Russia. Furthermore, some foreign partners also recognised that they traditionally had relied too heavily and for too long on their domestic partner, and had ultimately been undermined by their inability to demonstrate an increase in their own local knowledge and to maintain their relevance to a JV in Russia. Others decided either to make a big effort to develop a personal local network, and thus balance their domestic partner's biggest strength, or to try and find alternative methods to maintain their position within the partnership.

A statistical analysis of the causes of success and failure in 33 joint ventures further confirmed that, in an institutional environment which remains relatively weak, where an understanding of how to operate in the complex web of relationships, influence and politics is vital to success, partnership with a domestic entity is seen as a necessity by IOCs. Furthermore, it seems to us that this local knowledge of the business environment, and in particular the use of contacts, influence and relationships, is a core competence used by domestic entrepreneurs to build their businesses, and is also used as a bargaining tool in any JV formed with a foreign company. This skill is used to balance the IOC offering of technical expertise, management experience and, where needed, financing, and indeed often outweighs it, because the balance of bargaining power within joint ventures is established by an implicit "race to learn" in what is effectively a "competition for knowledge". The winner in this competition will be the partner who can most quickly acquire his counterpart's skills, and given the complex and enigmatic nature of local knowledge, this is most likely to be the domestic partner, as the acquisition of IOC skills tends to be a simpler procedure and indeed is often encouraged by the foreign partner as part of the partnership process. As a result the foreign partner can often find his relevance to a partnership undermined, leaving himself in a weaker bargaining position and often unable to maintain his status.

In response to this issue we have developed a "7R" engagement model (see below) which we believe can provide a positive outcome for foreign and domestic investors in a business environment such as Russia's, if a rigorous and systematic approach to the potential problems is adopted. This primarily necessitates a foreign partner not only acquiring local knowledge himself but most importantly applying it by becoming more involved in issues concerned with the domestic business environment, in other words being proactive in the process of knowledge transfer and effectively spending significantly more time on the 'soft due diligence'. In the pursuit of this positive strategy, we believe that both protective and proactive measures can help to maintain the relevance of foreign companies

The "7R" Engagement Model



Source: International Partnership in Russia: Conclusions from the Oil and Gas Industry, J. Henderson and A. Ferguson, Palgrave Macmillan, 2014

in a weak institutional environment. We believe that there is a need to fully understand the reality of the environment in which they are operating, using rigorous analysis and a wide network or relationships to create as full a picture as possible of the situation. Through this process, it can become clear that, although there are challenging issues to be addressed, they are by no means insurmountable, and that the opportunities available in Russia can more than compensate for the effort needed to access them. We also believe that foreign companies can optimise their chances of success by continuously renewing their knowledge base and their contributions to any JV, by offering reciprocity both of assets outside Russia but also of mutual learning inside the country, and by ensuring that the resources they offer, in particular the staff they contribute, are of a high quality and are adaptable to the domestic environment.

The "7R" Engagement Model

It is easy to categorise Russia as having a flawed business and political environment and to dismiss it as too difficult to deal with, but the expanding number of foreign companies now beginning to re-enter the Russian oil and gas sector suggests that the opportunities remain both interesting and very tempting. After more than 15 years of studying and working in the country we remain firm believers in the potential for partnership in Russia but also see the need for both a constructive and a sustainable engagement model. We believe that with the right practical approach, both mental, cultural and operational, foreign companies can be successful if they adopt a systematic process of engaging with the full range of key individuals, politicians, industry experts and domestic employees who will be at the heart of their business. Although this engagement can often be uncomfortable, in a working environment that is tough and confrontational, it can also provide huge mutual benefits to all the partners and stakeholders involved. Indeed, it can provide valuable experience for companies to use across their global operations; Russia is not unique in having a weak institutional environment where local knowledge is vital. We hope that the lessons drawn from our analysis can provide useful insights which can assist in the formation of partnerships in many other countries where the governance of commercial transactions is more reliant on individual decision-makers than traditional institutional mechanisms. ■