Projects to finance

The decision of a Houston bankruptcy court not to deal with the Yukos case has given the merger of Gazprom and Rosneft a fresh start. The deal's structure may have slightly changed since it was announced last autumn, but the consequences for foreign investors remain positive. Andrei Konoplyanik examines the new shape of Russia's energy industry and explains why Moscow must ratify the Energy Charter Treaty

MONTHS OF uncertainty over the future of the proposed Gazprom-Rosneft tie-up came to an end in March as government and company officials thrashed out the details of the merger's small print.

On 14 March, according to the Russian energy minister, Victor Khristenko, representatives of three government ministries and the leadership of Gazprom and Rosneft agreed on how the two companies will be combined. The word from Khristenko is that the merger plan will be finalised by June.

According to Sergei Oganesian, head of the state federal agency on energy, the new company's structure will be similar to a recent description given by Gazprom's chairman, Alexei Miller. In a plan that he claims already has government approval, Miller says Gazprom would become 100% owner of Rosneft. In exchange, the state would receive a minimum 50% plus one share controlling stake in the world's biggest natural gas producer – 0.54 trillion cubic metres (cm) in 2004. Rosneft would be integrated without its recently purchased asset, Yuganskneftegaz.

As a result, Gazprom would inherit a much stronger oil position. Last year, the group produced 12m tonnes of crude oil, the addition of Rosneft, which produced 21.6m tonnes of crude in 2004, would bring the consolidated total to 33.6m tonnes a year, making Gazprom the sixth-largest oil producer in Russia (see Table 1).

Table 1: Russia's biggest oil producers, 2004

	million tonnes
Lukoil	84.0
TNK-BP	70.0*
Surgutneftegaz	60.0
Yuganskneftegaz	51.7
Sibneft	34.0*
New Gazprom	33.6†
Yukos	33.3†

*Excludes Slavneft †Excludes Yuganskneftegaz

Re-establishing control

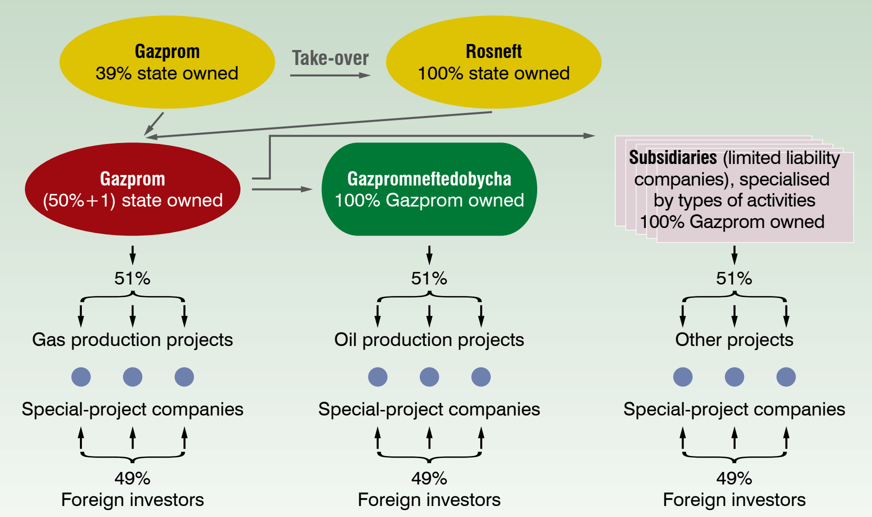
Re-establishing state control over Gazprom paves the way for the removal of the ban on foreigners owning shares in the gas monopoly, which should attract large inflows of foreign investment into the stock and to capital-intensive energy projects. Interest is expected to be particularly strong in upstream projects in frontier areas, such as eastern Siberia and Russia's far east (see p28).

As the main shareholder, the state can order the company to implement state priorities – such as the rapid development of frontier resources and the development of the unitary gas-supply system, owned by Gazprom by law.

But it must permit the company to do so within a framework that allows the organisation to be profitable. Forcing it to implement state priorities in a sub-economic way will inevitably fail: the financial resources required are so huge that it would be impossible to attract them by non-economic methods within an emerging market-based economy, especially from international capital markets.

Andrei Konoplyanik

Figure 1: Gazprom and foreign investors – how it may work



There is a great deal at stake for Russia. A study released in December by the ministry of economic development and trade (MEDT) forecasts that bringing the Kovykta and Schtokmanovskoye gasfields on stream in 2007-2008 and 2010 respectively will enable an increase in Russian gas production by 2015 to 0.765 trillion cubic metres a year (cm/y). But if those two fields are not developed, production will reach 0.690 trillion cm/y. Gas exports would reach 266bn if development does not proceed this decade and 307bn cm/y if it does.

If there is a danger of the corporate governance machinery breaking down, foreign investors will stay away

MEDT forecasts that some $160bn will be needed between 2005 and 2015 in the upstream gas industry – or $122.5bn if Kovykta and Schtokmanovskoye are not developed. Given such large project costs, international capital will be a *sine qua non*. It also says that to implement projects of this size, the state would need to introduce production-sharing agreements and develop an attractive investment climate, without obtaining funds from the federal budget.

To attract private-sector investment of this magnitude, the firm must be run efficiently, notwithstanding state ownership of more than half of its equity. If there is a danger of the corporate governance machinery breaking down, foreign investors will stay away.

Project financing

New projects are most likely to be funded with project financing – typical for greenfield upstream mega-projects in areas that lack economic infrastructure. Debt has become the dominant element in financing packages. The equity:debt financing ratio in the Baku-Tbilisi-Ceyhan oil pipeline, for example, is 30:70 and 20:80 in the case of Sakhalin-2.

As the scale of developments has increased, financing costs have become a much more important part of project economics. Similarly, the availability and cost of capital have become major factors in determining the competitiveness of energy projects in capital markets and their attractiveness to potential investors.

This will have a significant bearing on how the industry is structured. The new state-run company will have to set up wholly owned special-purpose units for each project. Before that, internal restructuring will be needed to make investment flows transparent and to eliminate cross-subsidies within the company that might prevent project financing arrangements from being put in place.

The ECT would diminish investment risks, driving down the financial component of production costs

In Gazprom's case, financial and legal unbundling has already taken place within the firm's vertically integrated structure, creating units responsible for gas and crude production, processing, transportation and underground storage, and creating financial transparency.

Special-purpose companies

These new business divisions are, in turn, likely to create fully owned special-purpose companies for individual projects, although the mother company itself is likely to take on gas-production projects. Up to 49% of the shares in specialised project units may be offered to foreign and domestic investors (see Figure 1).

This type of structure – and Gazprom's drive for diversification into areas such as liquefied natural gas (LNG) and power generation – will mean a greater number of links in the chain of operations, ranging from production to end-use. Projects are, therefore, likely to be more capital intensive and in greater need of risk diversification. This could take the form of an exchange of assets between partners in different segments of the value chain or in different countries. One example involves – according to press speculation – Shell swapping 7 percentage points of its 55% stake in Sakhalin-2 for a share in Gazprom's Schtokmanovskoye project.

Bankable mega-projects

The need for mega-projects to be bankable will also catalyse pricing reform in the Russian gas industry, with domestic gas prices being lifted to cost-reflective levels that will enable an appropriate rate of return (also encouraging more efficient use of gas).

The new state-owned company will have to fund its share at first from equity, which could be raised *inter alia* by issuing corporate bonds. The credit rating of the company has risen recently (in December, Moody's Investors Service raised Gazprom's rating from speculative Ba2 to investment grade Baa3, because of its "growing strategic influence" on the Russian economy) and is likely to improve when the merger is completed. Borrowing limits for the enlarged company will also be higher. Project financing will be used for the implementation of most capital-intensive development and production phases of the projects.

Ratify the ECT

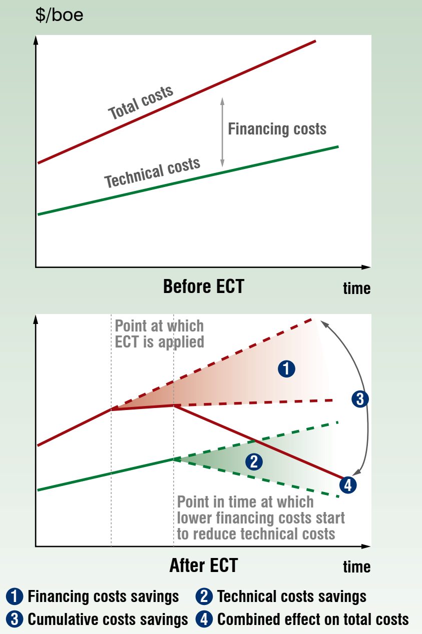
Consequently, the sooner Moscow ratifies the Energy Charter Treaty (ECT) the better for Russia. The ECT is the only multilateral instrument of international law within Eurasia that provides the requisite legal guarantees to investors, both Russian and non-Russian (see box). As long as it remains unratified, Russia will be at a disadvantage when it comes to cross-border energy trade and attracting capital.

Russia needs to lower costs in the oil and gas industry more than other similarly resource-rich countries. Distances to markets are long, production at major fields is falling, geology is complex and natural conditions are harsh. Cutting technical costs can help achieve this, as can reducing financing costs.

The ECT would diminish investment risks, driving down the financial component of production costs (see Figure 2). Lower capital costs would expand capital supply, through foreign direct investments – plus with domestic companies raising funds on the international market – and by stemming capital flight. In turn, that will enable technical costs to decline.

ECT and its instruments provide a legal framework for investments, reducing risk by lowering technical and financing costs and maximising the economic potential of projects. Its ratification by Russia will enable the multi-billion dollar investment projects to go ahead by making them more attractive to capital markets and acceptable to project financiers. That will stimulate economic development in new regions through the multiplier effects of those projects. □

Figure 2: The effect of ECT on project "X"



The Energy Charter Treaty

THE ENERGY Charter Treaty (ECT) and the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects were signed in December 1994 and entered into legal force in April 1998. To date the ECT has been signed or acceded to by 51 states plus the European Union.

The treaty is a legally binding multilateral instrument, the only one of its kind dealing specifically with inter-governmental co-operation in the energy sector. Its fundamental aim is to strengthen the rule of law on energy issues, by creating a level playing field of rules to be observed by all participating governments, therefore, minimising the risks associated with energy-related investments and trade.

The ECT's provisions focus on five broad areas:

- The protection and promotion of foreign energy investments, based on the extension of national treatment, or most-favoured nation treatment (whichever is more favourable);
- Free trade in energy materials, products and energy-related equipment, based on WTO rules;
- Freedom of energy transit through pipelines and grids;
- Reducing the negative environmental effect of the energy cycle by improving energy efficiency; and
- Mechanisms for the resolution of state-to-state or investor-to-state disputes. □

Andrei Konoplyanik is deputy secretary-general of the Energy Charter Secretariat in Brussels. www.encharter.org