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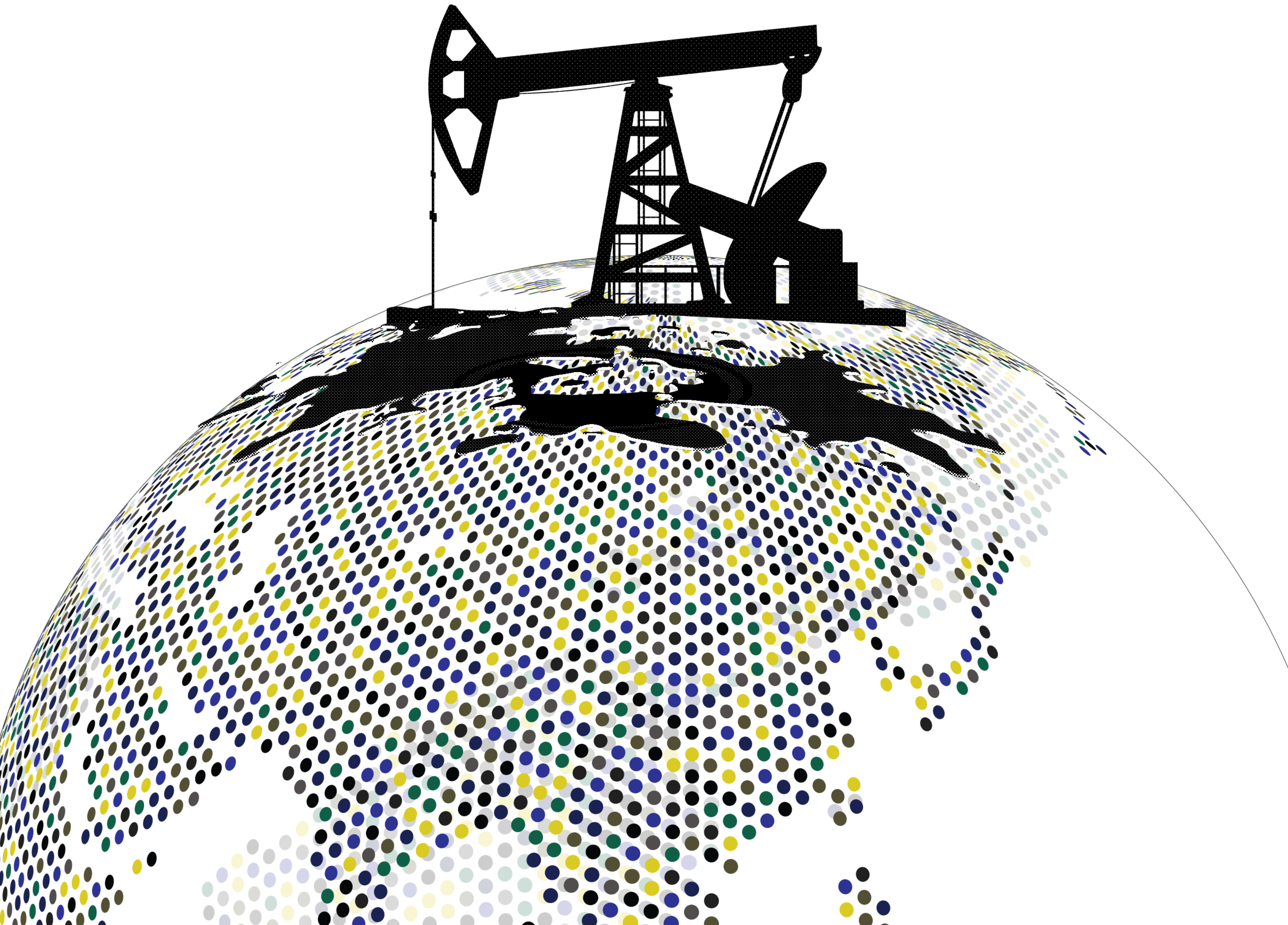
SANCTIONS & FINANCING: ROSNEFT'S GLOBAL EXPANSION

Bill Harney



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Sanctions & Financing: Rosneft's Global Expansion

Executive Summary

This report examines Rosneft's international operations and its source of financing while under Western sanctions. Intended to disincentivize malign activity, Rosneft, a Russia state-owned oil company led by Vladimir Putin ally Igor Sechin, has responded to sanctions by spearheading efforts to support the Nicolás Maduro regime in the Bolivarian Republic of Venezuela, acquiring a dominant position in the Kurdistani oil sector, and opening projects in Arab Republic of Egypt and Republic of India, among other countries. These actions have been achieved despite Rosneft's being locked out of Western financial markets, a drop in global oil prices, and a stagnating Russian economy. Rosneft has financed its global expansion by relying on its close relationship with the Kremlin to secure credit from state banks and the domestic capital market. In the process, Rosneft has amassed debt ratios and costs of financing far above competitors. However, as long as the Kremlin is willing and capable of prioritizing Rosneft for political purposes, Rosneft's financial health is not in jeopardy. Instead, the costs of the strategy are manifested through distortions in the Russian financial sector, reduced competitiveness in the energy sector, and elite competition in the public sphere.

The Russian Government's Oil Hand

In 2014, the United States levied sanctions against Rosneft, the Russian Federation's state-owned oil company, and its Chief Executive Officer, Igor Sechin, in response to Russia's invasion of Ukraine. Intended to punish and disincentive malign activity, the sanctions denied Rosneft access to Western financial markets and barred cooperation with international oil companies. In the half-decade since, the combined effect of sanctions, low oil prices, and economic stagnation in Russia has not diminished Rosneft's spending; in fact, Rosneft increased its international activity after 2014. In the Bolivarian Republic of Venezuela and Republic of Iraq, Rosneft invested in economically risky projects, offering the Russian government strategic leverage in geopolitically important regions. Rosneft's capacity to secure credit without Western markets and invest abroad raises critical questions about the efficacy of sanctions and the strength of the domestic Russian financial market.

Throughout Vladimir Putin's twenty years in power, Rosneft and Gazprom, another Russian state-owned energy company, have been critical to the regime's political and economic model by providing hard currency tax revenues and control over the country's most lucrative rent flows. This arrangement has allowed the Kremlin to invest in the military, maintain elite support, amass popular support by rebuilding the shattered social safety net, and mitigate economic shocks through large foreign currency reserves. Internationally, Western policymakers have become concerned that Gazprom, directed by the Kremlin, uses natural gas rents to align foreign elites to Moscow's political preferences and leverages European energy dependence to raise the costs of confrontation. Rosneft, while seen as involved in domestic politics, was not identified as a foreign policy tool before 2014 due to its small international footprint.

In a series of measures between March and September 2014, United States and the European Union sanctioned Rosneft and Sechin, preventing Rosneft from accessing Western debt markets and cooperating with Western oil companies. Interestingly, likely due to the EU's dependence on Russian natural gas, Gazprom avoided debt sanctions, though its banking (Gazprombank) and oil (Gazprom Neft) assets were targeted. This round of sanctions was intended to "increase the costs of economic isolation" by targeting the financial and energy sectors.[1]

Sanctions have not forced Russia to de-escalate and seek rapprochement. Instead, Russia has directed state, nonstate, and parastatal actors to challenge the global strategic position of the U.S. through military operations, influence campaigns, and economic leverage, including military operations in the Syrian Arab Republic and Ukraine; election interference in the U.S. and the EU; and financial support for governments and elites receptive to Russian aims. Within this context, Rosneft has emerged as a key actor, creating the economic linkages and the network infrastructure necessary for deeper political and military engagement. Rosneft has achieved this by foregoing fiscal prudence in the face of higher borrowing costs and reduced revenues to pursue costly, economically risky projects in regions of geopolitical significance.

1 "Announcement of Treasury Sanctions on Entities Within the Financial Services and Energy Sectors of Russia, Against Arms or Related Materiel Entities, and Those Undermining Ukraine's Sovereignty," United States Department of the Treasury, July 16, 2014. https://www.treasury.gov/press-center/press-releases/pages/jl2572.aspx.

"The sanctions regime closed the door on cooperation with international partners, denying Rosneft access to advanced technology and techniques. At the same time, the Kremlin prioritized confrontation with the U.S. through military and non-military means. Against this backdrop, Rosneft's global expansion served a double purpose: first, to augment declining production in domestic brownfields with international projects, and, second, to contribute to Russia's real and perceived geopolitical posturing."

Rosneft's Global Expansion

Since the late 2000s, Rosneft has faced a fundamental challenge: the bulk of readily accessible domestic oil fields already have been tapped, which means that sustainable, long-term growth requires partnering with international oil companies (IOCs) to exploit offshore and tight oil reserves. To bridge the gap, Rosneft identified international projects as a way to boost production and maintain resource replacement ratios while these capital intensive, long-term projects came online.[2]

Yet, the sanctions regime closed the door on cooperation with international partners, denying Rosneft access to advanced technology and techniques. At the same time, the Kremlin prioritized confrontation with the U.S. through military and non-military means. Against this backdrop, Rosneft's global expansion served a double purpose: first, to augment declining production in domestic brownfields with international projects, and, second, to contribute to Russia's real and perceived geopolitical posturing.

Therefore, when analyzing Rosneft's major global operations, it is important not to overstate their geopolitical function. In Venezuela, for example, Rosneft and Igor Sechin have long operated as the Russian state's principal organ. It is clear that the Kremlin has appreciated the value of Maduro's anti-American stance and views the current crisis as an opportunity to prove Russia's capacity to power project into the Western Hemisphere. But, Venezuela, devoid of foreign investors since the People's Republic of China's retreat, offered Rosneft a buy-low option replete with deep reserves and high-reward. For Sechin, Venezuela hit both marks: upstream production and pleasing the Kremlin. Each of Rosneft's major projects—Venezuela, Iraq, Republic of India, and Arab Republic of Egypt—offer a similar mix to varying degrees, revealing the delicate mix of profit and politics at the core of Russia's state enterprises.

Venezuela: High Risk, High Reward in the Western Hemisphere

Rosneft's activities in Venezuela began in 2010 with the formation of its first joint venture with PDVSA, a Venezuelan state-owned oil company.[3] In 2013, the parties finalized a second deal, granting Rosneft 40% control of the project and access to the resource-rich Orinoco Belt oil fields. In return, Rosneft paid USD 1.1 billion in two tranches and disbursed a USD 1.5 billion loan to PDVSA.[4] In the same year, as part of Rosneft's acquisition of TNK-BP, the company gained a 16.7% share in PetroMonagas S.A., which also operates in the Orinoco Belt.[5]

In 2016, against the backdrop of economic crisis and political conflict in Venezuela, Rosneft disbursed another USD 1.5 billion loan to PDVSA and, as collateral, secured a 49% stake in CITGO, which operates PDVSA's refining and distribution operations in the U.S.[6] Rosneft then paid USD 500 million to acquire an additional 23% of shares in PetroMonagas, raising its total control to 40%.[7]

2 "Rosneft Annual Report 2015," Annual Report, PJSC Rosneft Oil Company, 2016, https://www.rosneft.com/upload/site2/document_file/a_report_2015_eng1.pdf.

3 Rosneft Information Division. "Rosneft Takes an Important Step in Expanding into the Strategic Market of Venezuela," Press Release. Rosneft, December 8, 2011, https://www.rosneft.com/press/releases/item/114492/.

4 "'Роснефть' и Венесуэльская PDVSA Договорились о Шельфовых Проектах [Rosneft and Venezuelan PDVSA Agree on Offshore Projects]," РБК, July 2, 2013, https://www.rbc.ru/economics/02/07/2013/57040b939a794761c0cdf499.

5 "Rosneft Annual Report 2013," Annual Report. PJSC Rosneft Oil Company, 2014, https://www.rosneft.com/upload/site2/document_file/0x6IQAB-SaM.pdf.

6 "$17 Млрд На Кону: Что Может Потерять Россия Из-За Переворота в Венесуэле [$17 Billion At Stake: What Russia May Lose Due to Venezuelan Coup]," РБК, January 24, 2018, https://www.rbc.ru/economics/24/01/2019/5c49bbac9a79475ffe868c49.

7 "«Роснефть» Заявила о Законности Покупки Доли Petromonagas [Rosneft Announces Legality of Purchase of Petromonagas Share],"

РОСНЕФТЬ

ROSNEFT ASSETS & REGIONS OF OPERATION

25 COUNTRIES OF OPERATION

78 RUSSIAN REGIONS OF OPERATION

6% GLOBAL OIL PRODUCTION

41% RUSSIAN OIL PRODUCTION

6 SHARES IN GLOBAL REFINERIES

13 REFINERIES IN RUSSIA

EXPLORATION

RUSSIAN FEDERATION
- LLC RN-Exploration
- LLC RN-Shelf Arktika
- LLC Yermak Neftegaz
- LLC RN-Endyrneftegaz

Brazil
- Rosneft BRASIL E&P LTDA

Norway
- RN Nordic Oil AS

Venezuela
- Petromiranda S.A.
- Petrovictoria S.A.

IRAQ
- Bashneft International B.V.
- RN-Quasrok Pte. Ltd.

Myanmar
- Bashneft International B.V.

Vietnam
- Rosneft Vietnam B.V.

Mozambique
- RN Angoche Pte. Ltd.
- RN Zambezi North Pte. Ltd.
- RN Zambei South Pte. Ltd.

Source: Rosneft Annual Report 2018

In September 2017, Rosneft disbursed a USD 6.5 billion advanced payment to PDVSA for future oil sales. Later that year, Rosneft acquired licenses from the Venezuelan government to explore and develop two natural gas fields. Rosneft's activities in Venezuela were accompanied by operations by Gazprom and additional lending from the Russian state.

By the end of 2018, Rosneft had stakes in five joint ventures with PDVSA, owned two oil fields, and was owed at least USD 3 billion in outstanding loans.[8] Rosneft spent or lent roughly USD 8.5 billion in this period to acquire Venezuelan upstream assets capable of producing 66.5 thousand barrels per day and holding roughly 80 million tons in oil reserves. These figures equal 1.4% of Rosneft's total barrel per day production (4,673 thousand barrels per day) and 1.3% of Rosneft's 1P hydrocarbon reserves (6,368 million tons).[9]

Rosneft has penetrated the Venezuelan hydrocarbon industry by providing financing and political support during the ongoing economic and political crisis. These deals have exposed Rosneft to the risk that future Venezuelan governments may declare Maduro's hydrocarbon deals as illegitimate, which could threaten ongoing debt repayments, licenses, and joint venture partnerships. In short, economically, Rosneft has acquired a project with moderate short-term value and higher potential long-term value replete with high country and credit risk.

Geopolitically, Rosneft's activity in Venezuela cements Russia as the country's key foreign backer and strengthens Maduro's position through financing. Should Maduro be able to re-consolidate control over the country, Russia's willingness to support the regime will likely result in significant Russian influence. Concretely, this influence could translate into deepened cooperation in the energy sector, political support in international fora, intelligence sharing, and the establishment of Venezuela as a staging point for declared and covert Russian military operations.

Iraq: Little Gains in Production, Significant Gains in Influence

In October 2017, Rosneft signed production sharing agreements (PSA) with the Kurdistan Regional Government granting it 80% control of a project to explore five areas at a cost of USD 400 million. Following the transaction, Rosneft acquired control of the region's export pipeline for USD 1.8 billion and extended a USD 1.2 billion loan for the prepayment of oil deliveries.[10] Kurdistan's oil pipeline connects Kirkuk with a larger network, terminating in the Turkish port of Ceyhan. Rosneft's oil fields in Kurdistan are estimated to produce 10,000 barrels of crude oil per day, which amounts to 0.2% of the company's total production.[11] Concurrently, in southern Iraq, Rosneft began drilling operations at the Block-12 oil field acquired as part of its takeover of Bashneft in 2017. [12]

While Rosneft's acquisitions in Iraq nominally contribute to the strategic objective of developing an international upstream portfolio, they provide a negligible impact on Rosneft's production. Importantly, however, these deals open the door for Rosneft into the Iraqi oil sector while also complementing the Russian state's regional policy in the Middle East. With a hand on the most important cash flows in Kurdistan, Rosneft now has a direct lever to influence local elites and the flow of oil payments between Erbil and Baghdad—offering both geopolitical and economic advantages.

РБК, February 10, 2017, https://www.rbc.ru/rbcfreenews/589dd1729a7947b0a1b61975.
8 "$17 Млрд На Кону: Что Может Потерять Россия Из-За Переворота в Венесуэле [$17 Billion At Stake: What Russia May Lose Due to Venezuelan Coup]," РБК.
9 "Rosneft MD&A 4Q 2018," PJSC Rosneft Oil Company, 2019, https://www.rosneft.com/upload/site2/document_cons_report/MDA_ENG_4Q2018.pdf; and "Rosneft Increased Its Proven Hydrocarbon Reserves by 4% in 2018," Rosneft, February 11, 2019, https://www.rosneft.com/press/releases/item/114492/.
10 Foy, Henry. "Rosneft's Iraqi Kurdistan Oil and Gas Play Angers Baghdad," Financial Times, October 30, 2018, https://www.ft.com/content/ace52dd2-4f0c-11e8-ac41-759eee1efb74.
11 Ibid.
12 "Rosneft Annual Report 2017," Annual Report. PSJC Rosneft, 2018, https://www.rosneft.com/upload/site2/document_file/a_report_2017_eng.pdf.

Igor Sechin and Dmitry Medvedev tour a new oil and gas production cluster in Western Siberia.
Source: rosneft.com

Geopolitically, Russia has identified America's perceived rollback of operations in the region as an opportunity to increase its presence and influence in the region.[13] The Russian intervention in Syria is Moscow's starkest example, but Russia's goal is not to replicate America's role in the region. Instead, it intends to position itself as the key operator, forcing negotiations to flow through Moscow. It has done this by becoming the link between the State of Israel, Republic of Turkey, Islamic Republic of Iran, and Syria. Pulling Iraqi Kurdistan into the mix only increases Moscow's importance, granting it greater leverage in the formation of a new regional security architecture.

Economically, the logic for Rosneft in Iraq is similar to Venezuela. Foreign investors were weary of embroiling themselves in Kurdistan's fragile political situation, aware of the risks it posed. Rosneft, however, took the risk with the hope that investing now in Kurdistan will give the company the means to further penetrate Iraq's deep oil sector. With Russia's relationship with the Organization of the Petroleum Exporting Countries (OPEC) seesawing between warm and cold, a low-cost chance to gain simultaneously a greater presence in both Venezuela's and Iraq's oil sectors made strong economic sense.

India: The World's Fastest Growing Oil Consumer

In August 2017, Rosneft spent USD 12.9 billion to acquire a 98.26% stake in the Indian company Essar Oil Limited, which controlled a complex in Vadinar. This complex included a technologically advanced refinery, a deep-water port, oil terminal, power plant, and 3,500 fuel stations. The company's most important asset is the modern refinery, which is India's second largest and is able to refine 400,000 barrels per day. According to Reuters, the deal was Rosneft's first acquisition in India, the largest foreign acquisition of an Indian company,

13 Trenin, Dmitri. What Is Russia Up To In The Middle East (Polity, 2017) pp. 12-85.

and Russia's largest international acquisition.[14]

Essar Oil Limited, which has been renamed Nayara Energy, improves Rosneft's strategic position by offering synergies with existing operations in Venezuela. Nayara Energy and Reliance Industries, one of India's largest non-state energy companies, import Venezuelan crude oil from PDVSA, but, reportedly, make the final payment to Rosneft, allowing them to skirt U.S. sanctions against Venezuela. Rosneft has denied this charge, citing the lack of hard proof.[15] Since U.S. sanctions were re-imposed on Iran earlier this year, both Nayara and Reliance Industries have increased Venezuelan imports to offset the drop in Iranian oil.[16]

Unlike the riskier, politicized operations in Venezuela and Iraq, Rosneft's acquisition of the Essar Oil Refinery is largely risk-free. The energy consultancy group Wood MacKenzie forecasts that India will surpass China as the largest market over the next two decades. The modern Vadinar facility will position Rosneft to benefit from the growth through predictable, steady cash flows while also providing important links with Indian political and business elites. Furthermore, when combined with expanded drilling in Vietnam, petrochemicals plant in China and Republic of Indonesia, and a now-scuttled USD 30 billion investment project in Iran, it is easy to see how Rosneft's expanded presence in the Indo-Pacific is consistent with the Kremlin's interest in the "strategically important" and "geopolitically vibrant" region.[17]

Egypt: Offshore Natural Gas Production & Technology

In October 2017, Rosneft acquired from Eni, an Italian energy company, a 30% share in the Zohr field for USD 1.1 billion, with an option to increase to 35%. Eni controls 50%, and BP controls 15% of the remaining shares in the project. The Zohr field, located in Egypt's Mediterranean territorial waters, is estimated to hold 850 billion cubic meters of natural gas. Rosneft announced in November 2018 that it intended to invest another USD 2 billion in the project over four years.[18] In 2018, the Zohr field accounted for 3.21% of Rosneft's natural gas production.[19] Production capacity at the Zohr field continues to rise with daily volume increasing to 2.7 billion cubic feet per day in August, a 30% increase from February.[20]

Involvement in the project, the company's first in Egypt, achieves Rosneft's goal of increasing international upstream production while also contributing to its broader objective of increasing natural gas production. While possible to interpret the project within the geopolitical context of Russia's broader engagement in the Middle East, it seems more logical that the move was driven by economic incentives and the opportunity to gain expertise in offshore natural gas extraction. Specifically, by leveraging experience gained in this project, Rosneft will be able to further develop its liquefied natural gas (LNG) export capabilities in Russia.

14 Mukherjee, Promit. "Rosneft Seals First Asian Refinery Deal with Essar Oil Purchase," Reuters, August 21, 2017, https://www.reuters.com/article/us-india-essar-rosneft/rosneft-seals-first-asian-refinery-deal-with-essar-oil-purchase-idUSKCN1B10PL.

15 Parraga, Marianna. "Exclusive: After U.S. sanctions, Venezuela seeks to collect some oil payments via Rosneft," Reuters, April 23, 2019, https://www.reuters.com/article/us-venezuela-politics-rosneft-exclusive-idUSKCN1RU2A4.

16 Verma, Nidhi. "India's Venezuelan June Oil Imports Highest in Seven Quarters: Trade," Reuters, July 26, 2019, https://www.reuters.com/article/us-india-oil-idUSKCN1UL2H6.

17 "Rosneft Annual Report 2018," Annual Report. PSJC Rosneft, 2019, https://www.rosneft.com/upload/site2/document_file/a_report_2018_eng.pdf; Petlevoi, Vitaly. "«Роснефть» Отказалась Работать в Иране [Rosneft Refuses to Work in Iran]," Vedomosti, December 12, 2018, https://www.vedomosti.ru/business/articles/2018/12/12/789170-rosneft; and "Concept of the Foreign Policy of the Russian Federation," The Ministry of Foreign Affairs of the Russian Federation, November 30, 2016, http://www.mid.ru/en/foreign_policy/official_documents/-/asset_publisher/CptICkB6BZ29/content/id/2542248.

18 "«Роснефть» Вложит Более $2 Млрд в Крупнейшее Месторождение Газа в Египте [Rosneft Invests Over $2 Billion in Egypt's Largest Gas Field]," РБК, November 14, 2017, https://www.rbc.ru/rbcfreenews/5a0aecc49a79470f16c82915.

19 Derived from Rosneft's financial statements from 2017-18.

20 Farouk, Ehab, and Yousef Saba. "UPDATE 1-Egypt's Zohr Gas Field Output Rises to 2.7 bln Cubic Feet per Day - Minister," Reuters, August 21, 2019, https://af.reuters.com/article/commoditiesNews/idAFL5N25H1VW.

Skirting Sanctions: Domestic Credit

Before Western sanctions, Rosneft frequently partnered with Western financial institutions to secure funds for its largest, most important deals; facilitate the issuance of eurobonds on international capital markets; and orchestrate equity offerings. With Western sanctions, Rosneft has been unable to access international debt markets directly, and it is unlikely to find equity investors to meet its valuation of new shares. This has forced Rosneft to rely on smaller domestic banks, a shallower domestic bond market, and oil shipment prepayments. Despite this, Rosneft increased its long-term borrowing between 2014 and 2018, bucking the trend shown by competitors, such as Lukoil, Eni, Equinor, and Sinopec.

Bond Issuance

Prior to Western sanctions, Rosneft used both USD eurobonds and domestic ruble-denominated bonds to secure financing. In the build-up to the USD 55 billion takeover of TNK-BP in late 2012, Rosneft issued a two-tranche USD 3 billion eurobond with the help of Western institutions, including Barclays, Citigroup, and JP Morgan. Between October 2012 and December 2013, Rosneft accompanied the eurobond with multiple domestic bond issuances totaling roughly USD 4 billion at the time.[21]

Between 2014 and 2018, Rosneft raised USD 46.62 billion through the issuance of bonds on the domestic market.[22] Rosneft did not raise any capital through the issuance of eurobonds because sanctions had made it effectively impossible. Rosneft's coupon rate was between 7.30% and 9.40%, with the bulk of bonds 10-year issuances at 7.60%. Rosneft's WACC cost of debt (after tax) fluctuated between 2.88% and 3.55% from 2014 to 2017, before jumping to 8.44% in 2018. As seen in Graph #1, this cost of debt is comparable to domestic competitors' level, specifically Lukoil and Gazprom. Western competitors Eni and Equinor were able to source significantly cheaper debt, holding a WACC cost of debt (after tax) roughly around 0.91%. Sinopec, the Chinese state-owned energy company, availed itself of a WACC cost of debt (after tax) of 2.37% over the period. It is important to note that, prior to 2014, Rosneft's WACC cost of debt (after tax) was also above Western competitors due to the relative weakness of domestic Russian financial markets. During the pre-2014 period, however, Rosneft was able to bypass lower domestic borrowing rates through the issuance of eurobonds.

Loans

Rosneft financed the acquisition of several Yukos assets and TNK-BP through syndicated loans from Western banks for USD 22 billion and USD 31 billion, respectively.[23] These moves allowed Rosneft to become Russia's largest crude oil producer in 2007 and then become the world's largest publicly traded oil company in 2013, passing ExxonMobil for global oil production in the process.[24]

In the period from 2014 to 2018, however, it is clear that Rosneft was not able to secure a major loan directly from Western banking institutions. As seen in Table #1, Rosneft responded by increasing its RUB-denominated bank loans while simultaneously reducing its borrowings in USD/EUR by paying off liabilities incurred prior

21 "Rosneft Annual Report 2017," Annual Report. PSJC Rosneft, 2018, https://www.rosneft.com/upload/site2/document_file/a_report_2017_eng.pdf.
22 Approximately 2.9 trillion in Russian Rubles (RUB). This figure is converted at 62.2076, the average RUB/USD exchange between December 2014 and December 2018.
23 IQ.HSE. "Роснефть Привлекла Кредиты На $22 Миллиарда [Rosneft Attracted $22 Billion in Credit]," National Research University Higher School of Economics, March 20, 2007, https://iq.hse.ru/news/177692775.html.
24 "Роснефть привлекла $14,2 млрд для приобретения 50% ТНК-ВР у AAR [Rosneft Attracted $14.2 Billion To Acquire 50% of TNK-BP from AAR]," РИА Новости, February 13, 2013, https://ria.ru/20130213/922681805.html; and IQ.HSE. "Роснефть Привлекла Кредиты На $22 Миллиарда [Rosneft Attracted $22 Billion in Credit]," National Research University Higher School of Economics, March 20, 2007, https://iq.hse.ru/news/177692775.html.

Table 1: Rosneft's Long-Term Liabilities Between 2014 - 2018 (RUB billions)

Type	Currency	2014	2015	2016	2017	2018
Bank Loans	RUB	143	41	173	326	423
Bank Loans	USD, EUR	2067	1741	1107	878	921
Bonds	RUB	138	138	321	427	461
Eurobonds	USD	408	483	337	213	177

Values expressed in RUB at reporting period exchange.

Source: compiled from Rosneft's 2014-2018 Financial Statement

to 2014. Rosneft provides little information on the sources of its bank borrowing, but a window into the process is provided by a 2017 loan from Sberbank, a Russian state-owned bank. Rosneft secured the RUB 124.9 billion loan from Sberbank as part of an uncompetitive public procurement process.[25] A report by Bloomberg, however, indicates that sanctioned Russian banks, such as the Credit Bank of Moscow, may also be able to channel Western funds to Rosneft through the use of special purpose vehicles (SPVs) domiciled in lax regulatory environments, such as the Republic of Ireland.[26]

Equity Financing

In 2006, Rosneft conducted its initial public offering (IPO), raising USD 10.6 billion by selling 14.8% of its shares on the London Stock Exchange (LSE) and Russian stock market. International investors included international oil companies such as BP, Petronas, and CNPC. The issuing of global deposit receipts (GDRs) on the LSE was conducted with the support of J.P. Morgan and Morgan Stanley.[27]

In 2016, Putin announced that Rosneft would "privatize" a 19.5% share in the company, held by the Russian government, as a way to plug a hole in the government budget deficit.[28] At the time, the deal was heralded as a sign that sanctioned Russian firms were able to bypass Western sanctions. It was later reported, however, that Russian state-owned banks may have financed USD 8.5 billion of the USD 11.57 billion deal.[29] The purpose of the privatization was ostensibly to raise funds for the Russian government, not to raise capital for Rosneft through equity financing. Yet, the dearth of willing investors and likely financial intervention by the Russian government to incentivize eventual investors signals that international equity investors had a limited appetite for Rosneft's stock.

Prepayment Financing

Since 2005, Rosneft has received prepayments on

25 Malyarenko, Evgeniya. "«Роснефть» Заключила Со Сбербанком Кредитный Договор На 124,9 Млрд Руб [Rosneft Concludes Loan Agreement with Sberbank for $124.9 Billion Rubles]," РБК, July 12, 2017, https://www.rbc.ru/business/12/07/2017/59654c8e9a7947fb700de7a6.
26 Rudnitsky, Jake, and Donal Griffin. "Rosneft Takes Irish Detour Around Sanctions With Moscow Bank," Bloomberg, May 8, 2018, https://www.bloomberg.com/news/articles/2018-05-08/rosneft-takes-irish-detour-around-sanctions-aided-by-moscow-bank.
27 Smotrov, Aleksandr. "На Лондонской Бирже Начнется Свободное Обращение Ценных Бумаг Роснефти [Free Circulation of Rosneft Securities Begins on the London Stock Exchange]," РИА Новости, July 19, 2006, https://ria.ru/20060719/51540282.html.
28 Bierman, Stephen, Elena Mazneva, and Ilya Arkhipov. "Putin Sees Rosneft Sale as Soon as This Year to Ease Budget," Bloomberg, September 2, 2016, https://www.bloomberg.com/news/articles/2016-09-02/putin-sees-rosneft-sale-as-soon-as-this-year-to-ease-budget-pain.
29 Voronova, Tatiana, Oksana Kobzeva, and Dmitry Zhdannikov. "Exclusive: Russian State Bank Secretly Financed Rosneft Sale After Foreign Buyers Balked," Reuters, November 9, 2018, https://www.reuters.com/article/us-rosneft-privatisation-exclusive-idUSKCN1NE132.

future oil sales as a method of financing. Through this set-up, Rosneft signs a contract to sell a designated quantity of oil over a period of time, and, in return, the partner prepays a percentage, often at a discount, at an earlier date. Rosneft has used this method several times with Chinese banks and energy companies and independent oil traders, principally Glencore, Trafigura, and Vitol.

Rosneft received USD 6 billion in prepayment from Chinese banks during the takeover of Yukos' assets and, in 2009, split USD 26 billion with Transneft as a part of a prepayment plan for the construction of the East Siberian-Pacific Ocean Pipeline.[30] In 2013, burdened by the high debt load from the TNK-BP deal, Rosneft signed a USD 10 billion prepayment deal with Glencore and Vitol and a 25-year, USD 270 billion deal with CNPC.[31] Putin announced that the deal with CNPC would provide USD 70 billion in prepayment, but more recent estimates, accounting for the drop in oil prices, put the value closer to USD 35 billion.[32]

Rosneft has continued to seek out prepayment financing since the imposition of Western sanctions, but has found it difficult to orchestrate deals of similar value. Rosneft expanded cooperation with CNPC in 2017, but was unable to secure additional prepayments as part of the deal.[33] In 2018, Nayara Energy, effectively Rosneft's Indian subsidiary, acquired USD 3 billion in prepayments from a syndicate of Western financial institutions, reported to include ABN Amro, BP, Deutsche Bank, and Trafigura.[34] While modest compared to earlier pre-sanction deals, the willingness of Western actors to go forward with the deal, despite sanctions fears, bodes well for Rosneft. Trafigura, in particular, has emerged as Rosneft's closest oil trading partner since 2014, becoming Rosneft's second-largest trade partner and acquiring a stake in Nayara Energy.

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30 Kramer, Andrew E. "Rosneft to Send $60 Billion Worth of Oil to China," New York Times, June 20, 2013, https://www.nytimes.com/2013/06/21/business/global/rosneft-to-send-60-billion-worth-of-oil-to-china.html.

31 Chaturvedi, Shruti. "Rosneft Finalizes $10 Billion Oil-for-Loan Deal with Glencore, Vitol," Reuters, March 6, 2013, https://www.reuters.com/article/us-rosneft-traders-contracts-idUSBRE9251N620130306.

32 Фадеева, Алина. "«Роснефть» Увеличивает Поставки Нефти в Китай [Rosneft Increases Oil Deliveries to China]," Vedomosti, January 9, 2017, https://www.vedomosti.ru/business/articles/2017/01/10/672282-rosneft-postavki-kitai.

33 Ibid.

34 Verma, Nidhi, and Julia Payne. "Exclusive: Trafigura, BP Increase Loans to Russia-Backed India Refiner to $3 Billion," Reuters, November 23, 2018, https://www.reuters.com/article/us-india-nayara-bp-trafigura-beheer-excl-idUSKCN1NS0DD.

High Leverage and Costly Debt: Rosneft's New Normal

Rosneft now finds itself in a bind by which it is more leveraged than its domestic and international competitors, while it also forced to pay a higher rate for credit. Sanctions have taken their toll, but the situation has been exacerbated by the 2014-16 drop in oil prices and the stagnating Russian economy. The chief effect of sanctions has been that Rosneft has been forced to rely on Russian financial institutions. As shown in Graph #1, the cost of debt financing for Russian energy firms consistently has been higher than Western and Chinese competitors in the past decade. A key influencing factor is that higher interest rates in the Russian market drive up the costs of sourcing debt domestically. Until sanctions were imposed, Rosneft was able to look to Western markets to finance deals in order to lower the cost of debt. As a consequence, shown in Table #2, Rosneft has increased the share of RUB-denominated loans in its debt portfolio since 2014, while Gazprom and Lukoil, both of which can use Western debt instruments, have maintained a majority of non-ruble debt.

To compound issues, in summer 2014, world oil prices dropped from a three-year average of USD 110 per barrel to an average of USD 50 from early 2015 to the fall of 2017. The price drop drove down oil companies' projected earnings causing their share price and market capitalization to shrink. This price decrease forced the percentage of debt in the companies' capital structure to rise. Most of Rosneft's international competitors, as shown in Graph #2, responded by deleveraging to reduce their debt burden.

Rosneft, however, was already far more leveraged than competitors before the crash because of heavy borrowing in 2012-13 to finance the TNK-BP takeover. Rosneft went into 2014 with the goal of de-leveraging and, against the headwinds of the oil crash, managed to reduce its debt-to-capital ratio from 53% to 48% by the end of 2015. But, instead of further deleveraging as oil prices rebounded in 2017, Rosneft doubled down on its high volume of debt and has maintained a position far above competitors.

Rosneft has faced a trade-off since 2014: invest heavily in domestic and international expansion while relying on domestic credit or retrench and de-lever to weather the storm of sanctions and volatile oil prices. Rosneft has decisively chosen the former. It has been able to so because the Russian government has been willing to fill the void vacated by Western financiers: state banks provide the loans, and tax breaks protect the bottom line. Furthermore, because Rosneft's revenue is largely denominated in foreign currencies, ruble depreciations lessen Rosneft's effective debt load.

As a result, the risks associated with Rosneft's decision to pursue expansion, financed by willing state and corporate lenders, are borne not by the company, but by the state, society, and economy at large. Even with its high debt and interest rates, Rosneft is far from a troubled financial position. Its times interest earned ratio, a proxy for a company's capacity to repay debt, is low for the industry, but more than adequate to assuage fears of bankruptcy; revenues rebounded in 2018 after stagnating the previous three years; and the government has signaled a willingness to direct the necessary credit to fuel expansion.[35]

35 "Financial Statements for Rosneft," Bloomberg Terminal, April 2019.

Graph 1 : Cost of Debt After Tax

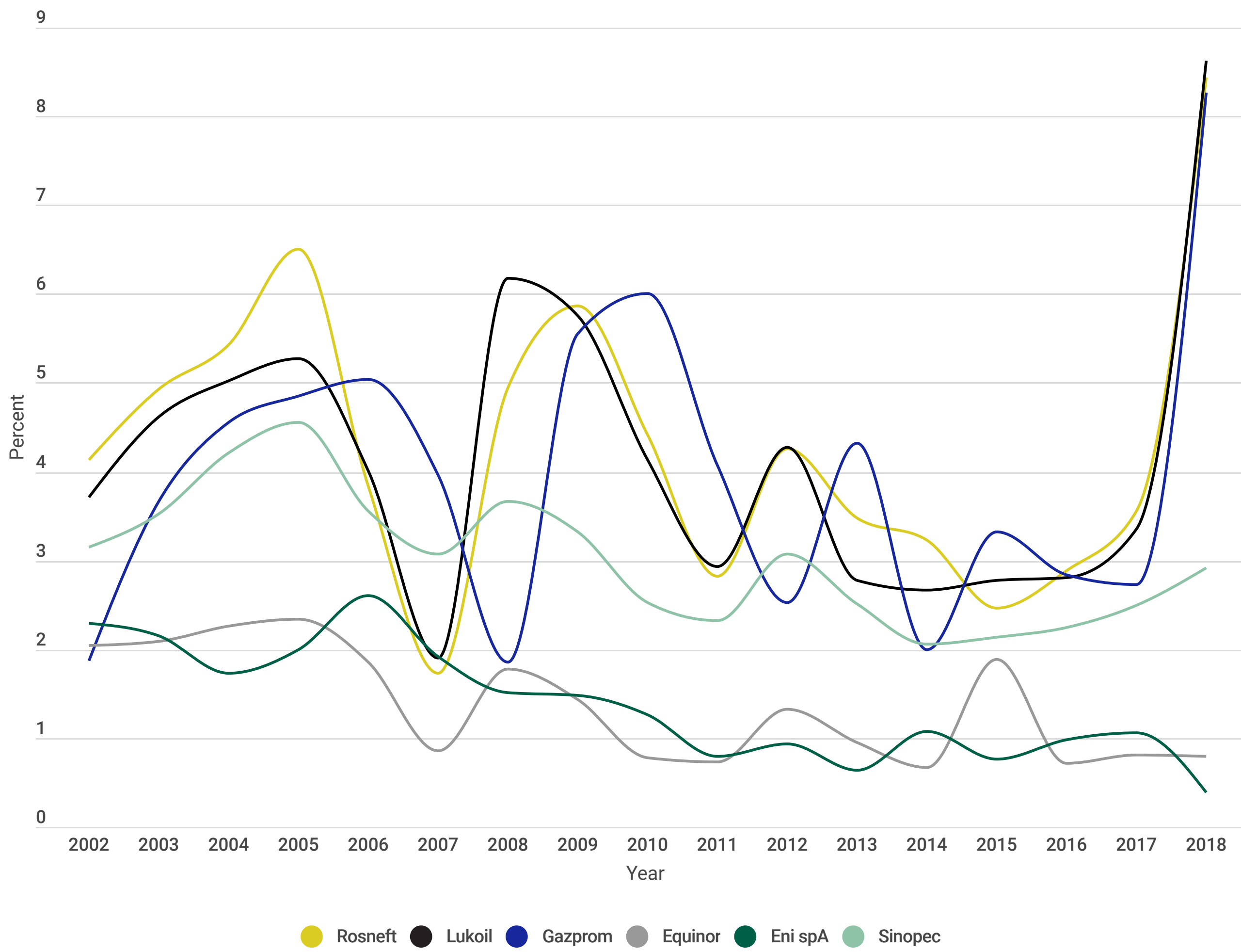
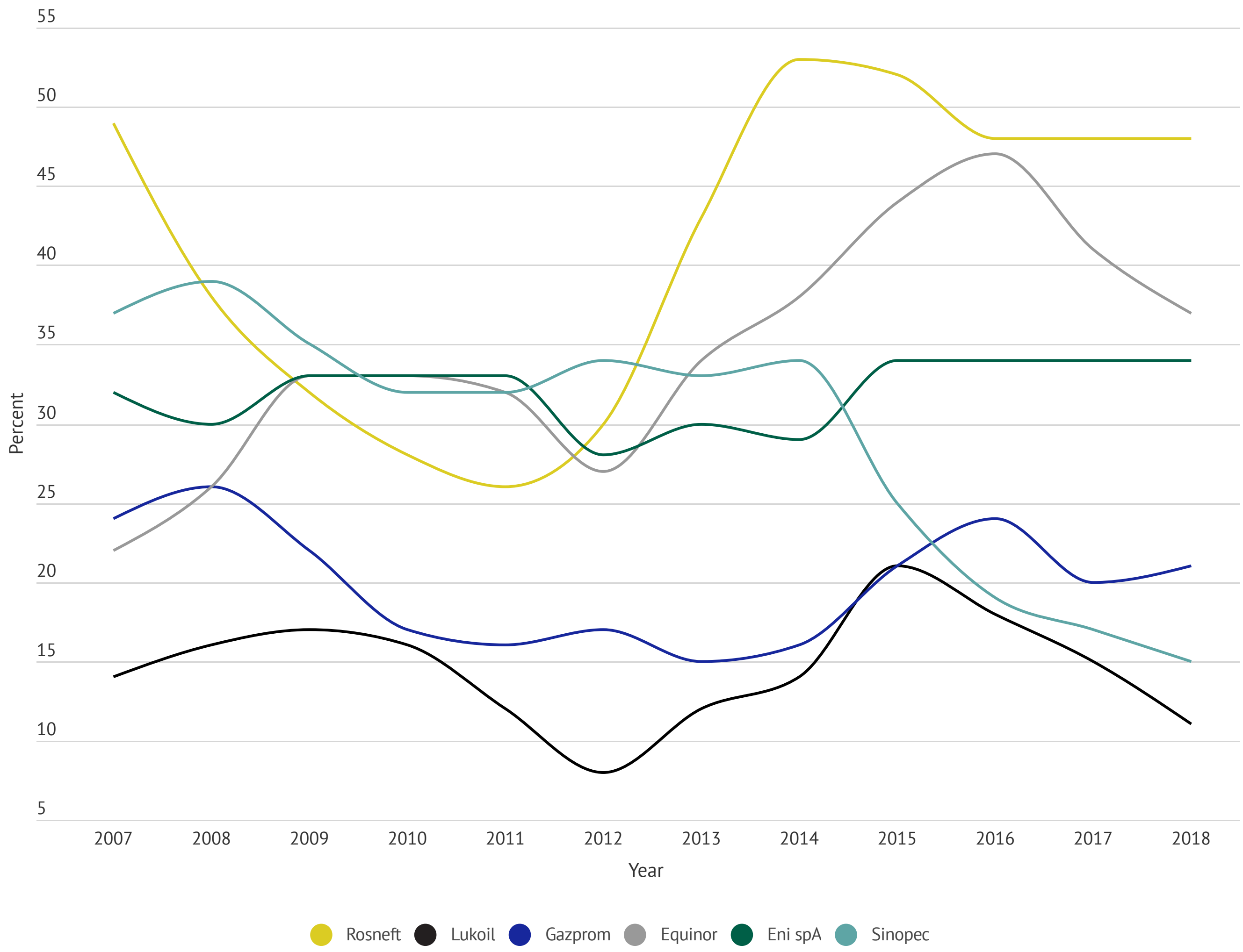


Table 2: Percentage of Total Debt Denominated in Given Currency

	2011	2012	2013	2014	2015	2016	2017	2018
Rosneft								
USD/EUR	89%	79%	86%	84%	86%	62%	42%	42%
RUB	11%	21%	13%	11%	10%	35%	50%	50%
Other	0%	0%	1%	5%	4%	4%	9%	8%
Lukoil								
USD	65%	93%	94%	85%	89%	80%	89%	-
EUR	3%	4%	5%	5%	8%	7%	8%	-
RUB	31%	3%	0%	0%	0%	10%	0%	-
Other	1%	0%	1%	10%	3%	3%	3%	-
Gazprom								
USD	-	-	-	46%	48%	37%	33%	-
EUR	-	-	-	27%	25%	27%	31%	-
RUB	-	-	-	25%	24%	31%	30%	-
Other	-	-	-	2%	2%	5%	6%	-

Source: Compiled from Rosneft Consolidated Financial Reports (2012-2018); Gazprom Financial Reports (2014 -2017); and LUKoil's Analyst Databook 2017 and LUKoil 2012 Consolidated Financial Statements US GAAP.

Graph 2: Debt-to-Capital Ratios



Rosneft Plants the Flag: But at What Cost?

The real cost of the Russian government's willingness to bankroll Rosneft's expansion is manifested through distortions in Russian financial markets, reduced competitiveness in the domestic oil sector, and elite competition over rents. These costs directly contribute to the structural weakness of the Russian economy, but, for the Kremlin, that is far less important than Rosneft's political value. In a larger sense, this dynamic exemplifies the trade off at the heart of Putin's Russia—market efficiency and long-term economic growth are easily sacrificed for political control at home and power projection abroad.

The decision for Russian banks to provide credit to Rosneft is, on the face of it, a prudent decision. Compared with other possible domestic targets, Rosneft has predictable, stable cash flows; comparatively transparent reporting practices; and clear support from the government. In an ideal situation, however, efficient financial markets should direct savings toward projects that create value. Rosneft's recent projects in Venezuela and Iraq are high-risk and politically motivated. Furthermore, of all the sectors in Russia, the energy sector seems like the least in need of support from Russia's development bank, VEB. Facing stagnant growth in many sectors, directing limited funds toward the oil company's global expansion and domestic consolidation bears clear opportunity costs when compared to the long-term growth potential of greater investment in education, infrastructure, and financial services for small- and medium-sized businesses.

This dynamic is compounded by the fact that Rosneft now relies heavily on domestic bond issuances. Due to Rosneft's strong ruAAA credit rating, the highest given by the Russian credit agency ExpertRA, the company draws investment away from other debtors. In keeping with the logic of efficient financial markets, the problem isn't that creditors are illogically funneling savings toward Rosneft, but that suddenly savings are being directed away from other projects. Where before Western creditors provided a base of savings for Rosneft, now the already shallow Russian domestic financial market is being forced to accommodate the far more competitive and credit-heavy oil giant.

The decision by the Kremlin to back Rosneft has created tension in the domestic oil sector, which, due to the links between power and oil in Russia, necessarily bears political consequences. In the wake of the confrontation with the West, the Kremlin has prioritized international power projection and directed both state and non-state organs to this objective. Rosneft, under Sechin, has committed significant resources toward this project and achieved results. This, in turn, has empowered Sechin to act more aggressively domestically to consolidate control over the oil sector and increasingly target the natural gas sector.

Experts long have argued that Putin prefers to keep elite squabbles behind closed doors in order to hide cracks in the regime from the public. All the same, it appears highly probable that Sechin played a key role in the very public takeover of Bashneft, which resulted in criminal charges against Yevgeni Yevtushenkov, a largely apolitical Russian oligarch, and Alexey Ulukayev, who was serving as the Minister of Economic Development at the time.[36] Sechin's ability to instigate and win battles against other high-level elites in the public view clearly signals his clout.

More recently, Sechin again has become involved in a public battle, this time with Nikolai Tokarev,

36 Walker, Shaun. "Ex-Minister's Harsh Jail Sentence Sends Shockwaves through Russian Elite," The Guardian, December 15, 2017, https://www.theguardian.com/world/2017/dec/15/russia-jails-former-economy-minister-alexei-ulyukayev-for-corruption.

"The real cost of the Russian government's willingness to bankroll Rosneft's expansion is manifested through distortions in Russian financial markets, reduced competitiveness in the domestic oil sector, and elite competition over rents. These costs directly contribute to the structural weakness of the Russian economy, but, for the Kremlin, that is far less important than Rosneft's political value."

the head of the state-owned pipeline company Transneft. It has its origins in reports that crude oil, extracted by Rosneft and transported through the Druzhba pipeline by Transneft, is contaminated, forcing shutdowns downstream at refineries and sullying the reputation of Russian oil standards. Each company has accused the other of being responsible. Tokarev also is reported to be close to Putin, who has yet to intervene.[37] Instead, the internecine battle continues to rage across domestic and international news outlets.

The battle with Bashneft and Transneft is not increasing Rosneft's operational efficiency nor increasing Russia's position as an oil exporter. If anything, it is reducing competitiveness in the industry, increasing the opportunity for graft, and hiding the real issues: a lack of investment in decaying Soviet-era infrastructure and scarce resources being directed away from improved production methods. Likewise, sacrificing long-term economic growth to sustain Rosneft's expansion is not going to recharge the Russian economy.

The Kremlin knows this is the real problem, but has so far been incapable or unwilling to make the necessary changes. Sanctions were intended to raise the costs of Russia's malign activity and limit the Kremlin's space for economic maneuver. In the past five years, Putin has shown that his regime is willing to pay high costs to maintain the instruments of political control, face down public protests, and deploy power abroad. Rosneft has survived sanctions because Putin has prioritized the state-owned enterprise, but that doesn't mean sanctions have been fruitless. The cost of sanctions are just being paid elsewhere in the economy.

37 Soldatkin, Vladimir. "Russia's Transneft Rebukes Rosneft over Tainted Oil Crisis," Reuters, July 8, 2019, https://www.reuters.com/article/us-russia-transneft-rosneft-oil-idUSKCN1U31VX.

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