

How Rosneft Is Turning Into Another Gazprom

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During the last half decade, the mismanagement of Gazprom has turned from comic to tragic. Incredibly, President Vladimir Putin and Rosneft CEO Igor Sechin seem set to carry out a similar destruction of Russia's latest national champion, the giant oil company Rosneft. It is a vivid example of the harm state capitalism can do to Russia's welfare.

On Oct. 22, Rosneft bought BP's near half of TNK-BP, and the next day it bought the other half from billionaires Mikhail Fridman, German Khan, Viktor Vekselberg and Len Blavatnik for a total of \$55 billion, mainly in cash. This was the biggest nationalization since Rosneft seized most of the assets of Yukos in 2004.

TNK-BP had been an extraordinary economic success before the Rosneft buyout. As three Sberbank energy analysts wrote in a recent report, "TNK-BP has been one of the best-performing large-market cap oil and gas equity investments in the world since 2007," paying huge dividends. In contrast, Rosneft's performance has been mediocre, despite the fact that it

seized Yukos valuable assets on the cheap. When Rosneft went public in 2006, its market capitalization was \$80 billion. Today, it has fallen to \$69 billion, roughly equivalent to its net debt.

Rosneft's purchase of TNK-BP made a big joke of Putin's claim that he wants to privatize state assets. On the contrary, the evidence shows that he favors state capitalism, combined with crony capitalism benefitting his best friends. Former Finance Minister Alexei Kudrin put it best when he commented on Rosneft's purchase of TNK-BP: "An inefficient company absorbs an efficient one ... [and] unfortunately, the company will be managed by the old Rosneft management."

Kudrin's words have come true. Sergei Bogdanchikov built up Rosneft as its CEO from 1998 until 2010, but he was ousted by Sechin, Putin's right-hand man from St. Petersburg with alleged ties to the KGB. Sechin wanted the CEO spot for himself and got it when Putin was re-inaugurated president in May of last year.

That Sechin was allowed to become CEO of Rosneft was just as astounding as Alexei Miller being appointed CEO of Gazprom in May 2001. Sechin had no known prior experience of managing a large corporation, although as deputy prime minister he was chairman of Rosneft from 2004 to 2011 in a typically blatant Russian conflict of interest.

Not surprisingly, Sechin seems to be making every mistake in the book. People complain that Sechin is an extreme micromanager even by Soviet standards. He wants full control, which limits his ability to benefit from the knowledge of others. Notably, soon after the TNK-BP deal was completed in March and the companies merged, 90 percent of the 1,600 employees in the head office of TNK-BP resigned from their jobs.

Yet Sechin has dug in. After the settlement with the main owners of TNK-BP, he showed the minority shareholders holding the remaining 5 percent of TNK-BP no mercy, excluding equal treatment of all shareholders. The price of the publicly traded TNK-BP stocks fell instantly by 40 percent.

Rather than correcting this costly mistake, Sechin went on the offensive. At an investor presentation in London on April 23, Sechin declared that Rosneft was "not a charity fund," clarifying his contemptuous view of minority shareholders. Apparently, he considers shareholders' yield "charity." Thereby, he has presumably capped the stock price of Rosneft until he convincingly changes his mind.

As if he had not scared away sufficiently many investors, Sechin proceeded to criticize the former owners of TNK-BP — including BP, which holds 19.75 percent of Rosneft's shares — for having paid too large dividends and investing too little. That is usually called economic efficiency. Instead, Sechin is promising more than \$20 billion in capital expenditure a year, which will eat up virtually the whole cash flow of the company.

Apparently, Sechin is determined to repeat this same fundamental problem with Gazprom. In its June report on Russian investment strategy, Sberbank specifically warns against commodity producers that have not realized that the commodity boom has abated but continue to over invest. It issued a particular warning against Gazprom and Rosneft.

Another problem with Gazprom is its propensity to invest in noncore assets. Once again, Sechin is following his master, deciding to invest in large petrochemical assets, while Rosneft's core activity is supposed to be oil production.

In his excellent book "Wheel of Fortune: The Battle for Oil and Power in Russia," Georgetown University professor Thane Gustafson argues that the best chance for Russian oil is likely to lie in tight oil in West Siberia. This means intensive development of old, smaller fields with new technology, which small independent companies do best.

But Sechin thinks he knows better. He understands that the future lies with uncertain and complex Arctic offshore projects with the help of major foreign oil companies, which cannot possibly deliver any production for the next two decades. But in a very Soviet fashion, he prefers huge, challenging projects, while ignoring economic efficiency.

Sechin has spent many of his few words on extolling the greatness of Rosneft. After all, he says, the company produced 5 million barrels a day in 2012, becoming the largest publicly traded oil company in the world. But at the end of the day, these are largely meaningless numbers. ExxonMobil produced only 4.2 million barrels a day. But Exxon is worth \$403 billion, almost six times as much as Rosneft, and Sechin is all too likely to increase this gap.

Gazprom used to be in a class of its own in terms of mismanaging the company and destroying its value, but it now has a serious rival. Yet there are differences between the two companies. While Miller controls the gas pipelines, Sechin has picked an interesting fight with the state-owned oil pipeline company Transneft, which is ruled by Nikolai Tokarev, another friend of Putin from the KGB.

Miller is legendary for his inability to make decisions, while Sechin, who is sufficiently close to Putin, makes decisions more quickly. Finally, for historical reasons, the oil market still benefits from far greater freedom and more private enterprise than the strictly controlled gas market.

Yet Sechin has already proved his ability to be a gravedigger of the electricity reform, and his ability to cause harm to the Russian economy must not be underestimated. He might repeat the damage in the oil sector.

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