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Russia's resource capitalism—market vs political signalling

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ABSTRACT

Since the early post-Soviet era, when many strategically important Russian oil and gas fields were sold on unfavourable terms, the state has been seeking to regain control of these strategic assets. With Putin's return to the Presidency in 2012, Russia's U-turn over oil and gas privatizations has again caused market consternation. We examine strategic asset acquisitions by Russian O&G companies during Putin's first terms as president and suggest that there should however, be few surprises. Under Putin, strategic deals in Russia are often informal, dominated by Russian partners, subject to internecine rivalries and, we show, are 'somehow' known by markets prior to promulgation. Findings suggest that in Russia deals of strategic substance are recognized by financial markets prior to the announcement of political policy.

1. Introduction

Politics and finance are closely intertwined in the oil industry of the Russian Federation. It is also indisputable is that quite possibly only one person, Vladimir Putin, has the capacity to seamlessly influence politics and capital markets. Central to understanding deal making in Russia is therefore to understand the powerful role of informal deal making - to which both capital markets and the Duma are secondary.

Given the ancillary nature of politics and capital markets in the Federation, the question we address in this paper is which are more effective in processing new oil and gas deal information: Russian financial markets or political promulgations by the Duma. Following the March 4, 2012 Russian Presidential election, Vladimir V. Putin was elected as President of Russia for the third time. Shortly after his May 7 inauguration, a new Minister of Energy, Alexander Novak, was appointed by Presidential Executive Order on May 21, 2012. Putin's long term ally, Igor Sechin, became Chairman of Rosneft on May 22, 2012. On May 24, 2012, Mr. Putin appeared to backtrack on statements made during the election campaign regarding foreign-owned companies' role in the development of Russia's potential Arctic reserves, essentially re-stating the legal position adopted by the Russian Duma in Mr Putin's first term in 2008 that only partnerships with state-owned companies would develop strategic assets.[2]

The previous week, TNK-BP, the third largest crude oil producer in Russia, in which British Petroleum holds a 50% ownership stake, had announced weak operating results. On May 28, 2012, Mikhail Fridman, the TNK-BP CEO, resigned, citing irreconcilable problems with the ownership structure which were preventing effective resource management. On June 1, 2012, BP announced it was seeking to sell its share in TNK-BP. On June 4, 2012, the Russian partner shareholders of TNK BP, Alfa-Access-Renova (AAR), reopened legal action against BP related to a failed exploration and production deal between the partnership and Rosneft, the state oil company.[3] On July 27, 2012 the court found against BP and awarded more than $3 bln in damage to AAR.[4] In October state-controlled Rosneft agreed with BP PLC to buy half of the Russian oil venture in cash and stock valued at nearly 60 billion dollars. Then, on the 12th of December 2012 the Russian oil company Rosneft completed an agreement with a group of Soviet-born billionaires to buy their 50% stake in oil venture TNK-BP for 28 billion dollars, according to a joint State and AAR statement, the deal marked a historic moment for the world's largest energy-producing country.

Whatever the intricacies of this troubled partnership, the market reaction to BP's intent to sell was one of surprise in many quarters of the Western media. This article argues that reasserting state asset control should come as no surprise. The proximity of the return of Mr. Putin to the presidency with BP's declaration of intent to sell its share of TNK-BP is consistent with the resource nationalism strategy of the previous Putin term. The net result is that forward looking investors should expect resource ownership to be increasingly concentrated in the hands of Russian-owned state and private companies. Additionally, this article presents evidence of an ongoing

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[1] Opinions expressed here are our own and do not reflect the views of Wood Mackenzie who only supplied the raw deal data for analysis.

[2] *Upstream Online*, May 24 2012. 'Putin qualifies vow for more open Arctic market'.

[3] *Upstream Online*, June 4, 2012. 'Russian court 'orders new TNK-BP hearing'.

[4] Siberian court awards $3 bln damages against BP, accessed August 1, 2012 http://www.reuters.com/2012/07/27/bp_russia_damages_idUSL638IR61B20120727.

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pattern of mismatch between market reaction and public statements under the previous Putin administrations in major oil deals in the period 2000–2006, highlighting that, unlike Western markets, in Russia what happens in internecine negotiations (before deals go public) matters more to financial markets than public statements.

This study addresses the relative importance of economic markets and political statements, variables identified by Ickes and Ofer (2006). To illustrate on March 21, 2008 the Russian State Duma passed a bill restricting foreign investment into the Russian strategic resource sector. Given that Russia holds the world's largest natural gas reserves, the second largest coal reserves and the eighth largest oil reserves, the real surprise is that announcement attracted little response from financial markets. The lack of reaction to the Duma announcement suggests the possibility that there may have been *a priori* economic signalling of the political announcement. We suggest that this signalling took place and continues to take place through strategic asset acquisitions prior to any political announcements. Market reaction for the four major Russian oil and gas (O&G) companies to the Duma statement is compared to the share price response at the date of announcement of 18 strategic resource acquisitions.

Our analysis of strategic asset deals (relative to the DUMA promulgations) allows us to answer questions as to the relative importance of economic and political signals in Russia. In part, prior studies have argued that Russia's mixing of political and economic signals has its root in the plethora of ill-defined Russian transitional forms of ownership which allows businessmen to operate like public servants and public servants to operate like businessmen (Levin and Satarov, 2000). Our empirical findings suggest a dominance of economic signals prior to political signals. Results support work by Ickes and Ofer (2006) who specifically identify resource and industry factors as more important explanatory measures of policy than political variables.

In formulating a theoretical framework for political risk, Simon (1984) notes that political environment assessment is concerned with the identification, analysis, and management of sociopolitical and governmental restraints on foreign investment. This approach fits neatly with our study of the Duma promulgation in that foreign investment strategic resources are subject to Russian domestic control. The Duma has classified 42 activities as strategic in nature, including geological prospecting and/or exploration and the extraction of mineral resources at fields of federal importance (MF). Selected mineral deposits are assigned federal importance, the justification being that control is necessary to uphold the country's defense capability and security interests. Federal deposits are defined as properties containing more than 70 million tonnes of recoverable oil and 50 billion cubic meters of recoverable gas. These criteria were used to determine the selection of domestic transaction data used in this study. Federal subsurface resources are also taken to include internal and territorial maritime waters and sections of the Russian continental shelf (InterfAX March 26, 2008).

Asset acquisition data are used to provide market evidence that natural resource deals precede and carry greater explanatory power than Russian political signals. Strategic acquisition deals each with a deal value in excess of 50 million US dollars (USD) are shown to result in a concentration of Russian control of Russian O&G reserves. Additionally, we find that market response to the deals and the Duma announcement suggest a mix of economic and political signals (with the former more significant). In essence, our Russian empirical evidence is that seemingly profound political announcements have little or no market effect.

Specifically, our study compares the informational significance of 18 strategic acquisitions that enabled Russian controlled Gazprom, LUKoil, Rosneft and TNK-BP during Putin's presidency to consolidate control over 68.8% of domestic reserves. While it is noteworthy that the four companies hold the majority of reserves in Russia, it is equally instructive to understand that a significant proportion of these reserves was actually acquired in the period 2000–2006 prior to any Duma announcement enacting control over strategic reserves.

A significant contribution of our work is that we use event study analysis to statistically compare market response to political announcements with strategic market merger and acquisition (M&A) events.

We are aided in linking strategic asset acquisitions with political announcements by the resource sector's unique 'locational' attribute, see Dunning (1998). Based on a comparison of market reaction at deal date and at the Duma announcement we provide statistical evidence of market reaction. Findings suggest that economic asset acquisitions were actually signalled to investors and operators in Russia *prior* to their political announcement. Consistent with Ickes and Ofer (2006), we find that explanatory economic measures significantly outperform market reaction to political announcements. Long-term changes in market capitalization suggest that both long and short-term market reaction carry valid and significant informational content about economic events, a finding consistent with the study of long term value for evaluating strategic investment decisions by Rappaport (1986).

2. Data review

Deals included in this study meet specific criteria. Similar to Kaplan and Weisbach (1992); Moeller et al. (2005) who study deal size, our study covers material transactions, which may potentially 'move' the market. We eliminate transactions of less than 50 million USD, where the deal value is defined as the total consideration paid by the acquiror excluding fees and expenses. We also eliminate transactions for domestic assets which do not meet the Duma threshold to qualify as Federal deposits, i.e. a minimum of 70 million barrels of oil or 50 billion cubic meters of gas. Deals which meet these criteria are included in the initial dataset, but deals which lack market data are not included due to a lack of share price. These data are necessary for an analysis of abnormal returns. Deals excluded are transactions by Rosneft and TNK-BP which lack market information. The MCSI All Country World Index was used as a benchmark of industry performance to assess the relative performance of the Russian companies which are the focus of this study.[5]

Daily share prices and market values for the companies were collected from Datastream. Starting periods for data vary as availability is subject to companies' initial public offering dates. All relevant deal announcement dates are cross-referenced in detail with corporate press-releases. The initial dataset is referenced to the Wood Mackenzie Acquisition Strategy Performance (ASP) database.[6] Data comprise successful asset and corporate acquisitions during 2000–2006, for bids announced between January 1, 2000 and December 31, 2006. This study's initial dataset therefore consists of 18 deals transacted by the four major Russian oil and gas companies including Gazprom, Rosneft, LUKoil and TNK-BP, which together now exert control over 68.8% of reserves in Russia (see Table 4). The state vs private/publicly held classification is based upon publicly available information on ownership structures as at the end of 2006.

Russian companies are shown to acquire assets from vendors who are in turn classified into four groups: Russian Sellers, Asian National Oil Companies, Majors, and International Large Caps. Russian Sellers include the four largest Russian oil and gas

[5] Morgan Stanley Capital International (MSCI) Barra, Inc. is used to provide data on MSCI ACWI (All Country World Index) oil, gas and consumable fuels index for the period 2000–2006. MSCI All Country World Index is chosen as a benchmark for this study over the widely used MSCI All World Index since this includes Russian Federation companies into its constituent stocks.

[6] Data are commercially available from Wood Mackenzie.

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