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Russian energy investments in Europe

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Contents

1 Introduction

Russian outward investments have surged during the past years and the leading Russian enterprises are gaining increasing leverage on the global business arena. The Russian economic might is best represented abroad by the country's leading energy companies. Not only is Russia the single largest primary energy supplier to Europe but the leading Russian energy companies have in recent years grown to challenge the traditional global energy majors, both in international supplies and foreign investments.

Due to increased state control over the energy sector in Russia and the rise of state-owned energy conglomerates, the international expansion of the energy Russian companies carries an ever strong polito-economic weight. Along with growing dependency on the Russian energy supplies, the expansion of Russian energy majors in Europe has been met with growing reservations in the host countries. The confrontation between the Russian and European parties over the energy issues has culminated both in competing infrastructure projects and reciprocal investment restrictions in the energy sector.

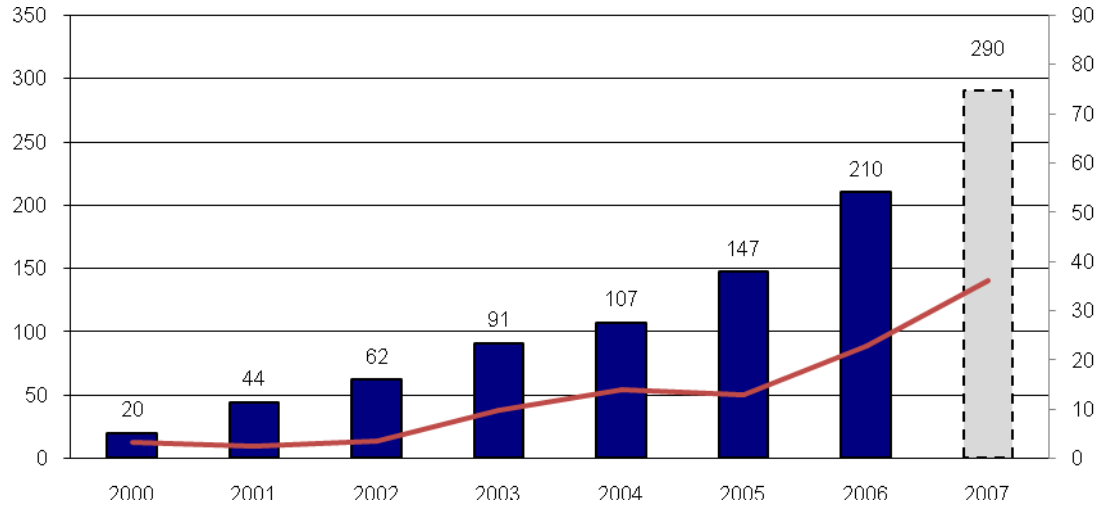
The current report aims to facilitate discussion about the ambiguous energy relations between Russia and the EU from the viewpoint of Russian investments in the European energy sector. The report presents the recent developments in the foreign expansion of Russian companies together with a brief statistical update on the Russian outward investments. In its main part, the report focuses on policy aspects of the Russian energy investments, providing investment profiles of the leading Russian energy companies together with an overview on the key infrastructure projects in the sector and discussion of investment reciprocity in the energy sector.

2 Russian OFDI trends in review

2.1 Key figures and development in Russian OFDI

In only six years, Russia's outward foreign direct investment stock has surged from mere $ 20 billion to nearly $ 210 billion at the end of 2006. The previous year was also the record year in terms of Russian OFDI, with the total value of Russian OFDI stock growing by more than $ 60 billion and the value of new transactions amounting to a record $ 23 billion. Based on the most recent estimates by the Central Bank of Russia (CBR), however, the OFDI growth in 2007 will again surpass that of 2006. During the first nine months of 2007, the aggregate value of new transactions stood at $ 36 billion. Should this trend have continued, and given the likely valuation changes in existing assets, we might expect the Russian OFDI stock to near $ 300 at the end of 2007. This would most likely yield further improvement in Russia's standing among the world's top investor countries (15th in 2006) and would strengthen its position as the leading investor among the emerging economies.

Figure 1 Russian OFDI stock at year end (left axis) **and annual value of new transactions** (right axis), *US $ bn*



Sources: Central Bank of Russia 2008, authors' calculations.

2.2 Sources of growth in Russian OFDI

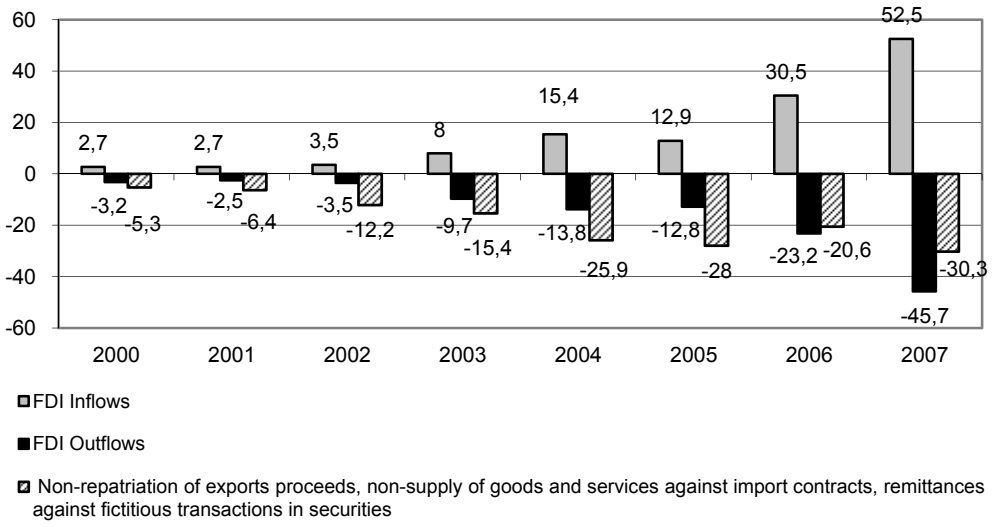
The more than tenfold increase in the Russian outward investments can first and foremost be attributed to the record-high energy and raw material prices and their impact on Russian economy. Besides the surging revenues from energy exports, several other factors have contributed to the rise of Russian OFDI.

- **The improved data collection methods** of the Russian fiscal authorities and the Central Bank of Russia (CBR) in particular have on their part contributed to the increase in recorded FDI from Russia, bulk of which used to leave the country unregistered during the 1990s. Especially the improved tracking of valuation changes of the existing foreign assets has contributed to compilation of more realistic datasets on Russian investments abroad.
- **The essential lack of domestic investment targets and discouraging industrial policy** has been a major driver for many leading Russian industrial conglomerates seeking to accommodate the accumulated export revenues. As many Russia's leading industrial enterprises have been forced to supply the domestic market at artificially low prices, the incentives to develop domestic operations has subsequently been lower than these to develop more profitable production infrastructure abroad.
- **Creation of safe deposits abroad** has been a key driver for capital exports especially in the 1990s as the controlling owners of the leading Russian business groups sought safeguards against governmental intervention and potential expropriation. The recently strengthened role of the state in Russian economy may yield resurgence of investments of this type.
- **The re-emerged political ambitions particularly in Russia's near abroad** have in some occasions guided the foreign investments of the Russian state-owned energy conglomerates, through which Russia has actively sought to establish economic and political leverage in its neighbouring regions.

Despite the visible improvements in recording the investment flows from Russia, the entire value of Russian companies' assets abroad is evidently not captured in official FDI statistics. Estimations on the total value of Russian investments abroad are notably inconsistent with each other and show significant diversion from the FDI statistics at best. However, the recent attempt by the CBR to estimate the amount of capital leaving the

country annually through unregistered capital exporting schemes proves to be somewhat in line with the earlier estimations on capital flight from Russia by the European Commission and the World Bank. Figure 2 illustrates this point – according to the CBR, 2006 was the first year since the beginning of Russia's transition when the value of official FDI from the country surpassed that of the "grey" capital exports.

Figure 2 Annual FDI flows and unregistered capital exports from Russia, 2000-2007, *$ bln*



Source: Central Bank of Russia 2008.

2.3 Energy and metals & mining dominate the Russian outward FDI

Russia is the world's largest energy exporter, as well as one of the largest producers of steel and several non-ferrous metals. The skyrocketing export revenues have contributed to the awakening of Russia's leading industrial conglomerates in seeking investment targets abroad. Along with the accumulated wealth, the Russian companies in the aforementioned sectors have gained vital experience in international investment practices, which have undergone dramatic improvement during the past decade.

The experience of the past years has shown, however, that the rapid internationalisation of the Russian companies is not limited to the natural resource-based sectors only. Many of Russia's leading industrial manufacturers have engaged in international M&A, while the

country's leading telecommunication companies are dominating players throughout the CIS region nurturing ambitious strategies of entering the Western European telecommunication sector.

Bulk of the value of the Russian companies' investments abroad is nonetheless concentrated in the energy and metal & mining sectors. The energy and metal & mining companies account for more than 90% of the aggregate foreign assets of the 10 leading Russian transnational companies (TNCs) (Table 1).

Table 1 Top 10 Russian TNCs ranked by foreign assets, as of 30.9.2007

Company	Sector	Principal host countries	Foreign assets, *$ mln*
Lukoil	Oil & gas	Baltic States , CIS, Finland, USA, Venezuela	19 332
Norilsk Nickel	Metals & mining	Botswana, South Africa, USA	17 384
Gazprom	Oil & gas	EU and the CIS, Balkans	12 545[1]
Severstal	Metals & mining	Italy, USA	4 955
Evraz Holding	Metals & mining	USA	4 261
RusAl	Metals & mining	Armenia, Australia, Guinea, Kazakhstan, Nigeria	4 150
Altimo	Telecommunications	CIS, Turkey	3 202
AFK Sistema	Telecommunications	CIS	2 350
VimpelCom	Telecommunications	CIS	2 120
Novolipetsk Steel	Metals & Mining	Belgium, France, Italy, USA	996
TOTAL			**71 295**

Sources: Vahtra 2007, based on company information and authors' calculations.

The only companies outside the aforementioned sectors that rank among the top 10 Russian TNCs are the country's two leading mobile telecommunication service providers. While the oil & gas industry remains the leading foreign investing industry by total assets, the growth has been notably stronger in the metal sector, which already accommodates aggregate foreign assets comparable to those of the oil and gas companies. It is also noteworthy that the two leading Russia oil & gas companies by foreign assets, Lukoil and Gazprom, hold around 90% of the sector's aggregate foreign assets. In the metal & mining sector, on the other hand, the assets have been distributed more evenly with five companies from the sector ranking among the top 10 Russian TNCs.

The recent years have seen deepening concentration of foreign assets in the hands of even fewer owners. The growth in aggregate value of foreign assets of the top 10 Russian

[1] The figure only includes the combined value of the key subsidiaries of Gazprom, on which the information was available. The vast state-owned holding comprises nearly 100 subsidiaries worldwide.

TNCs has been faster than that of the Russian OFDI stock. The combined value of the assets of the top 10 Russia TNCs amounts to more than $ 71 billion, which represents roughly a third of the country's entire OFDI stock. Similarly, the value of individual investment projects of Russian companies has soared. Between 2006 and 2008, the combined value of the 10 largest foreign acquisitions by the Russian companies amounted to over $ 20 billion (Table 2).

Table 2 The largest foreign acquisitions by Russian companies, 2006-2008.

Buyer	Target company	Target country	Sector	Share, %	Value, *$ mln*
Norilsk Nickel	LionOre Mining	Canada	Metals & mining	100	5 234
Altimo	Turkcell	Turkey	Telecommunication	13	3 200
Gazprom	Beltransgaz	Belarus	Oil & gas	50	2 500
Evraz Holding	Oregon Steel	USA	Metals & mining	100	2 300
Lukoil	Nelson Resources	Kazakhstan/ Canada	Oil & gas	100	2 000
Mechel	Oriel Resources	UK	Metals & mining	47	1 500
Norilsk Nickel	Gold Fields Ltd	South Africa	Metals & mining	20	1 200
Gazprom	NIS	Serbia	Oil & gas	51	900
Evraz Holding	Highveld Steel	South Africa	Metals & mining	79	678
Evraz Holding	Palini & Partoli	Italy	Metals & mining	75	620

Sources: Vahtra 2007, company information, authors' calculations.

3 The leading Russian energy companies abroad

3.1 Company profiles and listings of foreign affiliates

The Russian energy sector has only a handful of major players. These are Gazprom and Rosneft, both state-owned, and the privately-held Lukoil and TNK-BP. However, Lukoil and Gazprom alone have an overwhelming majority share of roughly 90 % (see previous table 1) of all foreign investments from the Russian energy sector thus establishing their absolute lead position in Russian OFDI. In addition, there are a few minor players like Novatek and the Itera Group.

The state-owned **Gazprom** is the world's largest natural gas producer. The company has a 20 % market share of the global natural gas market and it controls 25 % of world gas reserves. The company has a somewhat dominant position on the European natural gas market supplying roughly one third of the total gas imports of Western Europe. Gazprom exports gas to Europe mainly through an extensive natural gas pipeline network which in turn has contributed to Gazprom's significant presence on the European downstream market, especially in the CIS area but also to some extent in the EU as well. Gazprom has over 60 foreign subsidiaries and affiliates mainly in the EU and in the CIS countries.

Table 3 Selected Gazprom's foreign subisidiaries and affiliates

Country	Company	Type of operations	Gazprom's share, %
Armenia	Armrosgazprom	Gas distribution	45
Austria	Gas und Warenhandelsgesellschaft	Sale of gas	50
Belarus	Beltransgaz	Gas distribution	50≤
	Belgazprombank	Financial activities	100
Bulgaria	Overgaz Inc.	Investing	50
	Dexia Bulgaria	Gas marketing	51
	Topenergo	Gas distribution	100
Cyprus	Leadville Investments Ltd.	Investing	100
Czech Rep.	Gas Invest	Investing	n.a.
Estonia	Eesti Gaas	Gas distribution	37
Finland	Gasum	Gas distribution	25
	North Transgas OY	Gas transportation	100
France	Fragaz	Gas trading	50
Germany	Gazprom Germania Group	Gas distribution	100
	WIEH		50
	Wingas		35
	ZMB		100
Greece	Prometheus Gas	Foreign trade	50
Hungary	Panrusgaz	Sale of gas	40
	General Banking and Trust	Investing	26
Italy	Promgaz	Gas distribution	50
	VOLTA S.p.a	Gas trading	49
Latvia	Latvijas Gaze	Gas distribution	34
Lithuania	Lietuvos Dujos	Gas distribution	34
	Stella Vitae	Gas distribution	50
	Kaunas CHP	Electricity	99
Moldova	Moldovagaz	Gas distribution	50
Netherlands	Gazprom Finance B.V.	Investing	100
	Gazprom Netherlands B.V.	Asset management	100
	Blue Stream Pipeline Company	Construction, gas transportation	50
	West East Pipeline Project Investment	Construction, investing	100
Poland	EuRoPol GAZ	Gas distribution	48
	Gas Trading	Sale of gas	16
Romania	Wirom	Gas distribution	51
	WIEE	Gas distribution	100
Serbia	Progresgaz Trading Ltd.	Gas distribution	25
	NIS	Gas distribution	51
Slovakia	Slovrusgas	Gas trading	50
Slovenia	Tagdem		n.a.
Switzerland	WIEE	Gas marketing	50
	Gas Project Development Center Asia AG (Zug)	Development activities	50
	Nord Stream AG	Construction, gas transportation	51
Turkey	Turusgaz	Sale of gas	45
UK	Gazprom Marketing and Trading Ltd	Gas distribution	100
	Gazprom UK Ltd	Investing, banking	100
	Interconnector (UK) Ltd	Gas trading	10
	Wingas	Gas distribution	50
Ukraine	Int. Gas Transmission Consortium	Gas distribution	50≤
	RosUkrEnergo	Gas distribution	50

Sources: Company information, Vahtra (2006).

Lukoil is the biggest independent oil-producer in Russia being second only to the state-owned Rosneft. Lukoil has business activities in more than 30 countries worldwide and the company has a 20 % share of all Russian petroleum product exports. Lukoil's upstream activities are global but the bulk of its oil production and exploration activity is in the CIS countries and particularly in Russia. However, Lukoil's downstream activity has a strong emphasis on Europe. An overwhelming majority of the 22 countries Lukoil has petroleum retailing are situated in Europe, especially in the European Union.

Table 4 Overview on Lukoil's assets in Europe

Type of assets	Countries
Petroleum retailing	Azerbaijan, Belarus, Belgium, Bulgaria, Cyprus, Czech Republic, Estonia, Finland, Greece, Georgia, Hungary, Latvia, Lithuania, FYR Macedonia, Moldova, Poland, Romania, Serbia, Slovakia, Turkey, Ukraine, UK
Petrochemicals	Bulgaria, Ukraine
Oil refining	Bulgaria, Romania, Ukraine
Investing & services	Austria,Bulgaria, Cyprus, Czech Republic, Denmark, Lithuania, Netherlands, Romania, Serbia, UK, Ukraine

Sources: Lukoil Factbook 2007, company information

Rosneft is the second-largest oil producer and the main inheritor of Yukos assets in Russia after the dismantling of the former oil company. Rosneft has a strong emphasis on the domestic and CIS market. For instance in 2006 the company exported approximately 10 % of its crude oil production to countries outside the CIS. Thus Rosnefts foreign investmenst are quite modest. There are some exceptions, though, like the Bourgas – Alexandroupolis pipeline in the Balkans which will be discussed in more detail later in this report.

TNK-BP is a large Russian oil company among the 10 biggest privately-held oil companies worldwide when measured in crude-oil production. The company is a merger between BP's Russian assets and Alfa, Access/Renova group (AAR) assets formed in 2003. The company has mainly domestic activities and its significant European projects are in the Ukraine where it has downstream activity. The company mostly supplies crude oil to its mother company and it is unlikely that TNK-BP would internationalize its activities in the near future.

Novatek is the largest independent producer of natural gas in Russia. The total independent natural gas production in Russia accounts to roughly 4 % of total production and Novatek produces a third of this. Although Novatek considers itself as an independent company, one must bear in mind that Gazprom is a major shareholder in the company. The company has some foreign projects, for instance production plans on the coast of Egypt and joint ventures with the French energy giant Total. However, Novatek's foreign investments pale in comparison with Lukoil and Gazprom and represent only a fraction of Russian energy sector OFDI.

One of the largest independent gas producers in Russia is the **Itera Group**. The company has foreign activities foremost in the CIS and in the Baltic countries by controlling minority shares in both Estonian and Latvian gas distribution companies. However, when compared to Gazprom and Lukoil, Itera like Novatek and Rosneft are very small players on the European market.

3.2 Recent and planned Russian energy investments in Europe

The most important energy projects in Europe with Russian capital are the gas pipe line projects Nord Stream and South Stream as well other projects related to South Stream. The most significant infrastructure project regarding the oil sector is the Bourgas – Alexandroupolis pipeline. In addition, Lukoil has made some smaller investments in the oil sector.

The **Nord Stream** pipeline project is a joint venture by Russian and German actors. Russian Gazprom has a 51 % share in the project while the German BASF AG and E.ON AG share the remaining 49 % share of the project. The pipeline will stretch roughly 1 200 km from Vyborg on the Russian Baltic Sea Coast to Greifswald on the German Baltic Sea coast thus bypassing the current major transport countries of Belarus, Ukraine and Poland. The pipeline offers an alternative transport corridor for Russian gas into Western Europe and Germany in particular. The transport capacity of the pipeline in its first phase is estimated at 27,5 billion cubic meters per year and in its second phase it is estimated at 55 billion cubic meters per year. The latest estimated financial value of the project is roughly 9 billion euros. Another Nord Stream related investment was announced in February of 2008

by E.ON. and Gazprom. The companies stated that they have signed a memorandum to jointly build a 1 200 MW power plant, roughly the same as the producing capacity of an average nuclear power plant, to Lubmin Germany which is situated near the planned pipeline.

The **South Stream** pipeline project is a joint venture by Russian and Italian energy companies, Gazprom and ENI, which both have a 50 % share in the project. The pipeline will stretch, first, 900 km from Beregovaya on the Russian Black Sea Coast to the Bulgarian Black Sea coast. The onshore route to Italy will run though Bulgaria and Serbia and most likely through Hungary to its end-point in Austria. The second planned branch for the pipeline would run from Bulgaria through Greece under the Adriatic Sea to its end-point in Southern Italy. The transport capacity of the pipeline is estimated at 30 billion cubic meters per year. The technical and economical feasibility study conducted by the joint venture South Steam AG is due in late 2008.

Gazprom has made three significant energy infrastructure deals in early 2008 which are related to the South Stream project. The company has acquired stakes in energy infrastructure in Bulgaria, Serbia and Austria. First, Gazprom obtained a 50 % share in the Russo-Bulgarian joint venture for a company which will operate the South Stream pipeline on Bulgarian territory thus in turn strengthening the Russian grip over gas transport infrastructure in Europe.

Second, Gazprom has acquired a controlling stake (51 %) in the Serbian energy company Naftna Industrija Srbije (NIS) which operates, for instance, oil refineries. Gazprom made a lucrative package deal for the Serbian government where they connected the sale of NIS and the construction of the South Stream pipeline. Serbian government, reluctant at first to sell a majority of the company, changed their minds when Gazprom offered to build the South Stream pipeline through Serbia and also to build a gas hub in Serbia. In addition, Gazprom has made a substantial investment pledge to refurbish the refineries. The deal ensured Serbia annual transit revenues and favourable gas prices as well as a strategic position on the European energy map.

Finally, Gazprom has invested in the Baumgarten gas hub in Austria by acquiring a 50 % stake in a joint company with Austrian OMV. This is yet another infrastructure investment by Gazprom which enhances the South Stream project since Austria is the planned final point of the pipe line. Especially the Serbian and, to some extent, Bulgarian cases are somewhat in line with Gazprom's strategy of giving favourable gas supply terms in exchange for ownership of energy infrastructure.

Despite several successful foreign projects, not all Gazprom's European projects have succeeded. This is mainly due to the political fears in connection with the strategic importance of the energy sector. The most recent and serious blows for Gazprom took place in the UK and in Belgium. In 2007 the British authorities declined the permit for constructing an underground gas storage facility in Saltfleetby proposed by Wingas, a joint venture of German Wintershall and Gazprom. The second blow came in early 2008 in Belgium when the Belgian government refused the permit for erecting a similar facility on Belgian soil thus denying Gazprom the possibility of owning or constructing significant energy infrastructure in the country.

The **Bourgas–Alexandroupolis pipeline** is a joint venture by Russian, Bulgarian and Greek actors. Russian Transneft, Rosneft and Gazprom Neft together have a controlling share (51 %) in the project while Greek and Bulgarian actors share the remaining (49 %) share of the project. The pipeline will stretch 280 km from Bourgas on the Bulgarian Black Sea coast to Alexandroupolis in Greece on the Mediterranean coast thus bypassing the Turkish straits and offering an alternative transport corridor for Russian oil. The transport capacity of the pipeline is estimated at 35 million tons per year and the estimated financial value of the project is roughly 1 billion euros.

During the recent years **Lukoil** has made a number of strategic investments in Europe. The most noted expansion in Europe took place at the end of 2006, when Lukoil acquired 376 petroleum stations in six European countries from ConocoPhillips thus considerably enhancing the company's foothold in petroleum retailing in the EU. Lukoil has also made investments in its Balkan refineries during the recent years. First, the company has gradually acquired total control of the Bourgas refinery in Bulgaria. Second, after the re-,

launching of the Ploeisti refinery in Romania in 2004, the renovation process has continued and according to current plans it will continue until 2009.

3.3 The geography of foreign expansion

Russian energy companies have emerged as serious players in the global energy market since the collapse of the Soviet Union in 1991. In addition to the CIS, Russian companies have upstream activities, for instance, in South America, North Africa and Middle East. Downstream activities are less international but nevertheless Russian energy companies have significant activities e.g. in USA and Europe. However, despite the global character of the investments made by Russian energy companies, there is a clear focus in both upstream and downstream activities. Upstream activities like oil and gas production are concentrated in the CIS, particularly in Russia, and downstream activities like oil and gas distribution and infrastructure are strongly concentrated in Russia's close market, Europe.

The geographical scope of Russian expansion in Europe has two interesting dimensions. First, both Gazprom and Lukoil are interested in downstream infrastructure like, for instance energy distribution, storage and marketing facilities in European countries. Second, the Baltic Sea Region and Southern Balkans are at the core of major infrastructure projects by Russian energy companies which is evident in map 1. On the other hand, the Caucasus and Southern Balkans are also the key areas for the existing and proposed infrastructure projects (Baku-Tbilisi-Ceyhan oil pipeline and Nabucco gas pipeline) designed to reduce the European dependency on Russian supplies.

Map 1 Present and proposed oil and gas pipelines from Russia to Europe

Source: Adapted from Energy Information Administration (2008).

Both Gazprom and Lukoil have stated publicly that acquiring energy infrastructure in Europe is one of their strategic objectives. Russian energy companies are motivated by the desire to get a better grip of the energy sector value chain instead of a position as a mere crude oil producer. Both companies have also in practice been eager to purchase European energy infrastructure and like mentioned before, one of the most significant deals was signed in 2006 when Lukoil acquired nearly 400 European petroleum stations from ConocoPhillips. Gazprom, in turn, has been actively interested in European gas infrastructure and recently bought the Serbian energy company NIS and acquired important gas storage facilities in Austria. As table n shows, Gazprom's European affiliate list is impressive.

The two major gas pipe line construction projects in the Baltic Sea Region and Southern Balkans discussed earlier represent by far the biggest Russian energy sector investments in Europe. The Nord Stream project in the Baltic Sea Region is furthest in its development. The objective of the project is to construct a direct gas pipe line between Russia and Germany. This is accomplished by constructing a pipe line on the sea bed of the Baltic Sea, stretching all the way from the Russian Vyborg to the German Baltic Sea coast in Greifswald. Due to the strategic meaning of the pipe line, several Baltic Sea states, particularly Poland and the Baltic states have objected the construction of the pipe line on various grounds.

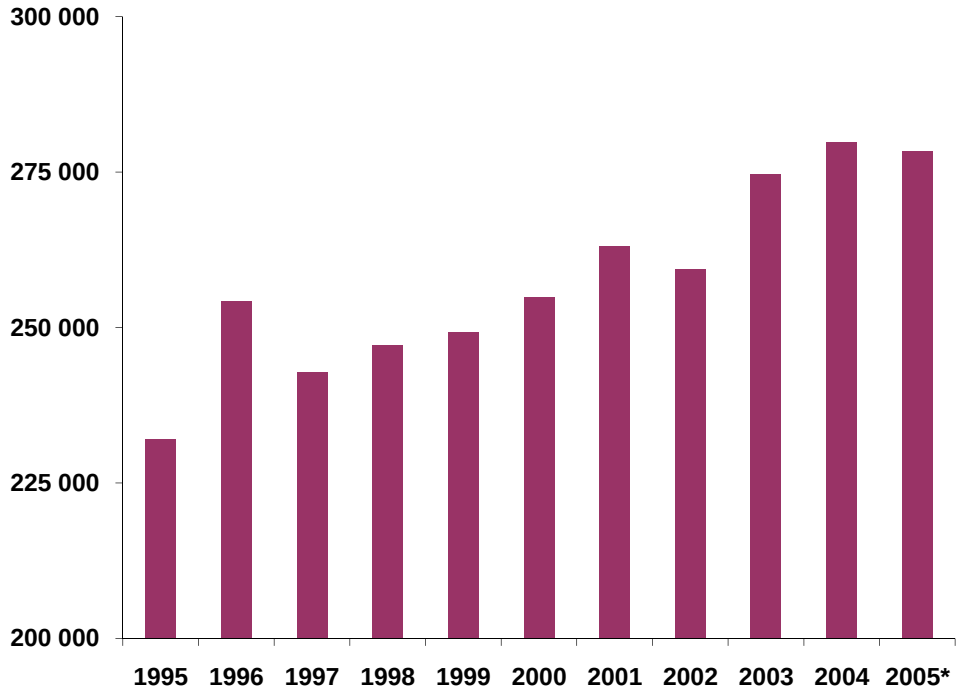
The South stream project backed by the Bourgas-Alexandropoulis oil pipe line is in the core of the focus in the Southern Balkans. South Stream will stretch from the Russian Black Sea Coast, Beregovaya, to the Bulgarian coast. The onshore route to Italy will run though at least Bulgaria and Serbia. The oil pipeline will stretch from Bourgas on the Black Sea Coast in Bulgaria to Alexandroupolis in Greece on the Mediterranean Coast thus adding to the geographical weight of the region. South Stream enjoys the same political and economical limelight in the Balkans as does Nord Stream up in the Baltic Sea region.

4 The rise of Russian energy multinationals – policy aspects

4.1 European dependency on Russian energy supplies

EU dependency on Russian energy is significant as the following overview of the EU gas and oil markets will clearly indicate. Final energy consumption of natural gas in the EU-27 has risen moderately in 1995-2005 as figure 1 shows. However, the preliminary estimates of Eurogas show that the total consumption of gas has somewhat decreased in 2006 and 2007.

Figure 1 EU-27 Final energy consumption of natural gas in 1995-2005 (1 000 toe)



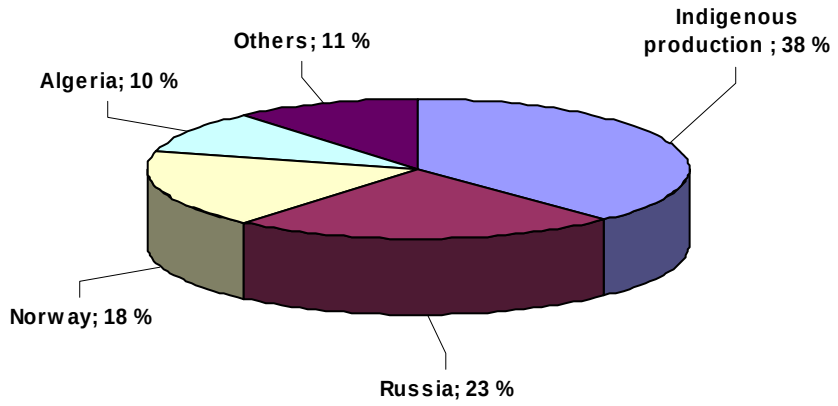
* *Provisional value*

Source: EuroStat

Where does the gas consumed in the EU originate? The biggest share so far (38 %) has been, as the statistics in figure 2 show, indigenous production. The most important gas importer is the Russian Federation and the Russian gas export monopoly Gazprom. Russian gas constitutes almost a quarter (23 %) of the European gas supply. The non-EU

member Norway[2] is a major gas source (18 %) for the EU. Another important gas exporting area is located in North Africa and particularly in Algeria (10 %) providing gas mostly to the Mediterranean EU countries. However, indigenous production has been decreasing for a longer period. According to preliminary statistics of Eurogas, indigenous production (EU25) fell by 4,9 % in 2006 and for EU27 indigenous production fell by 7 % in 2007. These statistics lead to the conclusion that indigenous production is decreasing at a faster rate than the consumption of natural gas. This in turn leads to an increased dependence of imports.

Figure 2 EU27 Gas Supply by Sources in 2007



Source: Eurogas preliminary figures and estimates

Table 5 shows that dependency on Russian energy is spread unevenly among EU countries. Some countries may have all their gas imported from Russia, like Finland and the Baltic countries, whereas some countries, like Spain and Portugal, don't import gas from Russia at all. The dependence on Russian gas is, roughly speaking, in relation to the geographical distance of an EU country from Russia. In other words, the bigger the geographical distance, the less an EU country imports gas from Russia. The importance of geography is typical for the character of the gas sector and particularly to pipeline deliveries which is the primary method utilized in the Russian gas exporting system.

[2] Norway has often stated that they are already exporting all the gas they are able. Hence, it is unlikely that imports from Norway could grow in the future.

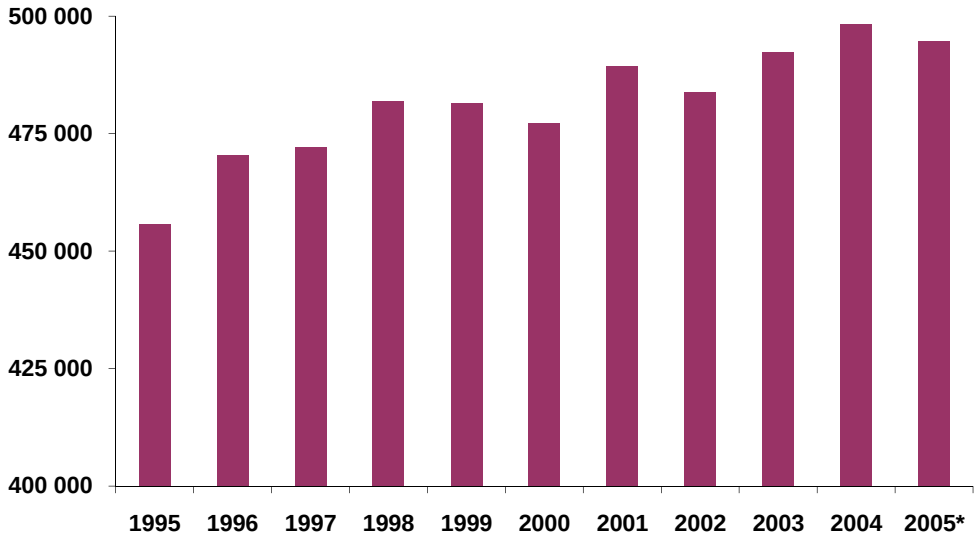
Table 5 Natural gas trade movements* and Russia's share of trade to EU27, 2006

	Country	Total consumption (Bcm)	Russian imports (Bcm)	Russian imports (%)
1	Bulgaria	2,9	2,9	100 %
2	Estonia	n.a.	n.a.	100 %
3	Finland	4,5	4,5	100 %
4	Latvia	1,7	1,7	100 %
5	Lithuania	2,9	2,9	100 %
6	Slovakia	6,3	6,3	100 %
7	Greece	2,9	2,4	83 %
8	Austria	8,7	6,9	78 %
9	Hungary	11,0	8,3	76 %
10	Czech Republic	9,5	7,1	75 %
11	Poland	10,6	7,0	66 %
12	Romania	6,3	4,0	63 %
13	Slovenia	1,1	0,6	51 %
14	Germany	90,8	36,5	40 %
15	Italy	77,4	22,9	30 %
16	France	49,6	9,5	19 %
17	Netherlands	18,5	3,0	16 %
18	Belgium	22,7	0,6	3 %
19	Cyprus	0,0		0 %
20	Denmark	n.a.		0 %
21	Ireland	3,4		0 %
22	Luxembourg	1,5		0 %
23	Malta	0,0		0 %
24	Portugal	4,1		0 %
25	Spain	35,2		0 %
26	Sweden	1,1		0 %
27	United Kingdom**	21,1		0 %

** Both pipeline gas and LNG included*
*** UK has subsequently initiated gas imports from Russia*
Source: BP Statistical Review, authors' calculations

Consumption of oil and petroleum products in the EU27 has risen moderately during the years 1995-2005 as figure 3 hows. Despite some fluctuation in consumption, the final energy consumption of petroleum products has risen 8.5 % in ten years and in 2006 the Russian share of EU crude oil imports was according to EuroStat roughly one third. Hence, the EU is certainly dependent on Russian oil exports.

Figure 3 EU27 Final energy consumption of petroleum products in 1995-2005, *1 000 toe*



** Provisional value*

Source: EuroStat

4.2 Motivations for Russian energy policy in Europe

The special character of the gas sector with the expensive transport infrastructure and long-term contracts combined with the growing worldwide consumption of energy and on the other hand decreasing energy resources in Europe are factors making sure that Russian energy companies and Gazprom in particular will remain as key players on the European energy market in the future as well. But what kind of strategic motivations shape Russian energy policy? Are there also some positive indicators characterising the EU-Russia energy relationship when analysed from a European perspective? These questions will be discussed in this chapter.

From one perspective, Russian strategic energy goals can be divided into several economical and political goals despite some overlap between the categories. Economical goals include increasing Russian profits (1) by enhancing the Russian position in the energy value chain and (2) by choosing the best markets for selling the gas. Political goals

include (3) bypassing transit countries, (4) gaining more political influence in neighboring countries and (5) blocking competition.

First, an economical goal of Russian OFDI is to enhance Russian profits by acquiring a better grip of the European energy value chain. Russian energy companies are interested in growing their roles in the value chain by purchasing various European energy companies, distributors, pipe line networks etc. This is due to the Russian motivation to enhance their position in the energy value chain where the Russian's have so far been left with only the role of a primary producer. Russian's are eager to get a better grip of the value chain by controlling European energy infrastructure. This has been evident particularly in the South Stream project where Gazprom has acquired energy companies and important stakes in pipeline infrastructure in planned transit countries such as Serbia and Bulgaria. As mentioned in chapter 3.1, Lukoil for its part has acquired a significant share of petroleum retailing with its purchase of nearly 400 petroleum stations from ConocoPhilips.

This is also where the Russian energy OFDI strategy is different in comparison with the energy OFDI of other emerging market investor countries like for instance China. The Chinese are for the most part only trying to ensure their access to foreign energy resources instead of actually controlling the whole energy value chain. However, Russian bids to buy European energy infrastructure have often been met with suspicion and not all of them have been accepted. A good example of this is the Russian bid to control the Latvian ice free oil harbor of Ventspils which has a direct connection to the Russian oil pipeline network dating from the Soviet time. Some years ago the Latvians refused the Russian bid to buy a controlling stake in the oil harbor which led Russia to build the very expensive Baltic Oil Pipeline System which enabled Russia to export oil from its own harbors thus rejecting Latvia's role as a transit country.

Second, an economical goal of Russian OFDI is to enhance Russian profits by choosing the best markets for selling the decreasing gas production. Volumes in the Russian gas production have already peaked and current gas fields which date for the most part from the time of the Soviet Union are gradually being exhausted. New replacing gas fields have been found but significant investments in developing new fields have been lacking partly

due to the fact that their utilization is considerably harder and more expensive compared to the current fields. At the same time Russia's domestic consumption of gas is in the rise. In fact, Russia is forced to supplement its own gas exports to Europe by purchasing gas from the former Soviet Republics of Central Asia. Hence, Russia is most likely to be unable to supply all its current and planned pipelines with gas. However, despite insufficient gas production the new pipelines represent possibilities for increased profits. With an extensive pipeline network Gazprom is able to benefit more from dynamic market forces just like in the oil market, which is not restricted by expensive and binding transport infrastructure to the same extent, Gazprom can sell its gas to the highest bidder and thus increase the price of gas.

Third, the political goal of bypassing transit countries is most apparent in the planned gas pipeline projects of Nord Stream and South Stream where the strategic objectives are evident in their geographical locations or even in their names, south and nord[3]. One key objective for Gazprom is to bypass the Eastern European transit countries, particularly from the northern and southern flanks of Europe in order to achieve a more direct connection with the large Western and Central European gas market. The bypassing of Eastern European countries would reduce transit costs and dependence to transit countries. This is the same strategy that Gazprom is applying in Blue Stream in which the Russians bypass the anti-Russian countries of Caucasus with a direct gas pipeline from Russia to Turkey through the Black Sea. Most of all, as a co-owner of both new pipelines Gazprom would have a better grip of its utilization.

Fourth, the political goal of the planned new pipelines is related to the bypassing of transit countries because it appears that the Russians are trying to increase the level of their political influence in important transit countries like CIS members of Belarus and Ukraine. Should these countries loose their monopoly status as vital transit countries as a result of new planned delivery routes such as the Nord Stream, they would be much more vulnerable for Russian pressure in gas deliveries since these countries would no longer have the counter power of controlling gas deliveries through their territories to Russia's lucrative export market in Western Europe. The same logic applies to Russia's Blue Stream project and the Caucasian countries as well. Thus constructing new gas pipelines

[3] Nord stands for north in English.

represents a possibility for Russia to exert political influence over the former Soviet republics. However, as an alleviating factor one must bear in mind that the former CIS republics are gradually starting to pay world market prices for their gas so possibilities for gas price disputes are likely to be fewer in the near future.

Fifth, the final political and to some extent also an economical goal of South Stream is to function as a block to the competing Nabucco gas pipe line. The Nabucco project is run by the European Union aiming for the construction of a gas pipe line from the Caspian gas producing region through Caucasus, Turkey and Southern Balkans into Austria thus bypassing Russia and diversifying the basis of European gas imports. However, should South Stream be built, it would certainly weaken the probability of constructing the competing Nabucco line since South Stream will use the same Caspian natural gas reserves as Nabucco thus exhausting the limited gas reserves before Nabucco. In addition, several energy companies in the Balkans have already agreed to be partners in South Stream thus reducing the probability of them engaging in another massive pipe line project. The Bourgas-Alexandroupolis oil pipe line discussed earlier, in turn, has the main objective of bypassing the Turkish straits as the sole possible oil transport route between the Black Sea and the Mediterranean.

Despite Russian strategic goals and Russia's importance as an energy supplier to Europe, one should also pay attention to some positive facts characterizing the EU-Russia energy relationship. First, the dependence between Europe and Russia in the gas sector is to some extent two-sided which is mainly due to technical reasons. All the major Russian gas pipe lines are headed towards Europe and at the moment, Gazprom is practically unable to export its gas anywhere else than Europe. So far the Russians have not utilized LNG-technology[4] eagerly although it would enable more flexible export alternatives globally through sea deliveries. Second, Russian gas deliveries to Europe have an excellent historical track record. Russian gas has been delivered reliably to Europe since the politically sensitive times of the Soviet Union for over 30 years and relatively minor disruptions in the gas deliveries like Russian-Ukrainian gas disputes were not targeted against the EU countries. Instead the minor disruptions in gas deliveries were caused by disputes among the countries of the former Soviet Union.

[4] LNG is mainly utilized at Sakhalin. Gazprom is increasing LNG exports from Sakhalin thus reducing its export dependency of the European market.

4.3 The changing role of foreign energy companies in Russia – implications on foreign expansion of the Russian energy majors

Along with increasing Russian energy investments in the EU and near abroad and growing concerns on energy dependency on Russia in the region, the issue of foreign participation in the Russian energy sector has, in turn, gained on relevance. Western oil companies have loudly called out for improving conditions for reciprocal investments and larger shares in Russian oil and gas production without major success thus far. The increasing state control over the Russian energy sector on the expense of foreign companies has a direct impact on the foreign expansion of the Russian state-run energy companies. Increasing control over domestic energy resources gained through expropriation of foreign companies in Russia considerably enhances the position of the Russian state-owned companies in the global energy sector. In following, the role of foreign energy companies in Russia and its linkages to the Russian energy majors' foreign operations will be discussed.

Most of the foreign TNCs entered the Russia during or after the first wave of the industrial ownership restructuring in the aftermath of the collapse of the Soviet Union. In most instances, the operations of foreign TNCs in the country's energy sector are based either on joint ventures or Production Sharing Agreements (PSAs), commercial contracts between the investors and the Russian Ministry of Industry and Energy, mainly dating back to early 1990s. The first joint ventures were created in 1989; currently, approximately twenty joint ventures are operational.

During the past ten years, the position of foreign TNCs in the Russian oil exploration has considerably weakened. In the beginning of 1990s, the foreign companies entered into the few PSAs under highly favourable terms, in charge of huge exploration and production projects. By the mid 2000s, most of the foreign companies were deprived from most of their former privileges and contractual rights. The experiences of ExxonMobil and Royal Dutch/ Shell in Sakhalin, Britis Petroleum in Kovykta, and Total in Kharyaga serve as cases in point. Amidst the rising energy prices and economic upturn, the Russian

authorities have recently altered the terms of the PSAs dating back to the 1990s, which have grown unfavourable under the current economic situation.

In recent years, there has been a remarkable shift in policies on resource extraction in the Russia in general and on foreign TNCs' participation in the extractive industries in particular. As pointed out by the OECD in its *2006 Economic Survey of the Russia*, the role of the state in the Russian economy has considerably strengthened. During the past three years, there has been a visible trend of renegotiation by the state almost every major energy project in the country with foreign control. Based on the contracts and agreements of the early and mid 1990s, marked by economic difficulties, institutional upheavals and low oil prices, many of the foreign TNCs were granted favourable terms to develop and extract the Russian energy resources. The increasing oil prices since the early 2000s and the strong economic growth that followed have given way to what some experts refer to as "resource nationalism". During the past three years, the Russian state-owned enterprises (SOEs) have acquired major energy assets from domestic private owners. By the end of 2007, the state had gained control over 47% of the oil and gas output in Russia. The trend of the strengthening role of the State has a direct effect on the foreign companies' operations in the Russia, which have lately seen their previous contracts and agreements on resource extraction redefined through unilateral acts.

As shown by the recent case of foreign-run extraction projects in the Russia, the current legislative framework offers considerable chances for arbitrary and selective application. Under the scrutiny and pressure of the Russian authorities have become only the large-scale projects with foreign control, while no comparable probes into the production sites operated by the SOEs have been carried out. During the past few years, allegations on environmental damage, misappropriation of costs and revenue between TNCs and regional authorities, and non-compliance with production terms, among others, have either disturbed or halted the activities of nearly all of the foreign-led energy extraction projects in the Russia. In all the cases, the environmental and operational claims have been dropped after the majority stakes in the ventures have been surrendered to the Russian state-owned companies. The most recent milestone in the current development is the forced sale by the Russian-British joint venture, TNK-BP, of the 63%-stake in the giant Kovykta gas deposit in East Siberia to Gazprom. The closure of the deal is expected during the first

half of 2008. Similarly, Royal Dutch/ Shell surrendered its majority stake in the Sakhalin 2 project to the state-owned Gazprom in early 2007. In addition, the Russian extraction projects run by Exxon Mobil and Total continue to face a threat of license revocation.

Two legislative acts currently under drafting will directly affect the position of foreign energy companies in Russia. According to the draft of the new subsoil law, foreign investors and Russian companies owned by them will not be admitted to bid in auctions for strategic deposits. Neither are foreign-incorporated entities allowed to acquire more than a 50% stake in the strategic deposits or enterprises by any other method. The deposits categorised as strategic include the oil deposits with reserves of above 70 million tonnes, natural gas deposits with reserves of over 50 billion cubic meters, and all deposits on the Russian continental shelf. In addition, foreign participation in the charter capital of the companies engaged in the development of federal mineral resource deposits (and in eight other strategic industries) will be restricted. In addition, the law on restricting foreign ownership in some 40 industries defined as strategic for the Russian economic and national security is expected to come in force during 2008. The bill requires foreign investors to seek government approval for purchase of a 25 to 50 percent stake in companies belonging to the strategic sectors, and 5 to 10 percent stake in companies in mining and extractive industries.

In the light of the recent developments, foreign TNCs are thereby bound to remain bystanders in the Russian oil and gas industry for time to come. There is little doubt that Russia will continue to welcome foreign TNCs and capital to develop the production and infrastructure of its energy sector and to finance international acquisitions by the Russian state-owned enterprises. However, the majority ownership of the country's key oil and gas extraction projects is evidently out of the reach of foreign companies. In addition, so far there are little signs that the government is giving up its control over oil and gas infrastructure and providing foreign companies with an access to downstream or exports. As a result, besides minority shares in a limited number of upstream ventures, there appears to be only little room for maneuvering for foreign TNCs in the Russian oil and gas sector.

The changing role of foreign companies in the Russian energy sector has strong policy implications and connections to the Russian energy majors' operations abroad for at least two reasons.

First, as the share of foreign companies in Russia's oil production diminishes, the Russian state-owned producers increase their take in the country's energy output, thus, further nationalizing the Russian energy production. Concentration of energy producing assets in the hands of state-controlled conglomerates obviously enhances Russia's bargaining position against the European energy importers. Along with increasing export revenues for the state, the state-owned producers have greater room for manoeuvre in choosing their export markets by supplying alternative markets to Europe despite the lower export margins due to the less efficient transportation systems.

This leads us to the second important implication of increasing state control over energy assets at the expense of foreign companies, namely the energy infrastructure. Most importantly, the notorious takeover by Gazprom of the majority share of giant Sakhalin-2 gas project from RoyalDutch/Shell was an important step in advancing the Russian geopolitical ambitions. Establishing control over the technologically advanced liquefied natural gas (LNG) production assets on Sakhalin, allows Gazprom to diversify its future energy supplies away from Europe. As the large-scale LNG exports from the island begin in late 2008, Gazprom will be in a key position supplying the South-East Asian markets and, hereby, altering the current balance of power between Russia and Europe as its only major importer of natural gas.

5 Conclusions

Russia's energy policy towards Europe is often portrayed in public as being dominated by Russia's political motivations and aspirations. This view states that Russian energy investments in Europe have for the most part the purpose of gaining more political influence among the energy importing countries of Europe, particularly in the former Soviet sphere of influence. In our opinion, this perspective, though accurate, paints somewhat a one-sided picture of the motives behind Russian energy policy.

We would like to complement this picture by adding the often neglected economic factors as motivations for Russian energy policy. Like we have discussed in this report, Russian energy investments in Europe have also been influenced by economic goals such as enhancing Russia's position in the energy value chain and choosing the best markets to sell the slowly diminishing Russian energy production. In other words, to improve profitability of the Russian energy industry. This is what companies, even state-controlled, are expected to do by default, regardless of their line of business or geographical location. We believe that by adding economic factors alongside with political we are able to build a more robust understanding of the driving forces behind Russia's energy policy.

Furthermore, the weak success of Western energy companies in Russia's energy sector and the increased state-control of the Russian energy assets have reflections on Russia's energy investments in Europe. First, concentration of energy production in the hands of state-controlled companies certainly enhances Russia's bargaining position against European energy importers. Second, increased state-control particularly in the Sakhalin-2 gas project with its LNG-capabilities allowing gas exports to other destinations besides Europe has advanced Russia's geopolitical aims by diversifying export possibilities.

The future of Russian energy FDI in Europe is to be shaped by increasing state ownership and control of the country's energy assets. As opposed to several other industries, the Russian energy investments abroad are unlikely to uphold the growth rates witnessed during the recent years. The strengthening state ownership in the energy industry foresees the development of the two state-controlled champions, Gazprom and Rosneft, into ever stronger global and regional energy majors, respectively. Under this scenario, it is likely

that the Russian energy investments in Europe will be carried out by virtually one or two companies, with a clear-cut aim of acquiring and building infrastructure assets throughout the continent. The Russian-led energy infrastructure projects currently under development are vital for Gazprom and Rosneft to establish the long-sought downstream presence in Europe and add to strategic options for oil and gas deliveries.

However, this line of development foresees ever smaller number of Russian energy investments in Europe. Once completed, the Nord Stream and South Stream gas pipelines and adjacent acquisitions of national energy companies recently carried out by Gapzrom are likely to provide the company with export capacity and leverage for years to come. In upcoming years, the Russian gas behemoth will be forced to struggle with the mounting investment needs in domestic upstream in order to fulfill its domestic and international supply obligations. Similarly to Gazprom, the other few Russian energy giants will inevitably face the moment when they are forced to concentrate on developing the long-neglected domestic hydrocarbon fields instead of pushing for rapid international expansion. The recent signals from the Russian energy policy front foresee the arrival of that day sooner rather than later.

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