

For Russia, 2003 marked a turning point in strategy. While the country sought to buy into external markets, it decided to ensure foreign ownership of its own assets would be drastically limited.

Sacha Kumaria explains.

Despite huge early promise and perpetual government pronouncements to the contrary, Russia's energy sector is ever more closed to western FDI. Investment occurs on terms strictly dictated by the Kremlin, while legislative uncertainty and aggressive state-owned enterprises (SOEs) are making life difficult for independent oil companies (IOCs) with long-standing investments in Russia. At the same time, these SOEs are availing themselves of Europe's liberalised energy markets and financial institutions, compromising the integrity of both by trading access to vast hydrocarbon reserves for politically guaranteed returns and international legitimacy.

For the western world, the events of 2001 – the inauguration of US president George W Bush, 9/11, Enron and the launch of the Doha Development Round – have dictated the subsequent course of world politics and economics.

Defining moments

For Russia, though, the defining year of the past decade was 2003. In February that year, BP announced that it would invest £6.75bn in the Tyumen Oil Company (TNK), a deal totalling more than twice Russia's inward FDI in 2002. A month later, as rising oil prices pushed up living standards, Russian President Vladimir Putin was re-elected with 71% of the popular vote. And in October, Yukos CEO Mikhail Khodorkovsky was arrested on unspecified and politically motivated criminal charges.

These events represented the end of 'the new Wild West', the decade following the collapse of the Communist state on Christmas Day 1991. Huge fortunes (by western standards) had been made and lost, the economy had seen boom and bust, and corruption and cronyism ran rampant. But, most crucially in the eyes of the newly re-elected president, Russia was perceived as a second-tier nation of regional, not global, stature. Something had to be done.

In 2000, Mr Putin struck a deal with the oligarchs: they could retain their assets but henceforth must follow the letter of the law and keep out of politics. Underpinning this deal was his vision of the modernisation of Russian society: energy profits would first revive the economy, then later the tax revenues produced would fund diversification. During the Yeltsin era, the challenge had been to collect these tax revenues at all.

The rules of the game were thus set: business was a means to a political end. Numerous new taxes were levied on energy firms and, as the oil price rose – averaging \$20 in 2002, \$30 in 2003 and \$40 in 2004 – Mr Putin's challenge was to manage the vast and growing revenues. Thus the legislation to create a stabilisation fund, intended to weaken fiscal temptations and reduce short-term dependence on oil revenues, was approved by the Duma in December 2003. And all further talk of privatisation, including perennial rumours about Rosneft, the last major state-owned firm, ceased.

Unique deal

BP's deal with TNK thus remains unique, both in scale and nature. Atypically, BP purchased a 50% stake in the firm, thus creating TNK-BP. No other western firm had considered an equal

partnership with Russian investors, and the deal was only considered politically palatable because of BP's long-standing presence in Russia.

Ironically, abroad the TNK-BP deal was perceived as representing the dawn of a new era of FDI into Russia – and among the most optimistic observers, of respect for the rule of law – yet it actually heralded the high-water mark. In Russia, developments were leading in the opposite direction.

Throughout 2004, rumours abounded of the Kremlin's decision to sell Rosneft to several Gazprom subsidiaries in return for 10.7% of Gazprom. The state would have owned just over 50% of Gazprom (and thereby Rosneft), further consolidating its role in the energy sector. However the deal, which ultimately fell apart amid Kremlin infighting, was also intended to create an entity capable of absorbing the plundered riches from what former Putin adviser Andrei Illarionov calls "the swindle of the century": the destruction of Yukos.

Political motive

At its peak in 2002, Yukos produced 2% of the world's oil. Over the next four years, it was hounded by a political campaign that saw it presented with back-tax claims of \$28bn and several senior executives imprisoned in Siberia. To finance the tax claims, it was forced to sell its most profitable production subsidiary, Yuganskneftegaz, to the Baikal Finance Group, an opaque entity ultimately revealed to be a subsidiary of Rosneft. And in August 2006, having failed to gain bankruptcy protection in the US, Yukos was ordered by a Moscow court to liquidate its remaining assets, after 30 minutes of deliberation.

The stalking of Yukos by the Russian state spooked many western investors, raising questions about retroactive tax liabilities, due process and the politicisation of the energy sector. IOCs operating in Russia were beginning to face similar issues. In late 2003, the Duma rescinded earlier legislation that had allowed IOCs to sign production-sharing agreements (PSAs) – which fix the legal and taxation arrangements for the life of an investment – with the Russian state. (A mid-2006 report by the state-funded Russian Academy of Natural Sciences even suggested that Exxon, Shell and Total should cede to Russian firms majority shareholdings in PSAs signed in the mid-1990s.)

Interest questioned

In February 2005, minister of natural resources Yury Trutnyev declared that only Russian majority-owned firms would "henceforth" be allowed to bid for extraction licences for "strategic mineral deposits". Yet the pronouncement was followed by the cancellation of Exxon's involvement in Sakhalin-3, leading Exxon CEO Lee Raymond to question Russia's interest in IOCs' capital and expertise.

The ministry remains a thorn in the side of IOCs. In May this year, Mr Trutnyev publicly suggested the reclassification of more than 70 hitherto non-strategic oil and gas fields, several of which are owned or co-owned by western firms. Then in June, he threatened TNK-BP with the revocation of its licences because of "low production" and chastised Royal Dutch/Shell for the cost overruns – which were caused by persistent ministerial inquiries – on the Sakhalin-2 liquefied natural gas project.

While no legislative proposals to alter existing PSA and licensing agreements are yet before the Duma, the near-permanent uncertainty has put off many western investors. Should the ministry try to target Shell for environmental violations, as has been rumoured, the major beneficiary of

such a move would undoubtedly be Gazprom, which is currently negotiating with Shell for a 25% stake in Sakhalin-2 in return for a 50% share of the massive Arctic Zapolyarnoye field. As Chris Weafer, chief strategist at Moscow's Alfa Bank, says: "The state wants to restructure Sakhalin-2. They have tried the carrot and now they are trying the stick."

The proposal replicates deals offered to western IOCs by Gazprom throughout Russia, and to utility firms throughout Europe. Typically, a controlling (or at least 25% blocking) stake in a production or distribution venture is exchanged for a share in an existing and future extraction project. That Gazprom is able to offer such terms is testament to its unique economic and political status. It owns 90% of Russia's gas reserves, enjoys explicit political backing from the Kremlin and has, as of June 2006, a monopoly on the exportation of gas and construction of gas pipelines. As a result, it is the world's third largest company, with a market valuation of \$276.9bn in August 2006.

Reasserting control

In mid-2005, the Kremlin regained majority control of the gas giant (which was borne of the former Soviet ministry of gas in 1992) by purchasing a further 10.7% stake for \$7.1bn. Gazprom has long wielded its clout domestically. For example, it has consistently delayed the building of gas pipelines from the TNK-BP-owned Kovytko gas field, preventing the partnership from exploiting the field while ensuring its continued deference.

But it is Gazprom's aggressive pursuit of overseas assets that is raising serious concerns in Europe – most prominently, its 51% stake in the North European Gas Pipeline (NEGP), which will transport gas under the Baltic sea into Germany. The undersea route, which bypasses the Baltic states, Belarus and Poland, has added around \$3bn to the total cost of the project, leading to speculation that economic considerations are secondary to political motives. Upon completion in 2010, the NEGP will vastly increase Gazprom's access into the lucrative western European market – it currently provides 30% of Europe's gas – while allowing it to bypass and isolate current eastern European transit countries, such as Ukraine and Poland.

In mid-April, the EU publicly declared the importance of diversifying gas supplies. Yet only days later, at a summit attended by German Chancellor Angela Merkel and Mr Putin, Gazprom negotiated with BASF a 49.9% stake in a joint distribution venture in Germany in return for a 24.9% stake in the gas field that will supply the NEGP. (BASF is the second largest gas supplier in Germany through its Wintershall subsidiary.)

Asset swaps

Not to be left out, but unwilling to surrender German assets, Germany's largest gas supplier E.ON traded its distribution network in Hungary (co-owned by the Hungarian state-owned firm, MOL) for a similar 24.9% stake. But, following negotiations with Dutch SOE Gasunie, Gazprom has gained access to a pipeline being constructed to transport gas from the Netherlands to the UK, Europe's most lucrative gas market. In return, Gasunie will receive a 9% stake in the NEGP, created by reducing the German companies' holdings to 20% each and thereby preserving Gazprom's 51% controlling share.

Since (and despite) the Ukrainian crisis in January, Gazprom has also discussed a similar asset swap with Italian SOE ENI, and has signed a 20-year gas contract with Danish SOE Dong Energy A/S. The Russian gas giant also signed a memorandum of understanding with Sonatrach, the vast Algerian state-owned oil and gas firm, in July, which many in Europe fear may be the first step towards a gas version of the Organisation of Petroleum Exporting Companies. Discussions

are also ongoing with now-partner MOL about extending the Bluestream pipeline, which supplies Turkey with Russian gas via the Black Sea, into south-eastern and, ultimately, central Europe.

Gazprom's strategy has been described as 'disaggregation', wherein, through a rapid pace of negotiation, EU member states can be bought off with asset swaps tied to long-term contractual obligations before the EU can devise either a cohesive external energy policy or coherent anti-trust statutes.

Russia has bridled at suggestions that Gazprom be treated differently from any other international firm. Following the EU statement in April, Mr Putin railed against "unfair competition in world markets", and presidential aide Igor Shuvalov affirmed the gas giant's commitment to the principle of reciprocity.

The facts suggest otherwise. While demanding unfettered access to downstream assets in the liberalised EU market, Russia has sharply restricted western investors access into Russia. Uncertainty around the inviolability of PSAs probably precludes major future FDI projects into the Russian energy sector. Rather, investors now clamour to gain a limited stake in the major SOEs, Gazprom and Rosneft. This skewing of investment, along political, not economic, lines will have detrimental long-term consequences for both Russia and the west.

Russian energy is now irredeemably politicised. Yet the potential profits have tempted some of the west's most revered financial institutions into co-operation with Russian SOEs. ABN AMRO has been retained by Gazprom to negotiate a cut-price gas contract with the government of Belarus in return for significant distribution assets in Minsk and transit pipelines into Poland and Lithuania. And in July, Morgan Stanley, Dresdner Kleinwort Wasserstein and ABN AMRO advised Rosneft on its controversial London initial public offering, despite a pending legal injunction related to assets expropriated from Yukos.

Sadly, however, the biggest loser from the reassertion of state control in the energy sector is likely to be the Russian public. Hydrocarbon wealth has underpinned recent rises in living standards, but the high oil price has masked decreasing production efficiency. As Mr Illarionov has pointed out, output has slowed and costs have risen at the Yuganskneftegaz production subsidiary since its expropriation from Yukos to Rosneft.

Incentives to sustain reserves by investing in speculative exploration are distorted by the high taxation of private firms or massive dividend payments to the state. The failure to exploit new fields means Russian oil production remains below its Soviet-era peak. Yet the harsh climatic and geological conditions in which new hydrocarbon deposits are likely to be located means access to western technology and expertise is essential. In the lucrative refining sector, too, Russian firms are lagging behind. On average, 700 litres of petrol can be refined from one ton of crude oil, yet Russian firms average just 470 litres.

Public's loss

Such inefficiencies cannot be sustained if the oil price drops significantly. Indeed, if the rising oil price is factored out, Russia's GDP has contracted in the past two years. But the greater danger is the damage done to Russian politics and society. The pursuit and dismemberment of Yukos and growing antipathy to FDI has demonstrated – despite the Kremlin's claims to have 'liberalised' the energy sector – that politics, not economics, now dominates the business calculus in Russia. To paraphrase Tolstoy: happy SOEs are all alike; every unhappy IOC is unhappy in its own way.

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