ConocoPhillips-Lukoil

One strange cocktail

by Vipal Monga

On Sept. 29, 2004, Houston-based **ConocoPhillips** announced it was paying $2 billion to buy a 7% stake in Russian oil giant **OAO Lukoil** from the Russian government. The news came amid a charged backdrop of war in Iraq and soaring oil prices fueled by strong demand from the U.S. and China. In Russia, President **Vladimir Putin** was worrying the markets by moving to take control of privately held oil producer OAO NK Yukos, the country's largest oil producer.

Despite this volatile landscape, ConocoPhillips and Lukoil managed to complete the largest privatization in Russian history and the largest investment ever by a U.S. company in Russia. A 7.6% stake has since grown to 10%, and an additional $3 billion could raise that share to 20% over the next two to three years. Conoco now has one representative on Lukoil's board, and the two companies will collaborate on joint ventures in Northern Russia's Timan-Pechora oil region and possibly in Iraq's West Qurna oil fields.

The deal was a deal of the year not just for its significance but also because it was a creative solution to strategic problems both sides faced. Conoco, the third-largest U.S. oil company, gained access to billions of barrels in Russian reserves and a chance to develop fields in Iraq, while Lukoil obtained the backing of a respected U.S. oil company. For Lukoil, garnering Conoco's support was a key driver to getting the deal done, says **Rick Burdick**, a partner at **Akin Gump Strauss Hauer & Feld LLP**, the Washington-based law firm that advised Lukoil.

Lukoil's reserves, the second largest in the world after **Exxon Mobil Corp.**'s, were being valued at a large discount to Western companies' reserves, Burdick explains. In fact, Lukoil's reserves had a $1 per barrel value at a time when reserves held by companies such as **ChevronTexaco Corp.** and Exxon stood at $8 to $9 per barrel chiefly because markets viewed Russian companies with some mistrust. "The Russians saw the valuation issue as significant," Burdick says.

Robert Israel, a partner at New York-based investment bank **Compass Advisers LLP**, which advised Lukoil, says that, from Lukoil's standpoint, partnering with a U.S. oil producer was seen as a step toward convincing international markets that Lukoil was a well-run, transparent organization. But the oil company was wary of ceding control. "From the Russian side, they tend to look at U.S. companies as overbearing, bureaucratic and arrogant," he says.

This was a major point. Lukoil was looking for a big partner—but not too big. The company was wary of cutting a deal with a behemoth the size of ExxonMobil, whose market capitalization is about 10 times that of Lukoil, or any of the largest oil companies. "It's sort of their way or the highway," Israel quips. "You can't be equity partners with a company the size of Exxon."

Conoco seemed a perfect fit. For its part, Conoco needed access to new reserves. Oil companies have been investing heavily in developing oil projects on offshore sites or in regions such as West Africa. As the Western oil industry consolidates, it's grown more difficult for a company the size of Conoco to boost its reserves by buying competitors.

Russia has huge oil reserves and big, emerging companies to develop them, but the country, first under the Yeltsin-era oligarchs, then under Putin, was still seen by many as too risky an investment.

"American companies have seen a lot of bad behavior in Russia," Israel says. "Contracts haven't been honored, and deals have been broken."

But despite misgivings on both sides, Israel and Akin Gump lawyers initiated talks in the spring of 2003. It took over a year to get the deal signed.

Conoco CEO **James Mulva** and Lukoil CEO **Vagit Alekperov** spent the better part of 2003 and 2004 flying to cities such as Zurich, London and Paris, meeting in unexpected places to avoid being seen together. They struggled with complex issues of corporate politics and culture. "In a deal like this, senior management have to get together to develop a relationship," Burdick says. "We knew it was going to take time."

Burdick recalls that the process, involving translators, was at times frustrating, as both sides grappled with major uncertainties. Conoco wanted to ensure that its investment would be safe after Putin peremptorily dismantled Yukos, jailing its CEO, **Mikhail Khodorkovsky**.


Burdick


Israel

"You can imagine what happens in the board room when Lukoil management is giving a presentation to Conoco on this deal and Khodorkovsky is arrested and suddenly everybody says private capital in Russia is dead," Israel says.

Ironically, events such as Yukos' breakup and the war in Iraq may actually have helped seal the deal. Given the negative international reaction to Putin's moves, both Lukoil and the Russian government had greater incentive to show that Russia remained open for business. A deal with Conoco would be a counterweight to the Yukos situation.

"All of these, in a strange cocktail, came together to help the deal," Burdick says.

Moreover, with the U.S. embroiled in Iraq, it became expedient to do a U.S.-Russia deal, Israel adds. Both countries wanted to strengthen ties and thought a corporate union would help that cause.

But while the deal was important for the corporate ambitions of the two companies, its ramifications for investing in Russia in general may be more significant. "It shows that a smaller company can gain access to reserves in an area like Russia, while Exxon hasn't been able to expand there," Israel concludes. "It says that if you're a good corporate citizen, you can work within the frame of government legislation and get deals done." ■

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