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Special Report for Alex Poole-Warren

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Russia

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EURASIA

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In May 2008, Dmitry Medvedev took over the Russian presidency from current Prime Minister Vladimir Putin, who had served as Russia's head of state since 1999. Six months into Medvedev's presidency, we consider it useful to assess political risks in the country and their impact on business operations in Russia. This report builds on our assessments and reports published in the run-up to and immediately following Medvedev's election.

Key Judgement

Overall, we assess that Prime Minister Putin still retains his previous role as the country's predominant leader, and is the guarantor of the present power-sharing agreement between the president and the prime minister. This is widely recognised and accepted by Russia's main political players, including President Medvedev. As such, any significant change in the political process will likely be instigated and overseen by Prime Minister Putin. Within the one-year outlook, the state is likely to push for a greater stake in the energy sector

as well as consolidation of other 'strategic' industries despite opposition from certain interest groups, most notably the liberal faction. Surgutneftegas is the most likely target for acquisition by Gazprom. The Russian state is also likely to target energy, metals and mining companies for price-fixing at a time of rising energy prices and falling demand for steel, as in the recent case of coking-coal producer Mechel. Finally, the ongoing TNK-BP dispute is primarily an internal conflict between the UK and Russian shareholders; the government intervened to put pressure on the shareholders to resolve the conflict at a time of falling confidence in the Russian market.

Some Recent Risk Relevant Events

10 Oct 08 PM Putin said that the government would spend some \$6.7bn on the Russian stock market in 2008 in a move to improve liquidity.

24 Sep 08 President Medvedev hinted that Polyus Gold may lose its licence for the Natalkinskoe gold deposit if operations did not improve.

26 Aug 08 President Medvedev recognised the independence of Georgia's breakaway regions of Abkhazia and South Ossetia.

08 Aug 08 Georgian forces entered Tskhinvali, South Ossetia, and Russian jets dropped two bombs near a Georgian police unit in Kareli and later at the Vaziani airbase outside Tbilisi.

31 Jul 08 President Dmitry Medvedev called on officials to stop harassing private capital, amid authorities' criticism of coal firm Mechel.

28 Jul 08 Prime Minister Vladimir Putin accused coking coal firm Mechel of tax evasion; the company's shares fell by another 28 percent.

08 May 08 Parliament approved Vladimir Putin as Russia's new prime minister by 392 out of 448 votes.

07 May 08 Dmitry Medvedev was inaugurated as

Russia's president; Medvedev named Vladimir Putin as new prime minister.

05 May 08 President Putin signed a bill restricting foreign stakes in firms in 42 strategic sectors; some investors voiced concerns.

15 Apr 08 Vladimir Putin agreed to become chairman of the pro-Kremlin United Russia party after leaving office in May 2008.

02 Mar 08 Dmitry Medvedev, Vladimir Putin's chosen successor, got approximately 70% of the vote in presidential elections.

15 Feb 08 Rosneft's president Sergei Bogdanchikov announced that his company could develop the Sakhalin-3 gas field together with Gazprom.

07 Feb 08 ExxonMobil agreed to sell the entirety of its annual output from the Sakhalin-1 gas field to Russia's gas firm Gazprom.

10 Dec 07 Vladimir Putin backed the first deputy prime minister and Gazprom chairman, Dmitry Medvedev, to succeed him as president of Russia.

Analysis and Forecasts

Has regime instability increased in Russia after Dmitry Medvedev's ascendancy to presidency? Will there be a conflict between Medvedev and Prime Minister Vladimir Putin?

There is currently a limited scope for a conflict between President Medvedev and Prime Minister Putin. The main players in Russia recognise and accept Putin's leading role in the political process.

The current political arrangement of power-sharing arrangement between President Dmitry Medvedev and Prime Minister Vladimir Putin is stable, as Putin's leading role in the political process in Russia is widely accepted, including by President Medvedev. Accordingly, major changes to the political process will likely need to be approved by Putin. Moreover, the prime minister's recent encroachment upon the

president's 'constitutional' areas of responsibility, such as foreign policy, is unlikely to be opposed by Medvedev. This was clearly illustrated in the early days of Russia's conflict with Georgia in August 2008, where Putin emerged as the main driving force behind the decision to intervene militarily in Georgia's secessionist region of South Ossetia. While the president and the prime minister occasionally disagree on business operations in Russia, this is not necessarily an indication of an emerging conflict between them. Rather, it points to their different approaches to governing and their opinions on the role of foreign investment in the Russian economy, which were clearly evident before Medvedev's election to presidency. Medvedev has publicly opposed the state's intervention into the economy, but he is unlikely to challenge the government's current policy, particularly given Putin's political clout and the popular support that he enjoys. A recent investigation into alleged price-fixing by Russia's coaking coal producer Mechel is a point in case. In July 2008, Prime Minister Putin publicly accused Mechel of tax evasion and price-fixing, leading the company's shares to fall 28% that day; President Medvedev immediately intervened by condemning state interference into business operations. While Medvedev's statement was aimed at assuaging investors' fears, he did not openly back Mechel or challenge the court's ruling that found the company guilty of abusing its dominant market position. Putin's public criticism of Mechel was likely intended as a warning to other coal producers to not artificially decrease output or raise prices in the face of already significant energy-price inflation (for instance, Evraz-controlled Rospadskaia also faced similar price-fixing charges).

Will there be a conflict between various interest groups in Russia? Where will such a conflict take place?

The strengthening of the Investigative Committee and the siloviki's push for expanding state control over Russian industries widens the scope for inter-factional conflict.

It is more likely that any future weakening of

regime stability will arise from an inter-factional conflict rather than a policy disagreement between President Medvedev and Prime Minister Putin. Overall, it is now more accurate to speak of a Putin group rather than a St. Petersburg group, as the current political and economic elite in Russia is centred around the prime minister and many of its members were not previously based in St. Petersburg. This includes First Deputy Prime Minister Igor Shuvalov, whose previous position included chairman of the Russian Federal Property Fund in Moscow and chief of staff of Prime Minister Mikhail Kasyanov, as well as Deputy Prime Minister and Chief of Staff of the Russian government Sergei Sobyanin, who was formerly based at the Khantia-Mansia Autonomous Okrug and the Tyumen Region administration. Dmitry Medvedev's election to presidency has not significantly altered the balance between the main interest groups in Russia. This is largely because the present cabinet line-up represents members of both the siloviki faction, who generally have close relations with Russian security services and advocate the state's involvement in the economy, and the liberals, who support pro-market economic policies and are largely associated with Medvedev. Members of the liberal faction head ministries responsible primarily for Russia's fiscal and economic policy, whereas representatives of the siloviki clan have secured industry-specific and defence portfolios. While interests of both factions are represented in the current government, there is still a potential for a conflict between the two groups. The most likely arena for such a conflict will be the Investigative Committee. When the Committee was established in September 2007 with the aim of investigating economic crime, amongst other issues, the move was widely viewed as an attempt to further strengthen the siloviki's influence over business operations in Russia (the Committee is headed by Aleksandr Bastrykin, commonly regarded as a member of the siloviki group). In recent weeks, government officials have spoken of expanding the Committee's influence by incorporating the investigative arm of the Interior Ministry under the Committee's jurisdiction. The liberals are likely to oppose further strengthening of the Committee's authority, particularly the siloviki's

use of the agency to target businesses and increase state control over industries. Admittedly, the siloviki have already pushed for establishing national champions in the shipbuilding, auto-making, machinery-producing and nuclear sectors, through the acquisition of privately owned assets. For example, Igor Sechin, Putin's long-time associate and an informal leader of the siloviki faction, has been appointed head of the State Shipbuilding Corporation, which was created in July 2007 to combine Russia's naval and civilian shipbuilders. More recently, in early October 2008, Sechin was appointed head of the board of Russia's electricity major Inter RAO UES, which has further strengthened the siloviki's grip on energy structures. Despite the liberals' opposition to this consolidation trend, we assess that the faction is not currently in a position to slow down or halt the process, especially since the creation of national champions is supported by Prime Minister Putin. It is also important to note that the siloviki have expressed interest in extending their influence not only over Russia's majors but also smaller businesses in key sectors. Russneft, Russia's seventh largest oil company, is an example here: in May 2007 Russian prosecutors charged the company's president, Mikhail Gutseriev, with tax evasion and other irregularities and subsequently froze Russneft's shares before the company was bought by Kremlin-friendly oligarch Oleg Deripaska. Similar tactics are likely to be employed by the state in the future in gaining control over important deposits.

What are the implications of the Law on Investment in Strategic Sectors for investment in Russia? Will there be any amendments to the law?

While the Law on Investment in Strategic Sectors defines the rules for operating in industries deemed 'strategic', it still upholds the state's authority to expropriate assets in the specified sectors. It is unlikely that the list of sectors with limited foreign access will be extended in the one-year outlook.

In May 2008, the Law on Investment in Strategic Sectors, which restricted foreign investment in 42 sectors, came into force. Under the new

provisions, foreign investors intending to purchase over 5-10% of a firm operating a 'strategic' deposit in subsoil extraction needed authorisation from a special commission headed by the prime minister. In other sectors considered strategic, such as atomic energy, armaments and major telecoms operations, investors required government approval for purchases of more than 25-50% of an enterprise, depending on the sector. The law has already been applied, most notably during the September 2008 tender for Russia's largest copper field Udokan, won by Russian iron ore and steel major Metalloinvest. Overall, the law has clarified the rules for operation in the sectors deemed 'strategic', but it does contain a loophole that permits the state to engage in the redistribution of shares, as such the legislation upholds the government's authority to engage in expropriation of assets. While the government will apply the law to assets where foreign capital exceeds specified ceilings (with investors facing confiscation and compensation below market prices), an arbitrary use of the law against other projects is less likely. We also assess that the list of strategic sectors will not be extended at least in the one-year outlook. The definition of a strategic sector was debated by the legislator for almost two years and the adopted law reflects a broader political consensus on the issue. Moreover, a proposal to broaden the list of sectors with limited foreign access would very likely meet with opposition from members of the liberal faction, and any amendments to the law would involve a long legislative process. In fact, in early June 2008, Finance Minister Aleksei Kudrin called on state officials to shorten the list of sectors with limited foreign access; similar statements have also been made by President Medvedev, who also ordered a review of the law in June 2008.

Will the Russian state increase its stake in the energy sector? Does the recent investigation into alleged price-fixing by Mechel signify a broader trend in Russia?

Foreign investors bringing substantial capital inflows will likely be welcomed, but increasingly as minor partners to Russia's state-controlled monopolies. Energy, metals

and mining companies are likely to face price-fixing charges at a time of high energy-price inflation and falling demand for steel.

The expansion of state control over the Russian energy sector is more likely with the May 2008 appointment of Igor Sechin, Putin's long-time associate and an informal leader of the siloviki faction, as deputy prime minister in charge of industry and environment. Sechin is also the chairman of state-owned oil company Rosneft, a position he has held since July 2004. Additionally, Sechin presided over Rosneft's acquisition of Yuganskneftegas, the main oil producing unit of bankrupt oil company Yukos, in December 2004. More recently, Sechin and Rosneft's CEO, Sergei Bogdanchikov, have spoken of the company's further expansion plans in the domestic and external market. As the government pushes for greater state control over energy assets, Surgutneftegas will likely be the next target. The Russian energy major operates large oil and gas fields in western Siberia and also owns a refinery in Kirishi. Gazprom, which has experience of joint development of energy blocks with Surgutneftegas in Yamal, would be particularly interested in purchasing the company and selling some of its assets, estimated to be worth some \$12 billion, to make further acquisitions in the sector. Moreover, our sources report that in 2007, state authorities decided not to gain a stake in Lukoil, Russia's largest privately owned oil company, because of the company's expansion plans abroad; some of the states where Lukoil operates or plans to expand its operations would not support the presence of a major energy company controlled by the Russian government. Overall, however, the energy sector in Russia is largely divided up, and the new battleground for consolidation will likely be the mining and metallurgy industries (particularly coal and steel) as well as associated power-generating assets. In terms of foreign investment in the energy sector, given falling oil output in Russia and the sector's reliance on foreign technology for exploration and production, foreign investors bringing substantial capital inflows will likely be welcomed, but increasingly as minor partners to Russia's state-controlled monopolies. Finally, it is important to note that

the Russian state is likely to target energy, metals and mining companies for price-fixing at a time of rising energy prices and falling demand for steel, as in the abovementioned case of Mechel. Indeed, on 26 September 2008, the Federal Anti-Monopoly Services concluded its investigation into alleged price-fixing by Russia's three energy firms: Surgutneftegas, GazpromNeft and TNK-BP, and found the last two companies guilty of abusing their dominant market position. Similar investigations are likely in the coming months. Indeed, the Federal Anti-Monopoly Services is in the process of conducting an investigation into alleged price-fixing by oil firms Lukoil and Rosneft, while the Irkutsk branch of the Federal Anti-Monopoly Services already found Rosneft guilty of violating anti-monopoly laws and fined the company \$9 million. The fines are, however, unlikely to be excessive or to affect the companies' finances in a significant way.

Does the TNK-BP case signify wider risks to foreign investment in the energy sector in Russia?

The TNK-BP dispute is primarily an internal conflict between the UK and Russian shareholders; the government intervened to put pressure on the shareholders to resolve the conflict at a time of falling confidence in the Russian market.

After months of a dispute over the management of the company and its broader investment strategy, the UK and Russian shareholders of energy joint-venture TNK-BP reached a preliminary agreement in early September 2008. Although the content of the deal has not been made public, our sources report that the agreement maintains the 50-50 joint-venture split, provides for TNK-BP's CEO Robert Dudley to leave the company and for three independent directors to join the board and finally agrees to a public stock offering by 2010. A number of issues still remain unresolved. In particular, despite the promises of an international orientation for TNK-BP, no specific plans have been announced so far. Similarly, no agreement has been reached on a CEO; this decision has been postponed until an extraordinary shareholders' meeting in December 2008. In the present economic environment, we

see it as being very much business as usual for TNK-BP in the coming months with neither a stock offering nor international expansion in the cards; the company will most likely focus on its current work commitments. A few state officials, most notably First Deputy Prime Minister Igor Shuvalov, have spoken of the state's involvement in resolving the conflict. It is indeed likely that faced with a crisis of confidence in the Russian market by foreign investors, not helped by TNK-BP's dispute and intensified after Russia's military involvement in Georgia, the company came under pressure to publicly smooth over its dispute before more reputational damage resulted. Neither the company nor the Russian government can now afford a dispute at the time of the financial crisis and falling investor confidence. Finally, we assess that the conflict was very likely instigated by Russian shareholder Mikhail Friedman, who has used similar tactics in the past. Most notably, Alpha Group, which is controlled by Friedman, battles Norway-based Telenor. The dispute concerns the two companies' strategy in Russian mobile phone operator Vimpelcom and their involvement in Ukraine's largest mobile phone firm Kievstar. In August 2008, Telenor considered the option of selling its nearly 30% stake in Vimpelcom. As such, the TNK-BP dispute points to risks associated with working with Alpha Group and Mikhail Friedman in particular.

Which sectors in Africa are likely to see Russian investment? What impact will Russia's investment in the energy sector in Africa have on oil and gas supplies to the European market?

Russian majors are likely to invest primarily in the mining and energy sector in Africa. Gazprom's involvement in energy projects in Algeria, Libya and Nigeria increases the risk of European gas contracts being renegotiated in the five-year outlook.

With an increase of revenues for Russian mining and energy companies, Russian majors have intensified their investment abroad. Given Africa's wealth of natural resources and the need for investment, the continent has become a natural investment market for Russian capital. A

number of Russian majors already operate on the continent or plan to access the market in the coming months. For example, Norilsk Nickel, the world's leading nickel producer, currently carries out mining operations in Botswana, having acquired a 85% interest in the Tati Nickel mine, and in South Africa, with a 50% stake in the Nkomati nickel mine. In May 2008, Russia's aluminium producer RusAl vowed to invest some \$5 billion in West Africa; the company is already one of the biggest investors in Guinea. As for Russian energy majors, in early September 2008, Gazprom and the Nigerian National Petroleum Corporation set up a joint venture in gas and power production. Moreover, in June 2008, Gazprom opened its representative office in Algeria with an aim of developing energy projects jointly with Algeria's state oil and gas corporation Sonatrach. A month earlier, Gazprom and Libya's state-controlled National Oil Corporation (NOC) had concluded a memorandum of cooperation that would involve establishing a joint venture for investment in the region. This followed from the Libyan government's decision to award Gazprom three offshore exploration licences in December 2007. This investment trend is likely to increase in the coming years. Indeed, in February 2008, Gazprom expressed interest in investing up to \$7 billion in a gas field in Ogoniland, in the Niger Delta region, which Shell had walked away from 15 years ago. The company's expansion into Africa has important implications for the European market. In particular, Gazprom's tightening grip on Europe's potential future energy sources (Gazprom currently provides 26% of Europe's gas supplies, while Algeria adds another 11%) increases the risk that short-term agreements between African suppliers and European contractors will replace current long-term gas contracts, forcing prices upwards. Russia's companies are most likely to invest in the mining (Alrosa, Norilsk Nickel, RusAl), energy (Gazprom, Rosneft) and defence (Rostekhnologii) sectors. However, Russian firms will likely face strong competition, primarily from European and Chinese investors. Chinese majors have already established their presence in Zambia and Angola, while the European Union pledged to co-fund a gas pipeline from Nigeria in September 2008. Still, the Russian state is likely to promote investment in Africa, as we have seen with

Gazprom's expansion plans, as long as the capital transfer does not affect the companies' domestic production in Russia.

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