

The Domestic Limits of International Expansion

RUSSIAN NATIONAL OIL COMPANIES & GLOBAL MARKETS

PONARS Eurasia Policy Memo No. 238
September 2012

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Gazprom and, more recently, Rosneft have both expanded their operations abroad, seeking to establish themselves as major players on the international petroleum market. Most commentators have portrayed this expansion as an orchestrated power grab to dominate global gas and oil markets, particularly in the European context, and an inevitable consequence of Russia's increasingly centralized authoritarian rule. It would be more instructive, however, to consider it as part of a global trend.

Over roughly the past three decades, but especially since the beginning of the 1990s, emerging country national oil companies (NOCs) have increasingly sought to internationalize their operations. In other words, like all multinational corporations (MNCs), they are pursuing investment, production, and employment in multiple countries and regions around the world. More specifically, NOCs seeking to internationalize are trying to become international oil companies (IOCs); that is, to expand their assets and operations abroad to include exploration, production, refining, marketing, and distribution.

This ambition to internationalize has been realized with differing degrees of success. While some have managed to compete successfully with IOCs to win the rights to exploit new and pre-existing petroleum reserves in the developing world (like the China National Petroleum Corporation (CNPC), Petrobras, and Petronas), others have been denied the necessary legal framework and/or investment capital to make this possible (Pemex, Sonatrach, and the State Oil Company of Azerbaijan (SOCAR)).

Viewed in comparative perspective, it is clear not only that Russian NOCs have achieved only a moderate level of success vis-à-vis their counterparts but also that there are considerable domestic limitations to their international ambitions. Counter conventional wisdom, these limits are not related to either the availability of domestic

reserves or the relative technical capabilities of NOCs vis-à-vis IOCs. They can instead be attributed to tensions between NOCs and IOCs that hinder the transfer of technical knowledge and, perhaps more surprisingly, to a divergence of interests between the Russian government and NOC managers regarding internationalization.

International Expansion of Gazprom and Rosneft

Gazprom first signaled its interest in pursuing internationalization in 1998 when it established *Zarubezhneftegaz* with the expressed intent of strengthening its international competitiveness and expanding its activities overseas. During the first half of the 2000s, this primarily took the form of signing gas purchasing and transit contracts with Central Asian governments, beginning with Kazakhstan (2001) and Uzbekistan (2002). But it has undergone two significant transformations since 2005. First, Gazprom expanded its operations in Central Asia to include exploration and production; as of 2012, it had signed agreements to commence such activities in every Central Asian state except Turkmenistan.¹ Second, Gazprom broadened the geographical scope of its operations beyond Central Asia. Although primarily exploratory, the number of countries in which Gazprom now operates has increased markedly. As of 2010, it operates in virtually every region of the world, including Africa, Asia, and Latin America, and has attained exploration licenses in several countries outside the Commonwealth of Independent States, including Algeria (2008), Bolivia (2007), Libya (2006), Nigeria (2009), Venezuela (2005), and Vietnam (2005).

Rosneft's foray into the international arena has been equally diversified but much less impressive in terms of its geographical expansion. Part of the reason for this is that it has occurred more recently. Since 2010, the company has sought to simultaneously expand its downstream and upstream operations abroad. In October 2010 it purchased PdVSA's 50 percent stake in a company (Ruhr Oel) that own stakes in four German refineries and controls approximately 20 percent of Germany's refining capacity.² In that same year, Rosneft signed an agreement to build a refinery in China, as part of a joint venture with CNPC. As of June 2010, it had upstream projects in four countries in three different regions: Algeria and UAE (Middle East and North Africa), Kazakhstan (CIS), and Venezuela (Latin America). Importantly, Rosneft has focused increasingly on acquiring offshore fields, allegedly to improve its own technical capacity to develop such fields. In May 2012, for example, it signed an agreement with Statoil to jointly explore offshore fields in the Russian sections of the Barents Sea and the Sea of Okhotsk and in the Norwegian section of the Barents Sea.³

Russian NOCs in Comparative Perspective

¹ Prior to this, Gazprom's involvement in exploration in Central Asia was limited to the *Tsentrlnaya* field within the Kazakhstani section of the Caspian Sea, in which it is the joint operator (with Lukoil) of *TsentrCaspneftegaz* and owns a 25 percent stake in the project. Gazprom's involvement in production was limited to the *Shakhpakhty* field in Uzbekistan, in which it is the chief operator.

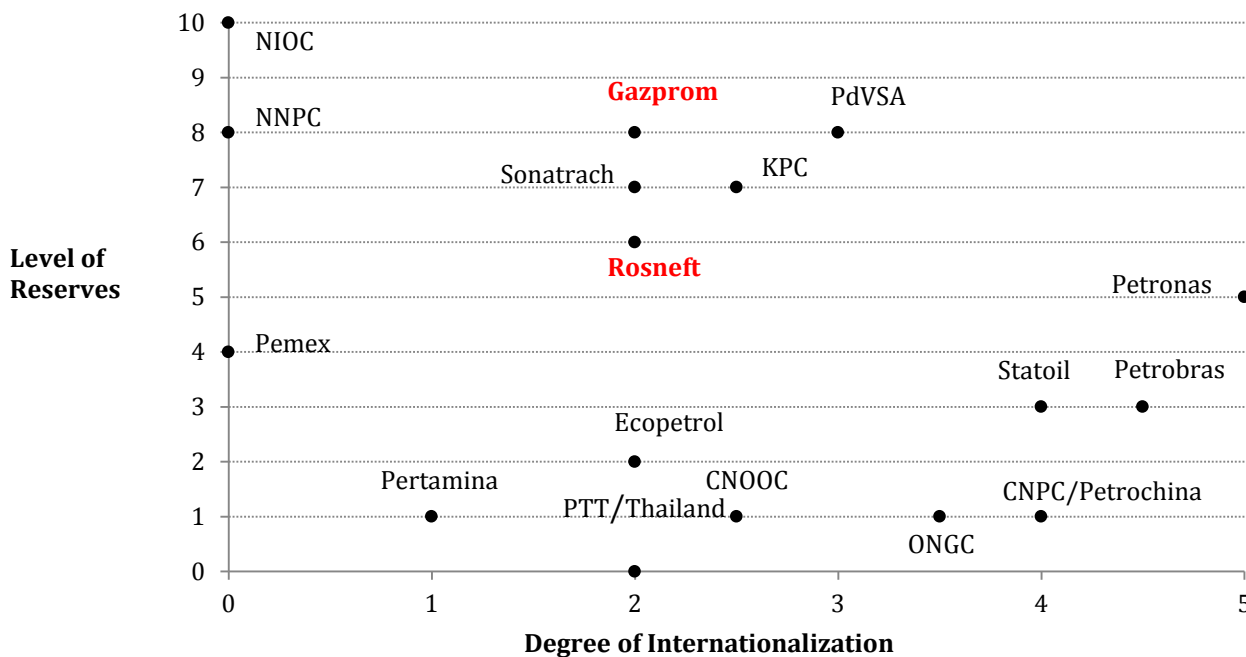
² The other 50 percent is owned by British Petroleum (BP).

³ The agreement also included Rosneft's possible acquisition of stakes in Statoil's international projects.

Despite their efforts to expand operations abroad, Gazprom and Rosneft have actually achieved a fairly modest degree of internationalization. This becomes evident when systematically comparing them to other emerging country NOCs around the world, including those of the other three BRIC countries (Brazil, India, and China).

As illustrated in the figure below, Russian NOCs trail behind Malaysia’s Petronas, Brazil’s Petrobras, China’s CNPC and CNOOC, India’s ONGC, and even Venezuela’s PdVSA and Kuwait’s KPC. This figure is based on an original composite index⁴ that assigns NOCs a “degree of internationalization score” (from 0 to 5) based on individual scores (from 0 to 1) for each of five indicators: a) geographical scope of foreign operations; b) foreign assets; c) foreign production; d) foreign profits; and e) vertical integration. According to this index, emerging country NOCs range from achieving no internationalization at all (0-1) to achieving a high degree of internationalization (4-5). Most fall between these two extremes with a moderate degree of internationalization (1.5-3.5).

Level of Reserves and Degree of Internationalization, 2000-2010



It is important to note that the appraisal given here is a significant departure from most other assessments of Russian NOC performance on internationalization. There are essentially two reasons for this. First, the extant literature offers no single

⁴ For details, see Pauline Jones Luong and Jazmin Sierra, “Crude Ambitions: The Internationalization of Emerging Country NOCs,” paper presented at the LASA Annual Convention, San Francisco, May 2012.

agreed-upon definition of NOC internationalization or clear (and comprehensive) criteria for what constitutes success. As a result, internationalization is often equated with engaging in any kind of activity abroad, from establishing a commercial office to a partnership agreement between two firms to winning a bid for an exploratory block. Second, and relatedly, this literature also routinely relies on a single indicator both to determine whether a NOC has internationalized and to assess the degree of internationalization across NOCs, such as the number of foreign countries in which a NOC has operations abroad.⁵ The problem for analysis is that each indicator clearly privileges some NOCs over others in its assessment of internationalization and none provides an accurate or complete picture of the empirical distribution of outcomes across NOCs.

It is also important to note that the “degree of internationalization score” (DIS) assigned to an NOC is not correlated with the level of reserves it holds. Thus, the typical explanation for why some NOCs are more “internationalized” than others—that they are either net exporters seeking to secure demand for their domestic production or net importers seeking to secure supply for domestic consumption—does not seem to explain the variation in the DIS across NOCs. If it did, we would see higher scores for Mexico’s Pemex and Indonesia’s Pertamina and lower scores for Petronas and PdVSA. The level of reserves does least well in accounting for the majority of NOCs, which fall into the moderate category despite varying levels of reserves.

Domestic Limits to International Expansion

Comparative research on emerging NOCs also suggests that there are two main domestic obstacles to achieving a high degree of internationalization.

The first obstacle is a history of tense relations between the NOC and IOCs. This is usually the product of the political context in which the NOC was created and its role in the nationalization of the petroleum industry—specifically, whether nationalization involved expropriation from IOCs and whether this process was consensual or conflictual. Tense relations can impede success because they have a direct effect on both the willingness and ability of the NOC to acquire the necessary technical expertise and managerial experience to expand abroad. Contrary to the conventional wisdom that NOC internationalization is an inevitable consequence of the diminishing gap in technological capabilities between NOCs and IOCs, this is in no way guaranteed for each individual NOC. Moreover, in most cases, reversing the asymmetrical technical advantage of IOCs vis-à-vis NOCs requires ongoing amicable partnerships with IOCs. Open hostilities can prevent the establishment of partnerships altogether, whereas mutual distrust can undermine the transfer of knowledge from the IOC to the NOC even where such partnerships exist.

The second obstacle is a divergence of interests between the government and NOC managers concerning the benefits of internationalization. Simply put: where one

⁵ Two exceptions include UNCTAD’s Transnationality Index (TNI) and Internationalization Index (II). These measures, however, are not comprehensive; for example, they can measure intensity of foreign operations but not scope and are only available for a few years (see Jones Luong and Sierra 2012 for a detailed critique).

side is less than enthusiastic, the efforts of the other can be undermined through various means. Governments can obstruct the NOC's access to financing and deny it diplomatic support for its overseas ventures. NOC managers can thwart internal reform (including technical as well as managerial improvements) and approach international projects with less vigor and attentiveness than domestic ones. Divergence also imposes a significant opportunity cost: where both sides regard internationalization as essential to the future viability of the NOC itself, there is a much greater likelihood that—on balance—international projects will be commercially rather than politically motivated.

Russian NOCs face both of these obstacles, albeit with some important points of departure from their counterparts in other emerging countries. Tense relations between NOCs and IOCs certainly exist, but they have more recent origins⁶ and the tensions are more a function of professional pride on the part of NOC managers and personnel than nationalism *per se*.⁷ They have nonetheless impeded the establishment of ongoing amicable partnerships with IOCs—even where there is wide recognition that such partnerships are acutely needed (for the development of hydrocarbons in the Russian Arctic, for example). This has been exacerbated, moreover, by the divergence of interests between the Russian government on the one hand and the management of Gazprom and Rosneft on the other regarding the necessity, let alone desirability, of internationalization. In short, managers within both companies consider pursuing exploration, production, and even refining abroad to be an unfortunate distraction from developing their own abundant and superior domestic reserves and to serve a purely political purpose. They express some resentment for being charged with developing inferior fields and taking on less qualified partners to develop them. In their lack of enthusiasm for global expansion, Russian NOCs are again somewhat unique among their counterparts. In most other emerging countries, NOC managers have either initiated expansion (like Petrobras) or readily endorsed the government's global initiatives (like Petronas). It is usually the government that is opposed.

What this means for the global expansion of Russian NOCs, at least in the short-term, is that we are not likely to see much improvement in the degree of internationalization they have achieved up to now. First, the recalcitrance of NOC management will slow down the pace of both acquisitions abroad and their development. Second, the quality and viability of overseas projects will remain fairly low, as the state-led process of internationalization continues to prioritize political goals over economic ones. In sum: NOC internationalization will serve as a fairly blunt political weapon for the Russian government, as these projects are unlikely to bear much fruit (or, as it were, oil and gas).

⁶ Here I am referring to the 1990s when IOCs were denied access to coveted Russian oil fields in favor of domestic oil companies and subsequently faced increasingly insecure property rights.

⁷ Private NOCs actually benefited from not having *neftianiki* at the helm; bankers proved much less resistant to adopting both advanced technology and Western managerial structure and practices (for details, see Pauling Jones Luong and Erika Weinthal, *Oil is Not a Curse*, Cambridge University Press, 2010, Chapter 5).

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