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Political risks of foreign direct investment in the Russian gas industry – The Shtokman gas field project in the Arctic Ocean

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Abbreviations

BOP	Balance of payments
BP	British Petroleum
CIS	The Commonwealth of Independent States
EU	The European Union
FDI	Foreign direct investment
FSB	The Federal Security Service of the Russian Federation
IMF	The International Monetary Fund
LNG	Liquefied natural gas
NAFTA	The North American Free Trade Agreement
NATO	The North Atlantic Treaty Organization
PSA	Production sharing agreement
UN	The United Nations
USA	The United States of America
USD	The United States Dollar
USSR	The Union of Soviet Socialist Republics
WTO	World Trade Organization
WWF	World Wide Fund For Nature

Executive summary

Russian Gazprom is developing the vast Shtokman gas field in the Barents Sea together with the French Total and the Norwegian Statoil. The objective of this research was to identify, in the light of the Shtokman project, the political risks that foreign investors may face in the Russian gas industry. The theoretical framework of the research was created based on several models about political risk, and the empirical data of the study was gathered by interviewing eight experts from Finland, France, Norway and Russia.

According to the findings of the study, changes in the Russian top leadership, the development of Russia's international relations, and the future of the global gas markets are among the main factors affecting the level of political risk in the Shtokman project. The foreign investors' bargaining power against Gazprom and the relations between the investors' home countries and Russia are significant factors as well. Moreover, project-specific issues, such as the initial contractual relationship, affect the project's risk level.

Nationalisation and forced contract renegotiation were concluded to be rather unlikely scenarios as in this case, Russia remains in control of the field's resources, and the foreign investors are only involved in the field's development. In fact, one of the key questions at the moment is the foreign companies' compensation for developing the Shtokman field. After the project's first phase, i. e. 25 years after the production has begun, the ownership of the field's infrastructure will be transferred to Gazprom. Half of the project's costs are to be paid already during the first phase, whereas the field's peak production is to be reached only during the following phases. Furthermore, the project contains significant risks as the political and the economic situation in the Russian gas industry may change considerably during the project's implementation.

However, the final decision to implement the field has not been made yet, and the current estimates for the production to start in 2016–2017 seem to be unrealistic. The project's future depends on the development of the Yamal gas fields, on the future of the global gas business, and on the partners' cooperation in the project. Because of these uncertainties, the most essential question remains open – is the challenging Shtokman project going to materialise in the foreseeable future?

Turku, 28.5.2010

Eini Laaksonen

1 THE RUSSIAN GAS INDUSTRY AND POLITICAL RISK

1.1 The Russian gas production and the Arctic gas resources

It has been stated that the oil and gas industry is the most sensitive sector in Russia. It is the country's principal source of budget income and export earnings. When it comes to gas, the state has remained in control of the industry despite the collapse of the USSR (Liuhto 2007, 24, 25). Instead of privatisation and restructuring, gas production has been organised into the state-led company, Gazprom, which incorporates all the old Russian structures related to gas and its production: producing companies, refineries, pipelines, trading companies, all regulatory agencies, and teaching and research institutes (Oxenstierna 2009, 30). At the moment, Gazprom produces over 80 percent of the natural gas in Russia, controls the gas pipelines and has a monopoly position in gas exports (Liuhto 2007, 25).

Gazprom has almost complete monopoly in the transport of natural gas, and it operates exempt from export tax, some import tariffs, and value added tax. As a consequence, Gazprom has become increasingly powerful, and is able to control both Russian and foreign gas producers in the market through its control of the pipelines, without which others are unable to deliver gas forward. This failure, in turn, may result in other companies failing to meet their production agreements, which again may result in them losing their licenses to Gazprom (Oxenstierna 2009, 30). The state allows Gazprom to swallow other companies, and the company has had its position legally reinforced (Moe & Rowe 2009, 109).

The Kremlin justifies the growing state domination of the economy by asserting that Russia needs *"national champions"* to be able to compete in the world markets. Under the governance of Alexei Miller, Gazprom has been transformed from a relatively independent partner of the state into a key instrument of the Kremlin, particularly in foreign policy (Poussenkova 2010, 51, 63). When it comes to foreign investors, the state seems to allow foreign parties to benefit financially from the development of the oil and gas industry, but it is nonetheless reluctant to give them control over it. Liuhto describes the situation of the sector as follows: *"Investing in the Russian oil and gas business has become a form of Russian roulette for foreigners. The revenues are high but the risks of political intervention are even higher"* (Liuhto 2007, 26). Russia's

economic growth is strongly tied to the performance of its oil and gas industries, and the state wants to maintain the control over these valuable resources[2].

At the moment, however, Russia is beginning to face new, serious challenges regarding its gas industry. The gas supply is facing difficulties as the traditional West Siberian basin is expected to reach its peak in production over this decade, and the resource bases in northern and eastern territories require investment and time before they will produce enough gas to offset the gradual decline of the old basins (Fernandez 2009, 2). Simultaneously, the global financial crisis is coming to an end, and energy prices are showing signs of recovery as the demand begins to increase again (IB 2009). Will Russia be able to meet the growing energy demand? Is Russia a reliable gas producer and supplier for the European and Asian markets in the future?

Russia intends to invest USD 1 800–2 100 million in the oil and gas industry by 2030 to increase production in order to keep up with projected European and Asian demand, in addition to the growing domestic consumption (IB 2009). In fact, Gazprom hopes that its share of European gas market will reach 32 percent by 2020, compared to the current 25 percent. Gazprom also expects its shipments to Asia will reach the same level as shipments to Europe at present (MT 2010a, 7).

The issue is complicated by the fact that planned increases in gas production and the consequently required investments are almost always linked to projected foreign sales, which in turn are influenced by the competition in the market. Currently for example the European gas market is actively searching for alternative gas suppliers and developing new energy sources to reduce the dependence on Russian gas (IB 2009). One example of this is the recent boom around shale gas[3], which has created a revolution in the gas fields of the USA (TO 2009). If the EU could use the shale gas reserves in its geographical area, the demand for Russian gas would be lowered. This would also

[2] For more information about the proven reserves and about the Russian oil and gas sector, see Appendices 1 and 2.

[3] Shale gas is a new source of natural gas, trapped in rock formations. Oil companies have known about it for decades, but dismissed it because it has been too expensive and difficult to extract. During the past few years, new technologies have been invented to fracture the rock and free the gas by pumping water underground (TO 2009). American companies are entering to explore the European possibilities, and at the same time, for example Norwegian Statoil, British Petroleum (BP) and French Total are entering the American gas market to gain experience and expertise about the shale gas production (PL 2010). Nevertheless, the Western Europe's basins are far smaller, often geologically more complex, and more populated than the fields in North America. Moreover, the lack of supply chain and appropriate rigs and equipment results in substantially higher well costs, and the environmental concerns must not be forgotten either (Economist 2009, E&P 2009, TO 2009).

reduce the mutual dependence, as well as the prices that Russia charges the final consumers in Europe (Economist 2009). However, despite the recent enthusiasm, critics say that even assuming that it is economically feasible, it will take years to develop Europe's shale gas resources. In the near future, the demand for Russian gas will continue and even increase, and consequently new resources and investments are required.

At the moment, Russia has to rely on conventional solutions to meet the increasing demand for natural gas. The Arctic[4] plays a crucial role in the development of the gas sector – it is the solution to the energy resource problem. The non-renewable natural resources under the Arctic ice cover are becoming more easily accessible due to global warming (RAD 2009), and the extensive continental shelves may constitute the geographically largest unexplored prospective area for petroleum remaining on Earth (USGS 2008). It has been estimated that the area accounts for about 22 percent of the undiscovered, technologically recoverable oil and gas resources[5] in the world. Within the European High North, most of them are located in the Russian sector, both onshore and offshore (Eide 2009, 42; Moe & Rowe 2009, 107). For example, the offshore Shtokman gas field on the Barents Sea, as well as fields in the Yamal Peninsula on the Kara Sea are proven to be rich in gas resources[6].

When discussing the Arctic energy resources, it has to be noted that some areas in the middle of the Arctic do not belong to any nation – they are no man's land. As the climate is warming and the ice cap is melting, the strategic position of these disputable Arctic areas has changed. All the countries in the immediate neighbourhood have their own interests in the area, not only in its natural resources but also in the rights to use different sea routes. Five countries compete of the right to control the Arctic resources: Canada, Denmark, Norway, Russia and the USA (Lind 2008, 39)[7]. Russia has a vested

[4] The Arctic region is usually defined by the Arctic Circle, which goes at 66 º 33' 39" north of the Equator (Glasby & Voytekhovsky 2009, NSIDC 2009). An alternative way to define the Arctic is the area where the average temperature in the warmest month lies below 10 º centigrade. Also the northern limit of upright tree growth has been considered as the border line of the Arctic region (NSIDC 2009).

[5] According to estimations, 90 billion barrels of oil, 47 billion cubic meters of natural gas, and 44 billion barrels of natural gas liquids may remain to be found in the Arctic, of which approximately 84 percent is expected to occur in offshore areas (USGS 2008).

[6] Shtokman holds 3.8 trillion cubic meters of gas and 37 million tons of gas condensate (Shtokman 2009). Yamal holds 16 trillion cubic meters of explored gas reserves, condensate reserves being estimated at 230.7 million tons. The largest single field in the Yamal peninsula is Bovanenkovskoye, holding 4.9 trillion cubic meters of gas (Gazprom 2009b).

[7] A map of the Arctic states as well as of the no man's land areas can be seen in Appendix 3.

interest in control over all the possible energy sources and has indeed engaged in provocative action concerning the Arctic oil and gas reserves. In summer 2007, Russian submarines set up a flag made of titanium on the bottom of the Arctic Ocean to symbolise the "conquest" of the North Pole (Numminen 2009), even though the Pole does not belong to any country and its position has been defined in international agreements (Lind 2008, 39).

For example, an area called grey zone between Norway and Russia has been an object of extensive negotiations over the last 40 years. The size of the disputed area is about 175 000 square kilometers, and it contains remarkable hydrocarbon and fish resources. Suddenly at the end of April 2010, President Medvedev and Norway's Prime Minister Jens Stoltenberg reached a breakthrough in the negotiations and announced that a deal on the bilateral maritime delimitation is to be signed. The recommended solution involves a delimitation line that divides the overall disputed area in two parts of approximately the same size. However, technical details still remain to be negotiated before the final treaty is ready for signature. Nevertheless, through this announcement, Norway and Russia showed to the other Arctic states that they are able to solve the grey zone dispute by themselves. The agreement simultaneously indicates the good relations between Norway and Russia (BO 2010b, Koivurova 2010).

According to Penkova (2009), there are three reasons why the Arctic region is so important to Russia. Firstly, the Arctic is expected to be Russia's "future economic and energy resource engine". Russia sees the Arctic areas as major sources of revenue, and therefore developing them is one of the Kremlin's priorities (Bennett 2009). In September 2008, President Dmitri Medvedev said in a session of the Russian Security Council that the Arctic shelf is a guarantee of Russia's energy security, continuing that the Arctic should become the resource base for Russia during this century (RIA 2009b). The second reason is the Northern Sea Route, a transport corridor between the North Atlantic Ocean and the Pacific Ocean along the Russian coast, which is expected to become one of the most important transit routes in the future as the ice keeps melting. The third reason deals with the area's strategic location and security value – the Arctic coast is also the base of the Russian Northern Fleet and the base of Russian nuclear submarines.

Because of the strategic importance of the Arctic, the state maintains a certain level of control over the operations in the area. In July 2008, President Medvedev signed a law

on Arctic resources, according to which permits to develop plots of the continental shelf will be handed out directly by the government without auctions or tenders. In other words, the government is empowered to choose companies to develop resource extraction on the continental shelf. Medvedev commented on the law by saying "The continental shelf is our national heritage", which was interpreted as indicating that the development of the Arctic will be left to Russian state-led companies. When further asked about the cancellation of auctions, Medvedev said "This was done consciously to ensure rational use of this national wealth" (TOR 2009, AE 2009).

However, Russia has recognised that technological and financial help is needed to get the Arctic energy projects running, as Gazprom lacks the required technical expertise (RAD 2009). In the Arctic there are several possible substitutes for the Siberian fields, such as the fields on the Yamal Peninsula and offshore fields like the Shtokman field in the Barents Sea (Robeck 2005, 13). Most of these potential fields are located far from consumption centres and in environments where it is more difficult to operate than in western Siberian fields, and consequently production costs are likely to be higher in the future, which increases the need for investment (Ivanov 2003; Robeck 2005, 13). The exploration and development costs alone will require considerable investment sums (Robeck 2005, 14). Foreign know-how and finance are required for the development of the Russian gas industry. As an example of a Russian-foreign joint investment project, Gazprom, Norwegian Statoil, and French Total are developing one of the world's largest gas fields, Shtokman, 600 kilometres northeast of the city of Murmansk (Statoil 2008). Gazprom is also planning corresponding projects in the Yamal peninsula (Gazprom 2009b).

Poussenkova (2009, 63–64, 71) argues that when choosing investors for the energy projects, the state companies might be guided by political rather than commercial considerations. According to Poussenkova, the politicisation of the Russian energy sector and the role of Gazprom are demonstrated by the Kremlin's decision to invite Total to the Shtokman project. By selecting this particular partner, the Kremlin accomplished two tasks. Firstly, Putin sent a signal to President Nicholas Sarkozy about his readiness to build bridges, which is important to Russia given its deteriorating relations with the West. Secondly, Putin offered an advance for France's opposition to the EU's new energy directives and to Brussels' attempt to create a joint strategy for the EU. In addition to admitting France, as well as Norway, to Shtokman, Gazprom has invited the German Wintershall and the Italian ENI into its energy projects. By giving

these countries the status of preferred gas partners, Russia is playing upon differences between European states. Poussenkova also notes the control that Gazprom has over the former Soviet Republic countries: during Putin's term, preferential gas prices for countries in the CIS were maintained. These countries can keep preferential prices if they permit Gazprom to establish control over their gas transportation networks (Poussenkova 2009, 66). The Russian gas industry welcomes foreign investors, but simultaneously it is a political playground.

To start new production to replace the depleting fields and to meet the growing demand, Russia has to invite foreign partners to its top sensitive sector. The Russian reserves are also attractive to the Western gas companies. However, foreign investors have not always had successful experiences in the Russian gas business – in such a politically sensitive sector, political risk is always present, particularly if the choices in investors have been made not only for commercial, but largely also for political reasons. The following chapter discusses the earlier experiences that foreign companies have had in the Russian gas industry.

1.2 Experiences of political risk in Russia

Despite the sensitivity of the Russian energy sector, foreign investors have invested in Russian energy projects in the past. However, some of the investors have also had to face the Kremlin's will to control the sector, particularly in cases concerning PSAs[8] signed in the 1990s. This chapter discusses the cases of Royal Dutch Shell, British Petroleum and Exxon Mobil.

Shell and Sakhalin-II

Sakhalin-II was initially a project of Royal Dutch Shell (55 percent) and Japanese partners Mitsui (25 percent) and Mitsubishi (20 percent). The Sakhalin-II is a gas and oil project, which comprises two offshore platforms, an oil and natural gas pipeline, and an LNG[9] plant. The project will take liquefied natural gas from the Sakhalin island to the east coast of Russia and feed the energy hungry markets of Japan, China and South Korea (NYT 2006a).

[8] PSA refers to a production-sharing agreement, which is a contractual arrangement for petroleum exploration and development, signed between a foreign company and a state as the owner of mineral resources (Bindemann 1999, 1).
[9] LNG refers to liquefied natural gas. LNG is natural gas that has been temporarily converted to liquid form for ease of storage and transport.

Shell and its Japanese partners formed Sakhalin Energy Investment Corporation (SEIC) and gained the rights to exploit the Sakhalin fields from the Russian government in 1994. At the time, Kremlin was desperate for foreign direct investment in the Russian energy sector to begin the implementation of projects. Consequently, during Boris Yeltsin's presidency, the government agreed to a PSA whereby the Shell-led consortium would start to pay profit taxes to Russia only after it had cleared the project costs (ATO 2006, CNN 2007).

Problems emerged when the Russian authorities accused Sakhalin Energy of breaking environmental and criminal laws, and consequently threatened to revoke its licences. In 2006, RosPrirodNadzor, the Russian environmental inspectorate, cited the Sakhalin Energy for allegedly damaging the seabed around Sakhalin, harming native whale populations, and illegally felling trees on the island (NYT 2006a). The inspectorate was joined by experts from WWF International, which had repeatedly given warnings that Shell's offshore platforms were threatening the breeding areas of grey whales and that the pipeline river crossings were damaging salmon migration routes. According to Shell, the company met the highest Russian and international environmental and social standards (TO 2006), and for example the offshore pipeline was re-routed 20 kilometres further away from the whales' feeding ground (TSSR 2006).

In response to the problem, the Russian authorities suggested that a solution would be for Shell to sell its interest to Moscow, which was interpreted by Shell to mean that the Russian government was using the environmental issue concern as an excuse to take control of the multi-billion dollar gas project (RO 2006). However, as the public bickering between Russian and foreign parties over the project intensified, Shell's bargaining position deteriorated. Gazprom sought a 25 percent stake in Sakhalin Energy, reducing both the Shell and Japanese partners' stakes. It was reported that the Japanese partners would have sold parts of their shares to Shell, which again would have swapped a 25 percent shareholding with Gazprom, in exchange for a 50 percent stake in Gazprom's Zapolyarnoye field (ATO 2006).

However, the problems increased when Shell announced that the costs of the project would be more than twice the initial estimation. The original estimation was USD 10 billion, whereas the new estimation was USD 22 billion (Bloomberg 2006). According to the PSA, the state of Russia would receive tax payments only after the costs would have been recouped, which meant that the cost overruns would have significantly

postponed the tax payments (ATO 2006). For example, the re-routing of the pipeline increased the costs of the project in addition to the generally rising costs of labour and steel materials for pipelines. Shell denied that it had spent money extravagantly (CNN 2007). In December 2006, however, Gazprom seized control of the project by buying a 51 percent stake of the Sakhalin Energy for USD 7.45 billion. Shell reduced its share of Sakhalin-II from 55 percent to 27.5 percent, Mitsui's share declined from 25 to 12.5 percent, and Mitsubishi's share fell from 20 percent to 10 percent. Simultaneously, Gazprom gained the right to control pricing and policies on all future sales of the field (NYT 2006b).

Nevertheless, even though the agreement lowered Shell's production potential and the amount of its reserves, it simultaneously removed a large measure of uncertainty over the deal by establishing the Kremlin's support for the project. The stability was welcomed by Shell after the threat of totally freezing the work on the project due to the revocation of the company's permits (NYT 2006b). After Gazprom bought the stake, the environmental complaints were dropped and the work continued (NYT 2008a).

BP and Kovykta

Another less than successful example is the BP (British Petroleum Company), which experienced problems in Kovykta through the TNK-BP, the BP's joint venture with three Russian billionaires. TNK-BP was formed in 2003 with the blessings of the Russian President Vladimir Putin and the British Prime Minister Tony Blair, who attended the signing ceremony. However, in May 2007, Russia's natural resources inspectorate accused TNK-BP for not producing enough gas in the Kovykta field. The licence to develop the field was owned by Rusia Petroleum, of which TNK-BP owned 63 percent. In 2006, Rusia Petroleum produced 1.5 billion cubic meters of gas from the field, whereas the target was 9 billion cubic meters. Under the terms of the licence, the project was to have supplied that volume of gas to the Irkutsk oblast, where Kovykta is situated. The company was ready to start the production at that level in 2006, but there was no demand for that volume in the Irkutsk oblast, and the planned pipeline to China had not been built. When TNK-BP applied for a permission to build a pipeline to transport Kovykta gas to China, Gazprom blocked the project, and when TNK-BP proposed changes to the licence, the Russian authorities turned down the proposals. Despite this, Oleg Mitvol, deputy head of the inspectorate, commented: "If they have not fulfilled their targets, it will be the end of the licence" (EDM 2007, RFE 2007, NYT 2007a, NYT 2007b).

Energy analysts said that this time, the Russian strategy was to maintain a monopoly in natural gas exports to Asia through Gazprom. The Kovykta field is among the largest natural gas deposits in the world, and especially valuable because of its proximity to the fast-growing markets in China (NYT 2007b). In June 2007, Gazprom was to buy TNK-BP's stake in Rusia Petroleum for USD 700–900 million, but the deal was stalled due to disagreement over the price (SPT 2007, FT 2010). The majority share in the project was thought to be worth some USD 20 billion when completed (SPT 2007).

Afterwards, in March 2008, TNK-BP faced further accusations – this time of industrial espionage, and the FSB arrested two of BP's employees on charges of spying for Western oil companies (NYT 2008b). A day later, a Russian environmental agency announced that it would inspect a large oil field in Siberia, the Samotlor, which is controlled by TNK-BP. The Samotlor field is among the worst environmental disasters in Siberia's oil region, and a part of the rationale for forming TNK-BP in 2003 was the environmental protection technology that BP promised to bring to the field. A spokeswoman for the Ministry of Natural Resources characterised the inspection as routine and noted that it would cover other fields and companies as well (NYT 2008a).

According to some analysts, the accusations against TNK-BP were partly trumped up in this case. As the oil prices skyrocketed, the Russian government began to reverse deals that appeared unfavourable for Russia (NYT 2008b). The Russian foreign ministry issued a statement indicating that the spy charges were not related to a diplomatic dispute between Russia and Britain, but that the arrests were purely a law enforcement matter (NYT 2008a). However, already in June 2007, the then outgoing British Prime Minister Tony Blair warned that the increasingly frosty relations between Russia and the West would harm foreign investment to the country (SPT 2008).

TNK-BP continues to have problems with Kovykta – even though it still owns the license, it is unable to develop the field under the pressure of Russian authorities which continue to accuse it for not meeting the license requirements (MN 2010). The battle over the field continues, and the threat of Russia stripping TNK-BP of its license continues to exist or even increases.

Exxon Mobil and Sakhalin-I

Since Shell and BP were forced to give up control over their projects, American Exxon Mobil's Sakhalin-I project has been the last remaining Russian gas venture under

foreign control. Sakhalin-I is a venture of Exxon Neftegas, a subsidiary of Exxon Mobil with a 30 percent share, the Japanese Sakhalin Oil and Gas Development Co (SODECO) with a 30 percent share, the Indian ONGC Videsh with a 20 percent share, and affiliates of Rosneft, RN-Astra with a 8.5 percent and Sakhalinmorneftegas-Shelf with a 11.5 percent share. The field's development has been successful, and in early 2007, Exxon Neftegas entered the record books when it completed the extended-reach Z-11 well on Sakhalin (OT 2007). The project has been producing oil for several years and gas since 2005, shipping small volumes to continental Russia (Reuters 2009b).

However, in a widening campaign of pressure over PSAs, the Russian environmental authorities also threatened this project. In addition, Pacific Environment and WWF submitted petitions to the consortium to suspend all oil and gas development activities near an annual feeding habitat of the critically endangered Western Gray Whale off the coast of Sakhalin Island. Shell, Gazprom and other companies in Sakhalin-II listened to the warnings and postponed the seismic surveying they had planned for 2009, but reportedly Exxon and Rosneft refused to amend their construction and extraction plans in the Sakhalin area (WWF 2009).

Another even more threatening issue for Exxon Neftegas is the ongoing dispute with Russia about the Sakhalin field's gas and gas supplies. Initially Exxon Mobil was to sell its share of the gas where it could gain the best price and was thus considering China (Reuters 2009a). In 2004, the Exxon-led consortium signed a preliminary agreement to supply approximately 8 billion cubic meters of gas to China and also engaged in talks with Japan and China on supplying liquefied natural gas (Forbes 2007). In 2006, the company reached a tentative agreement to ship 8 billion cubic meters of gas annually. The PSA excludes Sakhalin-I from Gazprom's legal monopoly on gas exports (Reuters 2009b). Nevertheless, the Russian government and Gazprom have refused approval to transport the gas to China, quite similarly to the case with BP's Kovykta field. In 2007, Gazprom announced that the field's gas is needed for the Russian domestic market, and consequently Gazprom wants to buy the gas at the domestic price, which is significantly lower than the international market price (TO 2007). Moreover, according to some assertions, Gazprom wants to build the pipeline and export the gas itself after buying it from Exxon Neftegas at lower than market price.

Since then, Exxon has been in discussions regarding selling gas from Sakhalin-I to Gazprom (Reuters 2009b). After the experiences of Shell and BP, Gazprom's influence

has grown significantly in the region, and according to some assertions, Exxon Mobil may eventually prefer to agree on selling the Sakhalin-I gas to Gazprom to avoid similar actions. In December 2009, Gazprom reported that during the next year, it aims to reach an agreement with Exxon Mobil on buying all the gas produced in the project (Bloomberg 2009a).

In January 2010, the Russian government rejected Exxon Mobil's proposal to invest USD 3.5 billion during the same year to further develop its Sakhalin offshore fields. This put the company's plans at risk again. Referring to the PSA, the refusal was interpreted to mean that higher expenses would delay the government in receiving its share of revenues (MT 2010b, 5). Government officials stated that they required Exxon to justify its spending better, while analysts suspected the delay was linked to the disagreements over Sakhalin's export plans (Reuters 2009b). Given the experience of Shell, it is quite unlikely that Exxon would inflate the project's investment costs, as this would give Russia an excuse to argue its actions in rhetoric related to the unfairness of the old PSAs. Nevertheless, the dispute over the gas exports, or over the selling price, continues, and the project's future remains somewhat threatening for Exxon Mobil.

To conclude, the PSAs signed during Yeltsin's presidency have appeared to be rather troublesome for foreign investors, as Russia is attempting to retake control of the strategic resources. The previously discussed cases have been summarised in Table 1.

Analysts have characterised the regulatory pressure and the resulting offers in the cases of Shell and BP as "hardball" negotiations rather than as nationalisations benefiting Gazprom, as the foreign partners have not been entirely removed. These cases were, however, seen as signifying Russia's changed attitude towards its natural resources. For instance, in the cases of Shell and BP, Western observers widely believe that environmental accusations and other pressuring issues were just excuses for pushing the foreign investors out of key positions in the gas projects, whereas Russian commentators were truly concerned about the damages caused to the nature and saw the projects as templates for how future projects would deal with environmental and social standards (RIA 2006).

Despite the pressure on foreign investors and the resulting risk for the investment, Russia's booming economy has continued to attract foreign companies to the country

(NYT 2008a). Moreover, now the Russian government again seems to be welcoming foreign partners into its new and crucial energy projects. The depression and the challenging environmental conditions of the future gas fields have again affected the government's attitude towards foreign investors in its top sensitive sector of the economy (TS 2009) – their help is needed. For example, Gazprom and Novatek, with the help of Putin, have been looking for foreign partners to develop gas fields in the Yamal Peninsula. Russia has been seeking investment and technology from companies such as Shell, BP, Total and Exxon Mobil. The Yamal Peninsula's LNG production is planned to be supplied to Asia, Europe and the USA. Simultaneously Russia aims for a 25 percent share of the world's LNG market (BW 2010, Bloomberg 2009b, NYT 2009). Gazprom will export the LNG from Yamal, but will return a portion of the revenue to Novatek, which can also be seen as a sign of change in the gas monopoly's position (EW 2010a). According to Gazprom, fields in the peninsula may produce as much as 360 billion cubic meters of gas a year by 2030 (BW 2010, Bloomberg 2009b).

Another Arctic gas field project, into which Gazprom has already accepted the French Total and the Norwegian Statoil, is the Shtokman project in the Barents Sea. This project will be discussed in detail in the following chapter.

Table 1 Experiences of PSAs in Russia

	Sakhalin-II	Kovykta	Sakhalin-I
Starting point	An oil and gas project controlled by Sakhalin Energy, owned by Shell (55 %) and Japanese partners Mitsui (25 %) and Mitsubishi (20 %).	The license to develop the Kovykta field was owned by Rusia Petroleum, of which TNK-BP owned 63 %. TNK-BP is a joint venture of BP and three Russian billionaires.	Sakhalin-I is owned by Exxon Mobil (30 %), Japanese SODECO (30 %), Indian ONGC Videsh (20 %), and Rosneft (20 %).
Problems	In 2006, Sakhalin Energy was accused of allegedly damaging the seabed around Sakhalin, harming native whale populations, and illegally felling trees on the island. Shell denied the accusations. Problems increased further when Shell announced that the costs of the project would be more than twice as large as was initially assumed.	In 2007, Russia's natural resources inspectorate accused TNK-BP for not producing enough gas at the Kovykta field in relation to the license agreement. TNK-BP argued it could not produce the required amount of gas since Gazprom had blocked the construction of a pipeline to China and local demand was insufficient. In 2008, TNK-BP faced further accusations of industrial espionage as well as of environmental polluting.	The project has been threatened by Russian environmental authorities, Pacific Environment and WWF for threatening Grey Whales on the Sakhalin coast. Moreover, Exxon Neftegas is in dispute with the government and Gazprom over the gas exports from Sakhalin. Gazprom wants to buy the gas for the domestic market, whereas Exxon wants to sell it to the highest bidder. Along with this dispute, the state has also begun to hinder Exxon's investments into the field.
Outcomes	In 2006, Gazprom eventually bought a 51 % stake of the Sakhalin Energy. Shell's share was reduced to 27.5 percent, whereas Mitsui's share decreased to 12.5 % and Mitsubishi's share to 10 %. Simultaneously, Gazprom gained the right to control pricing and policies on all future sales of the field.	In 2007, Gazprom was to buy TNK-BP's stake in Rusia Petroleum, but disagreements concerning the price stalled the negotiations and the battle continues. Even though TNK-BP still owns the license, it is unable to develop the field.	The dispute over the gas exports continues, and Exxon has not been able to sell the gas at the market price.

1.3 The Shtokman gas field project

The Shtokman gas field project is an interesting example of foreign investments in the top sensitive energy sector in the strategically important Arctic region. The field was discovered in 1988 and is expected to contain more than enough gas to supply the whole world for a year. The field's reserves, according to Russian measurements, account for 3.8 trillion cubic meters of gas and about 37 million tons of gas condensate. The annual production of the project is envisioned to reach 70 billion cubic meters of natural gas and 0.6 million metric tons of gas condensate, which is comparable to Norway's entire gas output. However, the field is located under the Barents Sea approximately 600 kilometers northeast of the city of Murmansk, at sea depth varying from 320 to 340 meters. Moreover, the extreme Arctic conditions of the region include icebergs, stormy seas, and six months of darkness every year (Shtokman 2009; MT 2010c, 7). However, an advantage would be the opportunity to supply gas directly to Europe and the USA without disturbance from the neighbouring countries (T&T 2010).

The license to explore and produce gas and gas condensate in the Shtokman field is owned by Gazprom neft shelf[10], which is a wholly owned subsidiary of Gazprom (Gazprom 2007). At first Gazprom refused to involve any foreign partners in the project, but in 2007, first the French Total and then the Norwegian StatoilHydro were accepted to develop the field with Gazprom (Lind 2008, 39–41). In July 2007, Gazprom and Total signed a framework agreement on the main conditions of cooperation in the first phase of the Shtokman gas condensate field development, and in October 2007, Gazprom and StatoilHydro signed an identical agreement. In February 2008, Gazprom, Total and StatoilHydro[11] signed a shareholder agreement establishing Shtokman Development AG, a company which is to develop the Shtokman field and to be the owner of the field's first phase infrastructure for 25 years since its commissioning. Gazprom owns 51 percent, Total 25 percent, and Statoil 24 percent of the company's stocks (Gazprom 2009a). The company is currently in the process of selecting locations and contractors for the Shtokman supply base (BO 2009a). The three owner companies have already invested about USD 500 million in the project, and the total costs are expected to reach

[10] Former Sevmorneftegaz, which was set up in 2002 to develop offshore oil and gas fields.

[11] In 2008, Gazprom Neft employed 48 300 people in the Russian Federation, Kyrgyzia, Kazakhstan, and Tajikistan (Gazprom Annual Report 2008). In the same year, Total S.A. employed 97 000 people in more than 130 countries (Total Factbook 2008), whereas StatoilHydro ASA employed 29 500 people in approximately 40 countries (StatoilHydro Annual Report 2008). On the 2nd of November in 2009, StatoilHydro ASA changed its name to Statoil ASA. The name StatoilHydro was used temporarily for a period of two years after the merger between Statoil ASA and Hydro ASA's oil and gas division (Statoil 2009).

USD 30 billion (RIA 2009a), USD 15 billion being required already in the first phase (MT 2010c, 7).

The gas is to be pumped from about 1.5 kilometers beneath the sea bed, piped 550 kilometers to the shore, and then piped on for the local use in the Northwest of Russia, to Europe via the Nord Stream pipeline, and to be turned into LNG at a plant in Teriberka near Murmansk and then shipped to North America (Moe 2009b, 78; MT 2010c, 7). The gas production in the field was to start in 2013. The gas was to flow to Europe via the second branch of the Nord Stream and to be exported as LNG to the USA and Canada starting in 2014 (EW 2010b). However, delays have taken place because of technology, money, and the current uncertainties in the gas markets. As regards technology, it took Statoil more than five years to complete the development of Snøhvit gas field, for example. The field is also located in the climatically challenging Barents Sea and consequently required special technological knowledge (BO 2009d). A great investment of time is required for the construction of fixed installations, in addition to the time required for drilling (Moe 2009b, 79). On the monetary side, the price of gas is crucial when considering the development of this challenging and investment-extensive field. Moreover, it is not today's price that is decisive, but the price that can be expected for the period that the field is in production (Moe 2009a).

Most analysts believe that the prices of oil and gas will increase over the coming years, but there is still considerable uncertainty regarding the future development of the prices. In addition, after the recent gas crises, the EU countries are now working intensely to reduce their dependence on Russian gas. The political insecurity combined with the economic crisis, which decreases the estimated gas demand, makes Russian gas more difficult to sell (Moe 2009a). Moreover, a technological breakthrough in the USA – the launch of gas production from unconventional gas sources – and the fact that consequently the world's largest gas importer has now become self-sufficient, call into question whether it would be purposeful to begin gas production in the costly Shtokman field any time soon (EW 2010b). The fall in the European demand and the surge in the North American shale gas output have dampened the project's export prospects (MT 2010c, 7). In fact, Gazprom is concerned about the possibility of the USA turning into a major exporter and competitor of Gazprom (NE 2010).

Furthermore, the development of the domestic Russian gas market influences the development of the field and of the whole energy sector. The insecurity in the export

markets and the fall in domestic demand makes it reasonable to assume that the development of new fields will not be prioritised (Moe 2009a). On the 5th of February 2010, the board of directors of the Shtokman Development consortium decided to postpone the implementation of the project by three years, and the production in the field is to start in 2016. In addition, the final investment decision still remains to be made and is now planned to take place before March 2011, and regarding LNG before the end of 2011 (Shtokman 2010; MT 2010c, 7; EW 2010b). Nevertheless, the Shtokman project should be viewed in a long-term perspective – even if Russia had a surplus of gas over the next few years, the situation might change sooner or later. The giant fields which presently are the core of Russian gas production are declining and, as a consequence, are in need of replacement (Moe 2009a). However, Gazprom, Statoil and Total might eventually decide to abandon the plans to build a plant to produce LNG, and instead decide to send all the gas by the planned pipeline south towards the other Russian pipelines, in addition to the Nord Stream via the Gulf of Finland to Germany (BO 2010c, IT 2010b). In April 2010, during his visit to Murmask, Vladimir Putin expressed confidence that the development of the Shtokman field will begin in a year's time as scheduled (IT 2010a).

Russia was required to take partners to develop the Shtokman field, as it lacked the necessary financing and technology. The country is also ready to cut red tape for investors in oil and gas projects on the Russian Arctic shelf. The government approved a legislation according to which the current numerous permissions required to engage in the offshore projects will be replaced by extended license agreements, and this facilitated legislation coincided with the Shtokman developers moving closer to the implementation phase of their large project (BO 2009b). However, large-scale investments in the top sensitive sector in Russia need to be well considered. According to a Norwegian business review, Statoil demands more stability in Russia before placing the full investments in the project (BO 2009c). In addition, Gazprom and Total are reported to disagree on several key technical issues in the project. It was reported in April 2010 that the contract of Yury Komarov, the Shtokman Development AG's CEO, will not be prolonged due to his support for the position of Total in the project, which was not well perceived in the Gazprom management (BO 2010a).

Moreover, an important issue is the legal solution for the inclusion of foreign companies in the project. Total and Statoil have not been awarded an ownership of the reserves itself, but of parts of the company that will develop the field (RAD 2008). Shtokman

Development AG will develop and operate about one third of the field, and the company will own the infrastructure during the first phase, meaning for 25 years after the production has started, after which everything will be handed over to Gazprom (Shtokman 2009; Moe 2009b, 78). Shtokman Development is not to own the license or sell the gas. It still remains uncertain, at least for the public, whether the arrangement will allow the foreign partners to book a portion of the reserves in the field even if they do not own a part of the license (Moe 2009b, 78), or whether they will be compensated for their investment in some other way. The full development of Shtokman is envisioned in three stages at four-year intervals, the first phase producing up to 23.7 billion cubic meters of natural gas per year. The peak production of 71.1 billion cubic meters per year is expected to be reached after 25 years (Shtokman 2009, Moe 2009b, 78).

This shows that state control over strategic resources is still a preferred option for Russia (RAD 2009). However, the difficulties of replacing their reserves are the main impetus for Western companies to become involved in the Russian petroleum business, despite the difficulties already experienced by foreign companies in projects such as Sakhalin-II and Kovykta (RAD 2008). Assuming that the field will be implemented, the revenues in the Shtokman project are likely to be high, but in the light of the past experiences, are the risks of political intervention even higher?

1.4 Earlier studies on political risk in Russia

Earlier academic studies have been written in English about risks in the Russian investment environment by, for example, Jones, Fallon a nd Golov (2000). They explored the obstacles faced by transnational corporations considering FDI in Russia. Their findings suggest that Russia's relative lack of success in attracting FDI and exploiting its potential benefits can be attributed to its national infrastructural factors and government policies. The five main obstacles, which help to explain the lack of investment into modern Russia are (1) "Russia's political and economic culture, and its impact on government reform policies"; (2) "the country's taxation and legal infrastructure"; (3) "the presence of the oligarchy and the prevalence of crime and corruption"; (4) "the limitations of the natural privatisation process"; and (5) "the failure of domestic enterprises and managers to adapt to competitive market conditions" (Jones et al. 191). They conclude that the central obstacle to FDI in Russia is the failure to achieve the framework for a competitive economy (Jones et al. 2000, 196).

Broadman and Recanatini (2001) studied the determinants of the geographic distribution of FDI within Russia and found that policy framework issues were among the factors that explain the variation of FDI flows across Russia's regions. Foreign investors who seek to sell as well as produce in a market, are most interested in the economic potential of the region. The infrastructure development is also important, as it affects how difficult and expensive it will be to access suppliers and to distribute to the markets. The third factor explaining differentiating regional flows of FDI is the local policy framework governing the economic activity, regarding, for example, prices charged by regular utilities, tax rates, customs clearance, etc. Referring to this third factor, the FDI is likely to flow to the regions where the political investment climate is most favourable and stable.

Mögel (1999), in turn, studied political risk by evaluating 19 factors in Russian regions and divided the regions into 7 classes by their investment climate. According to this study, on the scale from 1 (favourable) to 7 (menacing), 75 percent of the Russian regions belong to the classes 3 (undetermined) and 4 (rather unstable). The Murmansk region located in the Russian Arctic is one example of the regions classified as politically rather unstable. In Murmansk, for instance the legislative stability and proper implementation of treaties, the social situation, and regional development of reforms were seen to be at a rather low level, whereas the presence of strong interest groups and the internal security and military threat to the population groups were ranked high. However, the support for foreign investment was reported to be at the highest possible level (Mögel 1999, 34).

Fabry and Zeghni (2002) studied the Russian investment climate for foreign direct investment and, in particular, the paradox of Russia being one of the largest countries in terms of natural resources, well-educated labour force, and market potential, but at the same time being one of the least attractive host countries for FDI in the region. They found that in terms of quantity, FDI in Russia is too weak to enhance a restructuring process and contribute to modernisation of local resources and skills, and that in terms of quality, Russia is mainly attracting risk taker foreign investors or investors willing to act in offshore areas protected by local government or by production sharing agreements. They state that modern industrial sectors able to boost modernisation, transfer of knowledge and Western best practices are discouraged, and that foreign investors perceive the general business climate as unstable and risky (Fabry & Zeghni 2002, 289, 300).

Aleshin (2001) identified, classified and assessed risks inherent in joint projects in Russia and made practical recommendations for risk management. According to Aleshin, the execution of Russian projects is characterised by an environment of high uncertainty and risk, due to the absence of a formed market infrastructure and lack of sufficient experience and knowledge to work under such conditions. In this research, 16 dwelling projects were studied regarding their experienced internal risks. The analysis suggested that, for example, establishing closer contacts with the operational services of the city and developing information systems within the project participants could possibly reduce the risk events. The companies that had faced risk events had had limited knowledge of the organisation, construction process technology, and legal base of the investment activity.

Zarkada-Fraser and Fraser (2001) studied the perceptions that marketing managers of UK construction firms involved in the Russian market have of political risk and market potential in Russia, in comparison with other overseas markets. The analysis showed that the firms did not treat Russia any differently than all other markets. However, the respondents were found to be highly concerned about the Russian political environment and about the uncertainty regarding the future of the reforms. They were also worried about the possibility of government attitudes becoming unfavourable to foreign concerns in the future. The general state of the economy was found to be the second most worrying factor, with the legislative framework being the gravest concern.

Liuhto (2009) studied political risk in Russia and noted that the Russian society has become more fragmented and that nationalism grows. He states that “increasing nationalism equals increasing investment risk for foreigner investors, since a foreign investor is a stranger and a target for attack if the nationalistic waves overflow the dam” (Liuhto 2009, 36). He nevertheless continues that it should be remembered that political risk varies largely across industries. At the end of 2009, the telecommunications sector was the most risky industry for a foreign firm, but the state consolidation had continued also in the oil and gas industry. He notes that when Russia experiences difficult times, foreign oil companies enjoy good times in Russia, and vice versa, and therefore the current crisis gives at least a temporary relief for some foreign oil firms (Liuhto 2009, 36–37).

Click and Weiner (2007) investigated the effect of political risk on the value of petroleum reserves in the emerging markets. They utilised a global transactions

database of 1655 mergers and acquisitions, in which petroleum reserves were traded in 2000–2006. Contrary to the assumption in research literature, they found that the discount in the value of the reserves depends on market conditions – the higher the expected future market prices of oil and gas, the larger the discount, regardless of a country's initial riskiness. Their findings suggest that treating political risk and market risk separately is likely to yield inaccurate estimates of asset value, as political risk depends on market conditions: as assets become more valuable due to market conditions, a greater fraction of their value is destroyed by political risk. Moreover, their research shows that political risk may, in fact, substantially destroy asset value (Click & Weiner 2007, 2, 20).

Barchietto (2009) investigated the risk of expropriation in Russia and simultaneously assessed the attractiveness and profitability of foreign investment, particularly in the strategic natural resources sector. Her analysis begins with a look at the political situation when Putin came into power in 2001, and continues to the cases of Yukos and Sakhalin-II, which, according to her, are among the most striking cases of expropriation actions undertaken by the Russian government. She concludes that despite the worsening expropriation risk over the past few years and months and despite the current financial crisis, Russia remains a market with high-return potential, which investors should look at, while, however, protecting their projects by implementing successful hedging tools (Barchietto 2009, 1). Projects must be structured in agreements to deter the host country from expropriating, or the projects must be insured for added security (Barchietto 2009, 38).

Barchietto furthermore identifies the role of the government and state intervention as key problems in the Russian economy. She says that the state is the economic regulator, but it does not respect the supremacy of law and operates on the basis of unofficial rules that even the state does not observe consistently. Barchietto continues: *"No economic reform can stimulate business activity while the state is the servant of bureaucratic corporations and refuses to operate in a competitive environment. […] A regime characterised by personalised power is incapable of creating a dynamic post-industrial economy; its primary concern is to safeguard its own interests"* (Barchietto 2009, 42–43). She states that there is no doubt that Russia will stand with the West in trying times, but nevertheless, the West should not expect the new liberal Russia to be an easy and agreeable partner – shared values do not necessarily lead to shared national interest or common views on global governance (Barchetto 2009, 49).

Patton (2008) studied the energy policies of Russia and risks to international joint ventures in the oil and gas industry. He portrays the national oil companies as aggressive competitors against international oil companies and discusses the renegotiations of production sharing agreements. He states that Western oil companies are finding their traditional influence in the oil and gas industry deteriorating as high energy prices have brought about renewed nationalism, and as a result, many of the existing international joint ventures are experiencing additional business risks as Russia exploits its natural gas resources to become an assertive energy superpower (Patton 2008, 65).

Patton also mentions the Shtokman gas field, and notes that having seen the investments of Shell and BP downsized in Russia, companies vying for a stake in the Shtokman field will inevitably set their sights low, even though in the end foreign companies were accepted into the project due to the need of foreign offshore technology (Patton 2008, 75). However, Patton notes that if the international oil companies continue to transfer their only real sources of competitive advantage, i.e. technology, management know-how, and intellectual capital, to countries like Russia, they will have given up their only negotiation power. Once the national company has learned these lessons, such an oil-rich country will predictably renegotiate their agreements (Patton 2008, 79–80). Patton concludes that the shift in the balance of power, where the national oil companies are accumulating and exerting more control over their rich abundance of energy resources at the expense of the international companies, has become a significant impediment to the usual business of the oil majors. Russia is becoming more possessive of its energy resources and more aggressive in maintaining control of the sector's entire upstream and downstream operations (Patton 2008, 80).

To summarise, it must be noted that the presented studies have been conducted in different times in Russian history, some as much as a decade ago. Nevertheless, it can be seen that political issues and political risk play an important role in investment decisions, and in Russia this seems to be an especially important issue. The political uncertainties strongly influence the attractiveness of Russia as an investment destination, as well as the distribution of FDI within Russia. The level of political risk, however, largely depends also on the sector of the economy. Based on these studies, the natural resources sector, especially the oil and gas industry, seems to be extremely sensitive for the state, and simultaneously the sector's development affects the political

risk faced by foreign investors. The market risk cannot be fully separated from political risk, as in a favourable economic situation, the Kremlin's will and ability to control the energy resources increases. The current state of Russia's economy affects the level of political risk. A summary of the earlier studies is presented in Appendix 4.

As far as political risks in the Russian gas industry are concerned, not many studies were found to have focused on that sector in particular, not to mention analysing the sources behind the risks and potential effects that they may have on businesses. Moreover, international geopolitical issues, regarding, for example, the energy resources in the Arctic, and their effect on political risk in the Russian investment environment seem to be a subject which has not been studied extensively. This research is meant to fill these gaps and to explore the political risks particularly in the Russian gas industry.

1.5 The objective and structure of the study

As was noted in the previous chapter, not much research has been conducted on political risks in the Russian gas industry in particular. However, foreign companies in the Russian gas industry have faced political risks in their projects, and new, rather similar projects are being planned for the future, such as the Shtokman project in the Arctic Ocean. As a consequence, the research objective of this study is **to identify the political risks that foreign investors may face in the Russian gas industry in the light of the Shtokman gas field project**.

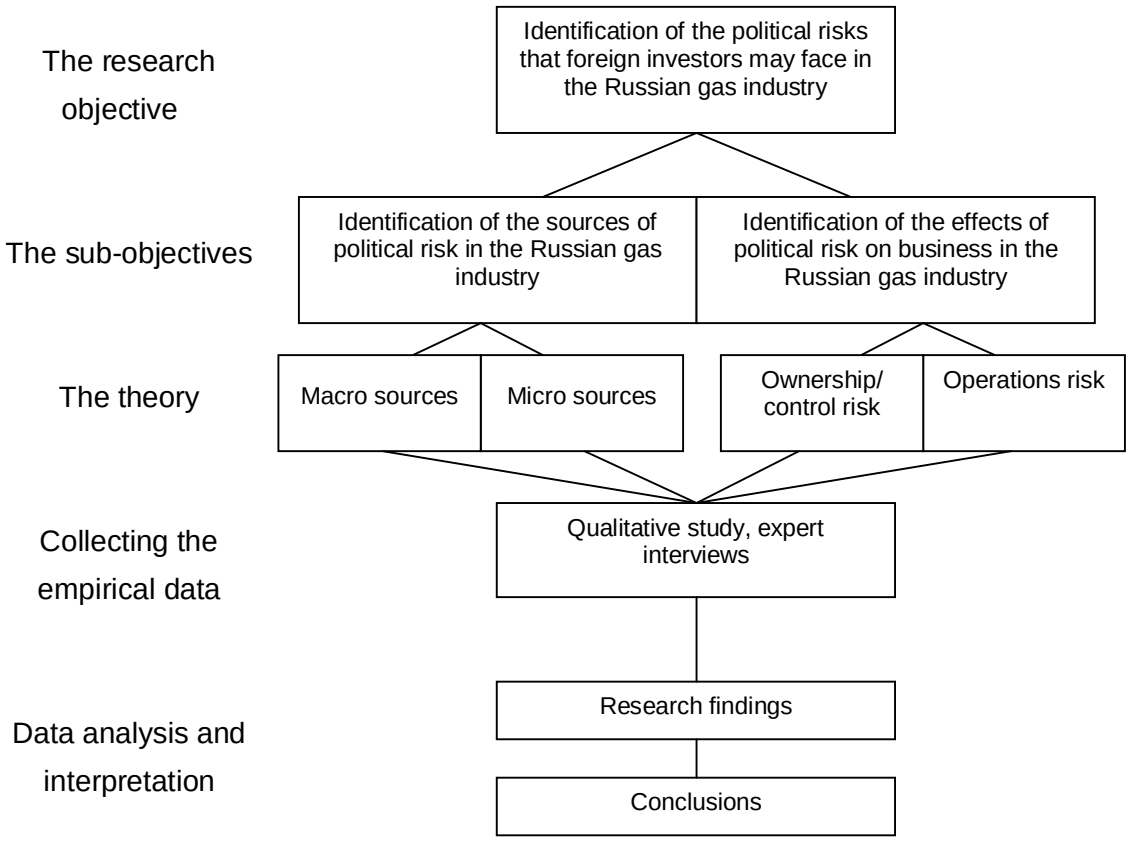
The research objective can be further divided into the following sub-objectives:

- Identification of the sources of political risk in the Russian gas industry
- Identification of the effects that political risk may have on business in the Russian gas industry

The issue is highly topical, as the Russian government is again in need of foreign capital and technology, and foreign investors are considering participating in Russian gas field projects, of which Shtokman provides a case in point. The Norwegian and French investors are participating in the field's development project together with the Russian Gazprom, and this project is, at the same time, an investment in the top sensitive sector of the Russian economy, and an investment in the strategically important Russian Arctic region. The issue has aroused a lot of discussion because of the possibly related political risk. As political risk in the Russian gas industry as such is

not a subject widely studied in an academic context, conducting this research is meaningful. Moreover, the identification of political risk factors in an FDI project in Russia is assumed to be useful information for the future, also for parties in other than the gas industry, as the gas business in the Arctic will provide opportunities for several other industries as well. Figure 1 describes the structure of this research.

Figure 1 The structure of the research



The theoretical framework of the study will be presented in the following chapter. The chapter discusses theoretical literature on political risk, both from the perspective of sources of political risk and of the effects of political risk on business. The theoretical framework for this study is formed through an analysis of the existing theoretical literature on political risk.

Chapter three briefly describes the research design of the study. In chapter four, the research findings will be presented. According to the sub-objectives of the study, the chapter first discusses the sources of political risk in the Shtokman project and then the potential effects of political risk on the project. The final chapter presents the conclusions based on a synthesis of the earlier experiences of political risk in Russia, of the theoretical framework, and of the empirical findings of the study.

2 POLITICAL RISK

2.1 The concept of political risk

According to Root (1987, 128–129), a foreign investment project needs to be analysed in the context of its political, legal, economic, social, and cultural environments. These aspects create the investment climate of a host country. The investment climate further comprises features such as general political stability, government policies toward foreign investment, other government policies and legal factors, macroeconomic environment, and international payments. Root notes that all these items depend directly or indirectly on the behaviour of the political system in the host country, and that changes in the investment climate will proceed mainly from changes in the behaviour of the host government or from general political instability.

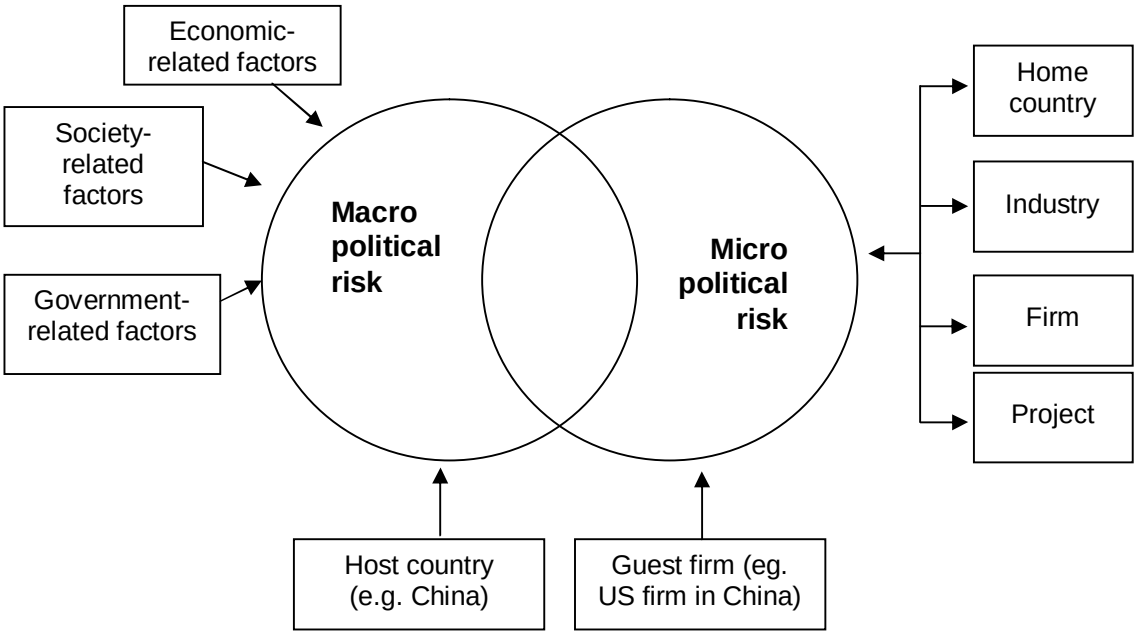
As a consequence, political risk arises from uncertainty about the host country's political conditions and government policies that are critical to the profitability of an actual or proposed business arrangement (Root 1987, 130). According to Alon and Herbert (2009, 127), political risk encompasses political events and processes that can negatively affect doing business. Political risk is conventionally distinguished from market risk, which derives from uncertainty about future changes in cost, demand, and competition in the market. (Root 1987, 130) Moreover, political risk should not be viewed as a static occurrence, but rather as a dynamic problem (Haendel 1979, 73). According to Root (1987, 130), "*political risk is created by a foreign investor's uncertainty about (1) general instability in the host country's political system in the future and/or (2) future acts by the host government that would cause loss to the investor*".

Robock (1971, 7–8), however, distinguishes between political instability and political risk by noting that political changes that do not significantly alter the business environment do not constitute a risk for international business. He also distinguishes between macro and micro political risks and defines macro political risks as unanticipated and politically motivated environmental changes broadly directed at all foreign enterprises. Micro political risks, in turn, are environmental changes intended to affect only selected business fields or foreign enterprises with specific characteristics (Robock 1971, 9).

Another example of a definition of political risk is that of Simon (1982, for reference see Alon & Martin 1998, 11), according to whom political risk is "*governmental or societal actions and policies, originating either within or outside the host country, and negatively affecting either a select group of, or a majority of, foreign business operations and investments*". This definition views political risk in the general environment context and also distinguishes between macro and micro risks.

Alon and Herbert (2009) have created a model that clearly presents the aspects of macro and micro political risks. The model is presented in Figure 2.

Figure 2 Micro vs. macro political risk



Source: Alon and Herbert (2009, 128).

According to Alon and Herbert (2009, 127–128), micro political risk is the political risk affecting a particular firm, project, or industry. At this level, the unit of analysis is not only the target country, as in macro political risk, but also the firm's nationality, industry, and particular project characteristics and their relationship to the country. Macro and micro political risks overlap, sharing some of the same determinants, depending on the firm's nationality, industry, and particular situation. Micro political risk is, in addition, similar to macro political risk as it emanates from the same forces.

Micro political risk is important to international firms because of its higher level of relevance and specificity. Most of the research to date has, however, focused on macro political risk, yielding broad insights about specific countries or regions, whereas academic research on micro political risk is still in its infancy. The paucity of research on micro political risk is assumed to be due to the difficulty in generalizing about risk that is particular (Alon & Herbert 2009, 127–128).

The distinction between macro and micro political risk is important, since political risk was found to vary by firm. For example, industries of strategic importance, such as natural resources, banking, finance, and utilities and insurance, are more likely to be regulated than industries of minor strategic importance, and thus face greater political risk. Micro political risk assessments are used to augment or adjust the more general macro political risk scores. Firms with particular sensitivities are more likely to be affected by certain macro risks, and thus, firms in strategic national industries may be more vulnerable to political risk intervention (Alon & Herbert 2009, 129).

A political risk analysis is basically a two-step process: forecasting relevant political developments, followed by evaluating the impact that such developments may have on the goals and operations of a particular firm (Lax 1983, 109). Robock's (1971, 7) conceptual framework for analysing political risk takes that into consideration and specifies (1) the sources of political risk, (2) the groups through which political risks can be generated, and (3) the effects of political risk, meaning the types of influence on international business operations. The conceptual framework is presented in Table 2.

Table 2 Robock's conceptual framework for political risk

Sources of political risk	Groups through which political risk can be generated	Effects of political risk on business
• Competing political philosophies (nationalism, socialism, communism) • Social unrest and disorder • Vested interests of local business groups • Recent and impending political independence • Armed conflicts and internal rebellions for political power • New international alliances	• Government in power and its operating agencies • Parliamentary opposition groups • Nonparliamentary opposition groups (guerrilla movements) • Nonorganised common interest groups (students, workers, peasants, minorities, etc.) • Foreign governments or intergovernmental agencies such as the EEC • Foreign governments willing to enter into armed conflict or to support internal rebellion	• Confiscation: loss of assets without compensation • Expropriation with compensation: loss of freedom to operate • Operational restrictions (market shares, product characteristics, employment policies, etc.) • Loss of transfer freedom (financial, goods, personnel or ownership rights) • Breaches of or unilateral revisions in contracts and agreements • Discrimination (taxes, compulsory subcontracting, etc.) • Damage to property or personnel from riots, insurrections, revolutions and wars

Source: Stefan H. Robock (1971, 7).

According to Robock's model (1971, 7), the sources of political risk can generate through certain groups into effects on business. With the help of this conceptual framework, it is possible to identify political risks, forecast their occurrence, and render them a more objective element in decision-making.

However, general definitions and models about political risk are rarely practical enough for conducting an analysis of an individual case project, and consequently in every case a situation-specific definition should to be created (Salonen 1987, 59). In this study, a special theoretical framework will be created in order to focus on the sources and effects of political risk in a gas field project. In addition to macro risks, we shall focus on the micro risks at industry, firm, and project level. The macro and micro sources of political risk, as well as potential effects of political risk, will be further discussed in the following chapters.

2.2 Macro sources of political risk

As presented in Robock's conceptual framework (1971, 7), political risk can result from several sources. Robock identifies the sources as (1) competing political philosophies (nationalism, socialism, communism), (2) social unrest and disorder, (3) vested interests of local business groups, (4) recent and impending political independence, (5) armed conflicts and internal rebellions for political power, and (6) new international alliances. Later on, Alon and Martin (1998) continued studying the sources of political risk. They created a macro political risk assessment model by concentrating on the internal and external factors of political risk, emanating from governmental, social, and economic environments.

In order to analyse the phenomenon specifically enough, we shall focus only on the government-related political risk factors in this study. The political risks that investors have faced in the Russian energy sector in the past have, in large part, been caused by the behaviour of the political system. As Root states, changes in a country's investment climate will proceed largely from changes in the behaviour of the host government. Schmidt (2001, 43) states that host governments attempt to influence the behaviour of foreign firms in order to shape the domestic environment and meet national objectives. As a consequence, we shall leave societal and economic political risk factors outside the framework of this study. The macro political risk construct according to Alon and Martin (1998, 15) can be seen in Table 3.

Table 3 The macro political risk construct

	Internal	**External**
Government	• Degree of elite repression • Degree of elite illegitimacy • Likelihood that regime change will affect policy	• Likelihood of political violence • Degree of involvement in international organisations • Possibility of restrictions on investment, capital, or trade
Society	• Degree of fragmentation • Potential for social conflict • Sense of nationalism, xenophobia, alienation and fundamentalism	• World public opinion • Disinvestment pressure • Regional diversity and incongruent interests
Economic	• GDP per capita growth • Income distribution • Likelihood that economic goals will be met	• Future economic policies regarding foreign direct investment • Likelihood of balance of payments problems • Likelihood of currency inconvertibility/instability

Source: Alon and Matin (1998, 15).

The internal causes of political risk are domestically generated. The first governmental factor in the construct of Alon and Martin (1998, 15), the degree of elite repression, is the extent to which the government uses sanctions or force against its own citizens. The degree of elite illegitimacy is defined relative to the portion of the population that does not respect the current regime. These two factors summarise the extent of political instability. The third factor, the likelihood that a regime change will affect policy, refers to the policy fallout if a regime change should occur and requires an assessment of the potential differences between the current regime and the likely successor regime (Alon & Martin 1998, 12–13).

External causes of political risk are induced by the home country, a third country, or the global environment (Alon & Martin 1998, 12). The first external governmental factor is the likelihood of political violence, which requires an evaluation of potential future conflicts, including war, border disputes, regional conflicts, and terrorism. Moreover, conflicts in one country may affect the neighbouring nations that house refugees or are sympathetic to the ousted regime. The extent to which a country is involved in international organisations is an indication of potential aid in crisis (e.g. IMF), as well as potential aid for infrastructure (e.g. the World Bank). The lack of membership, for instance due to sanctions or misdeeds, is an indication that the country may be left to fend for itself during a crisis, thus contributing to political risk. The possibility of regulatory restrictions represents a host nation's tendency to place restrictions on international payments, including restrictions on capital flows, repatriation limits, and trade restrictions. It also includes international boycotts and sanctions, expropriation, and interference with contracts (Alon & Martin 1998, 14–15).

According to Alon and Martin, all of these factors can be assigned a value between -2 and +2, where a -2 represents a high degree of political risk. Positive values are also allowed, as political risk may have both positive and negative variations. The factors are not given scores but should be used to red-flag problems in the macro political environment of the host country. They are indicators that particular categories may be significant contributors to political risk. Attention should be given to the assessment of the potential for political risk in years to come, especially as it relates to the life of the project being considered. Moreover, a weight may be assigned to each variable according to specific company concerns (Alon & Martin 1998, 17–18).

Simon (1984), too, focused on the internal and external dimensions of political risk. He states that a foreign company must not only assess the power structures within the host country to determine where the political and social pressure points are and how they are likely to evolve, but also take into account the role of the host and home countries in the international arena, in order to determine the potential for external actors to affect the operations of the company (Simon 1984, 125).

In several cases, the exact nature of the risk will depend on the intent and capabilities of the key actors shaping the events. This, in turn, will depend on certain characteristics of the host country. The most important characteristics are the stage of its economic development and the degree of openness in its socio-political system. To first consider the stage of economic development, industrialised and developing countries differ in their overall orientation towards foreign business. A suspicion of foreign companies as potentially exploitative entities is not as prevalent in industrialised societies as it is in developing countries. In developing countries, the need to promote indigenous business elements may be reflected in risks such as technology transfer requirements, joint venture pressure, local content rules, and, in extreme cases, nationalisations and expropriations. In industrialised countries these risks are less likely, and more moderate risks, such as environmental standards, licensing requirements, and price controls can be expected. Risks stemming from both internal and external conflict will also tend to be higher in developing countries, as vulnerability to conflict is often a by-product of the development process (Simon 1984, 127–128).

However, to better explain variations in macro risk for foreign companies, another set of characteristics describing the political climate in the host country needs to be added. By distinguishing between open and closed political systems, a further understanding of the origins of political risk can be attained. The degree of openness in a society is an important dimension of political risk, as it explains the propensity and capability of nongovernmental actors to shape events. In an open society, expressions of discontent can be channelled into elections, protests, boycotts, and other forms of nonviolent activity, whereas in closed societies these ways of expression are not available, and the repression of the populace can often erupt into violent activity. In addition, companies operating in a closed host country will face a greater degree of external pressure to disinvest, because home societal groups and international organisations are likely to view an investment in a country with a closed political system as either tacit approval of, or inadvertent support for, the repressive regime (Simon 1984, 128).

Based on the two characteristics, the stage of economic development and the degree of openness in the socio-political system, Simon (1984) has created a political risk framework in which he also included the aspects of internal/external and direct/indirect risk. The framework is presented in Table 4.

Table 4 A political risk framework

		INDUSTRIALISED		DEVELOPING	
		INTERNAL	EXTERNAL	INTERNAL	EXTERNAL
OPEN	DIRECT	• Host government licensing, price controls, taxation • Adverse legal rulings • Negative media reports	• Home government licensing, taxation policies • Regional and global organisations' monitoring of MNE operations	• Local content rules, joint venture pressure, technology transfer and import/export regulations • Strikes, protests, boycotts, negative public opinion • Adverse legal rulings • Negative media reports	• Home government licensing, taxation policies • Regional and global organisations' code of conduct for MNE
	INDIRECT	• Bureaucratic delays and procedures • Elections, public pressure for environmental controls • Local business pressure for subsidies, favourable treatment	• Host-home country trade disputes • Bilateral/multilateral trade agreements detrimental to MNE • Global economic developments	• Intra-governmental friction • General strikes, elections • Local business pressure for subsidies, favourable tax rates	• North-South issue disputes • Anti-MNE public sentiment due to home country's foreign/military policy • Regional/border wars • High external debt, default • Commodity price fluctuations
CLOSED	DIRECT	• Restrictions on remittances • Strikes, terrorism, violent demonstrations/ protests	• Home government restrictions on operations • Negative home and international public opinion, disinvestment pressure	• Nationalisation, expropriation • Terrorism, riots, strikes	• Home government restrictions on operations • Negative home and international public opinion, disinvestment pressure
	INDIRECT	• Coups, radical regime change, leadership struggles • Revolution, guerrilla war, riots	• Deteriorating host-home relations • International economic sanctions/boycott • International protests • Global economic developments	• Coups, radical regime change, leadership struggles • Revolution, guerrilla war, riots	• North-South issue disputes • Anti-MNE public sentiment due to home country's foreign/military policy • Regional/border wars • High external debt • Commodity price fluctuations

Source: Simon (1984, 132–133).

In the case of open-industrialised societies, the advanced stage of both the economic and political systems diminishes the risks that can stem from instability, such as revolution, factional conflict, and nationalisation. Host government actions directed at foreign companies are likely to be relatively moderate in nature, such as licensing requirements, taxation policies, and price controls. Moreover, if it is assumed that the society as a whole will be sharing in the economic benefits of the environment, the direct societal risks such as boycotts, strikes and protests are reduced. The risks to be faced are likely to be of a nonviolent nature, such as public pressure for environmental controls, adverse election results, bureaucratic delays, and the local business groups' lobbying efforts for protective measures (Simon 1984, 130).

If an industrialised host country has a closed political system, the risks that foreign companies face through elections, boycotts, protests, legal rulings and media reports are eliminated. Due to the closed political system, however, a new set of problems arises for the foreign company. Without any peaceful means available to press for their demands, disaffected groups will present a number of direct threats to companies, ranging from violent demonstrations to terrorist attacks. An additional problem is the risk of government-imposed restrictions on remittances during periods of instability. A revolution, guerrilla war, or sudden changes in leadership might take place. Externally, in turn, a foreign investor may face negative public opinion at home, as well as international pressure to disinvest from the host country (Simon 1984, 131).

The situation changes in the case of a developing country. In an open-developing country, the need to promote economic self-sufficiency will increase the likelihood of host government local content and technology transfer requirements, as well as import/export regulations. There is a risk of strikes, protests, and possible boycotts against the foreign company. The openness of the system allows for societal dissatisfaction to be demonstrated peacefully, but adverse legal rulings and negative media reports are potential risk issues. A foreign company might face overall suspicion of its activities in a developing country, which further increases external groups' pressure on foreign firms to pursue policies that are beneficial to the country (Simon 1984, 131).

In the case of developing countries with a closed political system, the risks tend to escalate in comparison with countries with an open system. This type of nations are the most likely to undergo radical transformations, thereby increasing the likelihood of

nationalisations and expropriations. In addition to the internal risk of being a target for the host government, foreign firms also face threats from societal groups, including terrorism, riots, and illegal strikes. The risks are rather similar to those that occur in closed-industrialised countries, such as revolutions and guerrilla wars (Simon 1984, 134).

To summarise the theories presented about macro political risk, it can be seen that foreign companies are exposed to a number of political risks originating from a variety of macro-level sources, and depending on the model, they can be grouped in various ways, such as governmental-societal-economic, internal-external, and direct-indirect. The following chapter continues the discussion of sources of political risk at micro-level.

2.3 Micro sources of political risk

According to Alon and Herbert (2009, 128), micro political risk emanates from internal and external antecedents, firm-related factors, and from economic, societal, and governmental forces. As was noted earlier, this study focuses only on government-related risk factors. Consequently, the economic and society-related risk factors will be left outside the discussion. The model of micro political risks is presented in Table 5.

Table 5 A micro political risk assessment model

INTERNAL ANTECEDENTS	EXTERNAL ANTECEDENTS	FIRM-RELATED FACTORS
Economic-related factors 1. Labour conditions 2. Congruence with national economic interests and goals 3. Availability of alternative suppliers	**Economic-related factors** 1. Degree of economic dependence on the home country 2. Involvement in regional economic agreements (e.g. WTO, NAFTA) 3. Balance of payments	**Contribution of the firm/project to the local economy** 1. Level of technology transfer 2. Exports generated by firm/project 3. Size of operation
Society-related factors 1. Degree of power distance 2. Degree of uncertainty avoidance 3. Degree of collectivism	**Society-related factors** 1. Influence of adverse international activist groups 2. Extent of cultural distance 3. Extent of international societal disputes	**Bargaining power of the firm relative to the government** 1. Dependence of firm on local market 2. Extent of natural resource seeking 3. Level of firm diversification
Government-related factors 1. Level of governmental control 2. Degree of nationalism 3. Congruence with governmental goals 4. Transparency and corruption	**Government-related factors** 1. Diplomatic stress with the home country 2. Involvement in regional political agreements (e.g. NATO, UN) 3. Extent of currency (in)stability	**Governance structure** 1. Degree of ownership 2. Extent of financial policies adverse to the BOP (e.g. transfer pricing) 3. Intra-corporate transfers

Source: Adapted from Alon and Herbert (2009, 130–135).

Internal sources of political risk stem from inside the country. The first government-related factor of the internal antecedents is the level of governmental control. The more the government controls the economy, the more likely it is that economic decisions are made for political rather than economic reasons, and as a consequence, the higher the firm's political risk exposure rises. A local constituent or a well-connected individual is often preferred to a foreigner. The second factor, nationalism, is an element that can lead to negative governmental sentiments toward foreign investment from specific countries, as well as to blaming the problems of the society on foreign factions. A high or increasing degree of nationalism can lead to nationalisation or expropriation. The third factor is congruence with governmental goals. It means that firms whose practices are at odds with the host government's policies or priorities, tread on thin ice. The fourth factor is transparency and corruption. Particularly for firms negotiating terms for market entry or investment, lack of transparency in processes and requirements, as well as corrupt practices, are important barriers. Rules and regulations may not be easily available, or may be idiosyncratically interpreted by individual officials, with fees, commissions, or bribes being common.

The first external government-related factor, diplomatic stress with the home country, refers to the diplomatic and economic relations between the two countries. Multinational firms represent their home country and thus will gather good will or hostility unrelated to their performance in the host country. The second factor, involvement in regional political agreements, such as in bilateral and multilateral agreements, covers subjects as diverse as free trade areas, custom unions, common markets, and economic cooperation, typically binding members by specific regulations regarding trade and investment. Participation means that the potential market is larger and consequently the potential returns on investment are higher. Bilateral and multilateral agreements stimulate investment and often favourably affect macro political risk exposure. The third external governmental factor, currency instability, can have a negative, unpredictable effect on the host country's balance of payments and trade deficits, and affect its inflation rates and cost of living, etc. (Alon and Herbert 2009, 133–134). Interestingly, this factor is classified as an external economic, not governmental, risk factor in the model of Alon and Matin (1998, 15).

The firm-related factors have been classified into three groups: contribution of the firm or project to the local economy, bargaining power of the firm relative to the government, and governance structure. The first group comprises three factors, the first of which is the level of technology transfer. The higher the level of the company's technology, the lower the firm's micro political risk. Technology transfer can reduce the host country's hostility, notably if the technology can diffuse into the local economy, for example through training or imported assets. Moreover, the larger the size of the operations, the less likely is political intervention due to the greater potential for job creation. The third factor is the level of exports – firms with high export outputs are less dependent on the host country and can help the country to improve its balance of payments conditions, which reduces the risk exposure (Alon and Herbert 2009, 134).

The second group, bargaining power of the firm, also consists of three factors. The first one is the firm's dependence on the local market, which increases the bargaining power of the host government and decreases the bargaining power of the company, increasing the level of micro political risk exposure. The second factor is natural resource seeking. Being a natural resource firm suggests the potential to exploit the host country's natural resources, exporting them without replenishing, and thereby ultimately impoverishing the host country. This explains why natural resource seeking firms are more likely to be regulated, or at worst, nationalised or expropriated. The last

factor in this group is the level of firm diversification. The more diversified the company is in terms of operations across countries or diversification of its products within the economy, the less likely it is to be regulated. Since diversification provides alternative sources of revenue to the firm, the host country loses its power to significantly affect the firm's global operations (Alon and Herbert 2009, 134–135).

The third group, governance structure, consists firstly of the extent of local ownership. If the ownership of the business unit is primary held by the foreign partner, the host country could consider the business relationship exploitive, especially if the profits are repatriated rather than shared locally. Local ownership, alternatively, increases the benefits to the local economy or citizens, which lowers the likelihood of negative micro political outcomes. The second factor is financial policies adverse to the balance of payments. Companies' policies that undermine the host government's balance of payments are not likely to be considered positively, and may encourage financial or other restrictions. The last factor, indicative transfers, is an indication of to what extent the affiliate and parent firm are integrated. For example, extensive use of expatriates rather than local personnel can highlight goal inconsistencies between the firm and the host government, increasing the likelihood of negative political risk (Alon and Herbert 2009, 134–135).

The model of Alon and Herbert (2009) is rather comprehensive, comprising internal and external as well as political, societal, and economic issues, in addition to firm-specific matters. Some of those concepts were, however, discussed already earlier by Schmidt (2001), who also identified technology transfer and ownership structure as issues affecting micro political risk faced by foreign investors. In his article, he discusses political risk faced by a single investment project. According to Schmidt (2001, 43), political risk depends on the characteristics of the foreign investment: who owns it, what technology it uses, and to what economic sector it belongs. Exposure is a function of operations and organisational attributes, and consequently a framework for political risk analysis must concentrate on the relationship of the type of foreign investment project to the application of restrictive host government policies. Project risk analysis is an approach for appraising the political vulnerability of foreign direct investment based on attributes or characteristics of the investment. Schmidt states that the nature of a foreign investment can be captured in two sets of independent variables: the general, and the special nature of investment (Schmidt 2001, 43–45).

The first set of variables, the general nature of investment, is derived from production-related characteristics of the foreign operation. Foreign operations can be categorised according to whether they are conglomerate, vertical, or horisontal investments. Conglomerate investments refer to production abroad of final goods or services not similar to those produced at home. These investments can be perceived by the host government as providing the least benefit to the local economy, and of these three categories they represent the most likely target for government intervention. These investments are thought to represent mere opportunistic diversification, seeking profits and/or growth for the parent company, while providing little or no integrative impact on the economy and bringing no proven technology. Vertical investments refer to the production abroad of raw materials or intermediate goods to be processed into final products. These investments are less likely to face host government intervention because they often offer a substantial inflow of foreign capital during start-up, they are frequently export-oriented, and they often provide an integrative impact on the economy, creating backward and forward linkages. The third category of investments, horizontal investments, refers to production abroad of the same or similar goods and/or services as those produced at home. Host governments view these investments as the least likely for control measures, because they are made with an eye toward satisfying host country market demands and the operations bring with them proven technologies and expertise. Managerial, product, and marketing know-how make horizontal investments a desirable form of foreign enterprise (Schmidt 2001, 46–47).

The second set of variables, the special nature of foreign direct investment, comprises three attributes: sector of economic activity, technological sophistication, and pattern of ownership. Sector of economic activity refers to the primary business activity of the foreign direct investment operation, and it is perhaps the most important attribute in relation to political risk. The activities have been divided into three sectors. The first sector, the primary sector, includes business operations engaged primarily in agricultural production, forestry, mineral exploration, and extraction. The second sector, the industrial sector, includes manufacturing operations engaged primarily in the chemical or mechanical processing of raw materials or substances into new products. The third sector, the service sector, includes investments engaged primarily in transportation, communication, finance, insurance, and related business services (Schmidt 2001, 47–48).

Host government policies aimed at controlling or influencing the activities of foreign investors are most frequently applied to primary and service sector investments. When it comes to primary sector investments, extractive operations, such as those related to petroleum and mining, face a significantly high degree of political risk. Foreign investment engaged in the removal of natural resources is associated not only with the loss of national wealth, but also with the idea that such natural resources should be exploited for the benefit of the host country population, not for private profit. In the service sector, in turn, investments that experience the application of restrictive policies include banking, insurance, communications, transportation and utilities, as they generally have to do with strategic areas of the economy that are considered socially and politically sensitive. Industrial manufacturing operations are lower priorities for government-initiated investment controls – for them, however, the likelihood of government intervention is contingent upon technological sophistication and patterns of ownership (Schmidt 2001, 47–48).

The second attribute, technological sophistication, refers to the difference between firms that depend on a single scientific breakthrough and those with sustained high-level research, development and innovations. Host governments frequently seek technologically attractive foreign investments in order to secure the benefits of capital as well as those of the technological and managerial know-how that transfer to the local economy. However, at the same time, host governments attempt to avoid technological dependence on outsiders. One way to forestall the dependence is to implement investment policies aimed at controlling technologically rich foreign operations. However, when a firm can maintain a status of “necessary” in the eyes of the host government by the continuous inflows of technology, product improvements, and technical and managerial skills, the occurrence of political risk is reduced. Any effort by the host government to control the operation would result in the foreign firm’s withholding of technical expertise and management skill. As a consequence, the higher the level of technology in the investment, the less likely the operation is to be a target of government constraints (Schmidt 2001, 47, 49).

The third attribute, pattern of ownership, refers to financial control of the foreign investment. In a wholly owned investment, 100 percent of the equity in the foreign investment is owned by the parent firm. In a partially owned investment, less than 100 percent is owned by the parent firm. On one hand, it can be argued that, in order to attract foreign investment, it would be in the national interest to allow 100 percent

foreign equity in the capital structure of the entering direct investment. However, on the other hand, in an increasing number of cases such wholly owned operations – and often even majority positions – are not acceptable. Governments demand greater domestic control over foreigners, often through local participation, which gives local firms opportunities to invest and moves the foreign firms to act more in accordance with the interests of the nation. For the foreign firm, adapting the ownership strategy to fit the host country environment can be an effective means of minimising risk. With shared ownership, the investment takes a more local image, which reduces the public pressure on host governments to undertake unfavourable actions against foreigners (Schmidt 2001, 47, 49–50).

It can be concluded that the definitions of Alon and Herbert (2009) and Schmidt share some similarities, but still have a somewhat different perspective on the issue. However, the perspective depends on the case in question. To assess political risk for a certain sector, firm, or project, the relevant risk variables for it first need to be identified and then examined. To present a sector level example of a micro political risk construct, for instance Lax (1983, 112–113) studied the political risk in international oil and gas industry and identified the key variables in analysing political risk in this industry[12]. In comparison with the model of Alon and Herbert (2009, 130–135), he also mentions nationalism and corruption as internal governmental risk factors, but identifies other issues as well:

- dominant ideology and possible changes;
- institutional development, including the strength of the legal system, the legitimacy of the government, and the degree of bureaucratisation;
- instability, including the existence of disaffected groups, governmental use of coercion and suppression, and the outbreak of violence;
- continuity and changes in leadership and in the perspectives of other major political leaders and/or parties; and
- domestic and foreign policies, including goals and policy changes.

When it comes to external risk factors, Lax (1983, 112–113) also mentions host government participation in international treaties and the relationship between the host

[12] See the categorisation of the variables in Appendix 5.

and the home government in security, trade, and aid issues. Additional factors mentioned are

- involvement of the host in international conflicts and potential results of conflicts not involving the host directly;
- world petroleum market conditions (prices, supply and demand);
- world economic conditions, including economic growth and energy consumption; and
- developments in other oil-exporting countries (demonstration effect).

Lax (1983, 112–113) also identifies firm-related political risk factors. Alon and Herbert's concept of size of operation is closely related to Lax's risk factor position in the world industry (including sources of crude, reserves, production, and market outlets). Special bargaining advantages (technology, managerial skills, services, and capital) factor can also be found in both categorisations. Furthermore, Lax identifies factors such as the nationality of the company and dealings with host government (receptive, diplomatic, and open, or unreceptive, brusque, and unyielding) as factors affecting political risk.

Consequently, the categorisation of Lax (1983, 112–113) for micro political risk on oil and gas industry shares some concepts with the general micro political risk model presented by Alon and Herbert (2009, 128). However, there are some additional factors in the categorisation of Lax: the petroleum specific factors. The group comprises the following factors:

- ownership,
- domestic reserves/production,
- host's relative market position,
- level and destination of exports,
- strength of the national oil company,
- role of the foreign firm in the national oil industry,
- prices,
- domestic ability to operate the industry, including commanding the necessary skills, technology, know-how, and capital, and

- ownership/contractual relationship between the firm and the host.

Lax's categorisation also includes the economic and sociocultural factor groups, but discussing them is not relevant to the purpose of this study.

Even though Lax's categorisation of micro risk factors for oil and gas industry is quite close to the topic of this study, the categorisation will be further modified to better suit our purpose of identifying the government-related political risk factors, and some concepts will be adopted from the previously presented general models of political risk sources. In addition, the effects of political risk on business will also to be included in the framework of this study. The effects of political risk will be discussed in the following chapter.

2.4 Effects of political risk on business

Political risks rarely lead to such dramatic changes as expropriation or nationalisation, but typically policies are aimed at a specific firm through price controls, mandates for locally-sourced content, limits on expatriates employed, and so forth. Nevertheless, the effects of macro political risk can be dramatic when a government is overthrown or the economic system is revolutionised. The effect of micro political risk on a firm has been found to be substantial and unpredictable as well, and also more frequent and widespread (Kobrin 1982, for reference see Alon and Herbert 2009, 128).

Political risk may ultimately have a significant influence on the value of a firm. However, risk may also carry with it the possibility of additional returns (Ellstrand et al. 2002, 771). Political risk emanates from uncertainty regarding potential outcomes, which can either help or hinder business interests, or prove to be better or worse than expected. Thus, political risk can be seen as a neutral phenomenon with associated probabilities of positive and/or negative potential outcomes for participants. For instance, the ideological changes that have swept the former communist countries are examples of positive changes in the political risk climate of the host country. Firms that have banked on a protectionist environment have either missed opportunities or, even worse, made inappropriate investments on incorrect assumptions (Alon and Herbert 2009, 130). In addition, in politically risky markets, firms will find less competition than in more stable markets, since risk-averse competitors may be unwilling to compete there (Ellstrand et al. 2002, 771). Nevertheless, this study focuses on the negative political risk effects that may lead to an inadequate return on investment. This choice was made

considering that negative political risks can be seen as more crucial to foreign investment projects.

Robock (1971, 7) identifies the following effects of political risk on business:

- confiscation: loss of assets without compensation,
- expropriation with compensation: loss of freedom to operate,
- operational restrictions (market shares, product characteristics, employment policies, etc.),
- loss of transfer freedom (financial, goods, personnel or ownership rights),
- breaches of or unilateral revisions in contracts and agreements,
- discrimination (taxes, compulsory subcontracting, etc.), and
- damage to property or personnel from riots, insurrections, revolutions and wars.

When they occur, all these factors are likely to result in an inadequate return on investment.

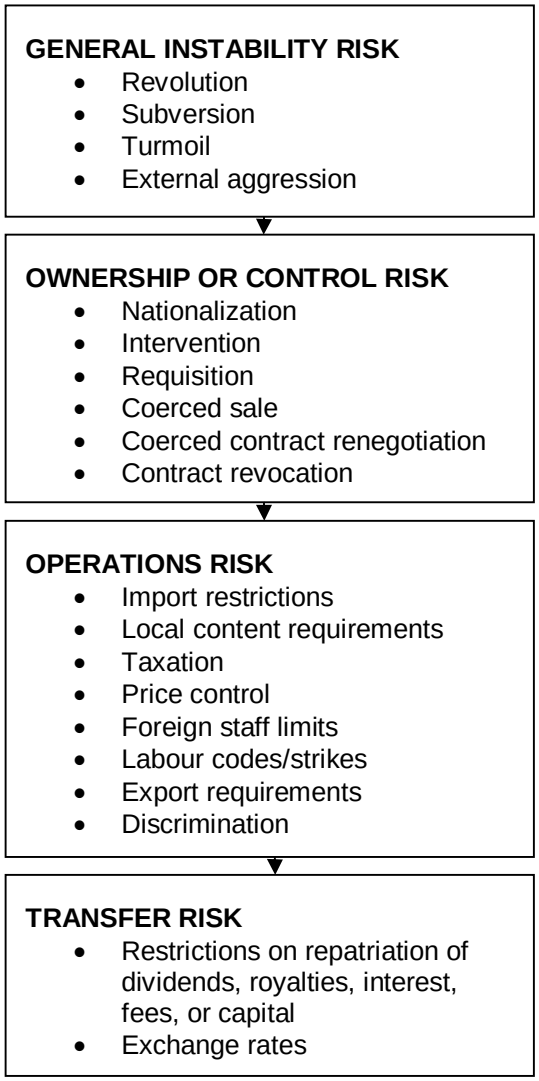
Root (1987, 130–131) groups political risks in four classes in terms of their impact on an investment project:

1. General instability risk. This proceeds from management's uncertainty about the future viability of the host country's political system. It may not always force the abandonment of an investment project, but it will almost certainly interrupt operations and lower profitability.
2. Ownership or control risk. This results from management's uncertainty about the host government's actions that would destroy or limit the investor's ownership or effective control of this affiliate in the host country. This class includes several kinds of expropriatory acts by the host government that deprive the investor of his property.
3. Operations risk. This proceeds from management's uncertainty about the host government's policies or acts sanctioned by the host government that would constrain the investor's operations in the host country, whether in production, marketing, finance, or other business functions.

4. Transfer risk. This derives mainly from management's uncertainty about future government acts that would restrict the investor's ability to transfer payments or capital out of the host country, i.e. the risk of inconvertibility of the host country's currency. A second type of transfer risk is the depreciation of the host currency relative to the investor's home currency. Exchange depreciation almost always results from government actions or government policies.

Based on the four classes, Root (1987, 132) has created a four-hurdle model to help managers structure the collection and analysis of information on political risk. The model is presented in Figure 3.

Figure 3 Evaluation of political risks of a foreign investment entry decision process



Source: Adapted from Root (1987, 132).

As can be seen in Figure 3, the general instability is the first hurdle to be assessed. If managers anticipate a chaotic political situation over the planning period, they will not investigate to the entry proposal any further. Otherwise, they move to the ownership or control risk. Nationalisation is the claiming of foreign-owned property by the host government with transfer of title. Intervention is the seizure of foreign-owned property either by the government or by a private group, such as workers, supported by the government. Requisition is undertaken by the government in response to an emergency situation, with the expectation that the property will be returned to its foreign owners at a later time. Coerced sale is action by the host government to force foreign investors to sell all or part of their property to a government entity or to local nationals, usually at less than market value. Coerced contract renegotiation is action by the government to force a foreign investor to agree to changes in his contract with the government. Finally, contract revocation refers to the unilateral termination by the host government of its contract with a foreign investor. In the majority of expropriation cases, foreign investors sooner or later receive some compensation, but it rarely meets the international standard of "prompt, effective, and adequate". Since expropriation is one of the worst actions that the host government can take against an investor, the expropriation risk of a project has to be carefully assessed by managers (Root 1987, 133).

If the risk is judged acceptable, managers move on to the operations risk. To assess operations risk, managers must determine the character of the project's operations, then estimate its expected cash flows over the planning period, and finally evaluate the probable effects of risk factors on local currency return on investment. The final hurdle is the transfer risk. To assess that, managers need to forecast the likely direction of changes in the dollar value of the host country's currency over the planning period and then estimate the net effects of those changes on the cash flow of the project. However, the exchange rate will reflect the internal rate of inflation, and thus higher prices in the local market will act to offset the lower dollar value of the host country (Root 1987, 133–134). Finally, if the management finds the level of all these risks acceptable, the project can move on, assuming also that the investor is satisfied with the expected rate of return (Root 1987, 134).

In the theoretical framework for this study, the sources and effects of political risk were to be conjoined into a single construct. The framework for this study will be discussed in the following chapter.

2.5 The political risk construct for a gas field project

The aim of this study is to identify the sources and effects of political risk in the Russian gas industry. The key theories and models regarding political risk were presented in the previous chapters, but none of those was seen as being simultaneously specific and comprehensive enough. As a consequence, a special model for this study will be based on the previously presented models of political risk (Robock (1971), Lax (1983), Simon (1984), Root (1987), Alon and Martin (1998), and Alon and Herbert (2009)).

Robock's (1971, 7) conceptual framework for political risk distinguishes between the sources and effects of political risk, which was chosen to also be the structure of the framework of this study. He also identifies the groups of individuals and authorities through whom political risk can be generated, but those issues were not discussed, as they do not belong to the focus area of this study. Robock, however, does not distinguish between the internal or external or political, economic, or societal sources of political risk, whereas Alon and Martin (1998, 15) offer this kind of structure for conceptualising macro political risk. The risk factors they discuss in their model remain, however, at a rather general level and consequently are challenging to be analysed thoroughly. The construct consisting of internal and external as well as political, economic and societal factors was adapted to the framework of this study, as it provides an unambiguous structure for organising the factors that can be seen as sources of political risk.

Simon (1984, 132–133), in turn, presents a model for analysing macro political risk in different types of countries, depending on whether they are industrialised or developing, and whether their political system is open or closed. This structure provides an understanding that in different kinds of countries different macro issues are relevant when analysing political risk. The vast model offers a plenitude of factors by distinguishing between internal/external and direct/indirect sources of political risk. However, a problem remains regarding classifying countries according to the level of industrialisation and the openness of the political system. In the case of Russia, for example, the question of the right country type can be controversial. Moreover, the classification of variables into direct and indirect political risk factors does not seem to offer a further clarifying structure for understanding political risk in the context of this study. The model also lacks the classification of governmental, societal and economic risk factors.

When it comes to micro-level sources of political risk, Alon and Herbert (2009, 130–135) present a micro political risk assessment model, which consists of internal and external antecedents that are divided into economic, societal and government-related factors. The model also contains firm-related factors that are divided into three groups: contribution of the firm/project to the local economy, bargaining power of the firm relative to the government, and governance structure. These headings, as well as the factors under them, are somewhat overlapping, and consequently the model was not unambiguously understandable. It, however, provides useful concepts for analysing firm and project-related factors of political risk.

Lax (1983, 112–113) creates a political risk construct focusing on the oil sector factors. The model comprises host (internal) macro-level factors divided into governmental, economic, societal, and petroleum-specific factor groups, external macro level factors, and corporate variables. This model seems to be all-inclusive, taking into account all the possible sources of political risk, which obviously is the goal when studying which issues may have an effect in the faced political risk, but simultaneously makes the analysis complicated and causes a potential loss of focus.

To be able to analyse political risk in the Shtokman gas field project closely enough, the source factors of political risk will be limited into the governmental variables. The risk will be studied both in terms of macro and micro political risk factors, based on the previously presented models. However, depending on the model, some concepts are present both in the macro and micro risk models. Consequently, distinguishing between macro and micro risk factors is not simple, as the same factors can have an impact on both levels. In addition, the concepts overlap within different models, and the same concepts can be placed differently under the groups government, society, and economy. This makes it reasonable to create a specific theoretical model to frame this study in order to meet the research objective as accurately as possible.

In order to analyse political risk in a particular industry and in the case of a particular project, it seems more beneficial to focus on certain issues and conduct an in-depth analysis of the relevant factors. The political risk construct created for this study offers a theoretical framework for analysing political risk in the Russian gas industry, and simultaneously provides a new conceptualisation of government-driven political risks and their possible effects on business for further research. The political risk construct for analysing a gas field project is presented in Figure 4.

Figure 4 The political risk construct for a foreign direct investment into a gas field project

SOURCES OF POLITICAL RISK			
		INTERNAL	**EXTERNAL**
GOVERNMENTAL MACRO SOURCES		• Continuity and changes in leadership and in the perspectives of other major political leaders and/or parties • Institutional development (legal system, bureaucratisation, corruption) • Level of governmental control over the economy	• Foreign policies of the host government (goals and policy changes) • Host government participation in international treaties, conventions and organisations • Involvement of the host in international conflicts
MICRO SOURCES	**INDUSTRY**	• Domestic gas reserves and production • Strength of the national gas company	• World petroleum market conditions (prices, supply and demand)
	FIRM	• Bargaining advantages (technology, managerial skills, services, and capital) • Position in the world industry (reserves, production) • Dependence of a foreign firm on the local market vs. the level of firm diversification	• Political/economic relationship between the host and the home government, (security, trade, and aid issues) • Company dealings with host government (receptive, diplomatic and open, or unreceptive, brusque, and unyielding)
	PROJECT	• Level of technology transfer • Exports generated by the project • The size of the project • Extent of natural resource seeking	• Congruence with governmental goals • Ownership/contractual relationship between the firm and the host

EFFECTS OF POLITICAL RISK ON BUSINESS	
OWNERSHIP/CONTROL RISK	**OPERATIONS RISK**
• Coerced contract renegotiation • Contract revocation • Intervention • Coerced sale • Nationalisation	• Price controls • Foreign staff limits • Import/export requirements • Restrictions on repatriation of dividends, royalties, interest, fees, or capital • Discrimination (taxes, compulsory subcontracting, etc.)

The political risk construct for a gas field project consists of governmental sources of political risk and of the effects that the risk may have on business. The sources of political risk have been divided into the internal and external as well as into the macro and micro level sources of political risk. Micro level risks have been further divided into the industry, firm, and project-level sources of political risk. All these sources may lead to potential effects on business, which can be related either to the ownership or control of the investment project or to the business operations concerning the project.

To further discuss the political risk construct, **the macro level sources** of political risk comprise factors that are related to the host government's stability, behaviour, goals, and external relations, and which might cause such uncertainty in the country's business environment that it could harm foreign investors' business in the country and possibly cause inadequate return on investment. The first concept is continuity and changes in leadership and in the perspectives of other major political leaders and/or parties. The same issue was also discussed as the likelihood of regime change, referring to a possible policy fallout, which would require the assessment of the likely successor regime. The potential issues causing changes in leadership and/or in perspectives are elite repression, elite illegitimacy, and competing national philosophies, such as nationalism, socialism, and communism. These issues were discussed in several models, but as they are likely to cause political risk only indirectly, the concepts are not included in this model.

Institutional development refers to the strength of the legal system and to the degree of bureaucratisation and corruption, all of which can influence a foreign company's operations and also decrease or increase the experienced political risk. The last internal macro source of political risk is the level of governmental control over the economy. The more the government controls the economy, the greater the firm's political risk exposure becomes, as the more likely it is that the economic decisions are made for political rather than economic reasons.

When it comes to the external macro sources of political risk, the first concept is foreign policies (goals and policy changes). It is closely related to the second concept, host government participation in international treaties, conventions and organisations (such as UN and NATO). Involvement of the host in international conflicts is the most severe issue regarding external relations, and it refers to the evaluation of current and potential future conflicts, including war, border disputes, regional conflicts, and

terrorism. All in all, these external issues can have an effect on political risk as investors from foreign countries may sense the consequences of international alliances, as well as those of disputes concerning the host country.

The micro-level sources of political risk consist of industry, firm, and project-level issues. **The industry-related sources** are domestic gas reserves and production, and the strength of the national gas company. Both of the concepts refer to the business environment in the host country's gas industry, and also to the bargaining power that the host government may have against a foreign investor, whether directly or through a state-owned gas company. The concept of world petroleum market conditions refers to the external industry-related issues, such as prices, supply and demand of gas, which may have an effect on the host government's actions regarding the industry.

The firm-level sources are as follows: bargaining advantages, such as technology, managerial skills, services, and capital, which can affect the political risk by influencing the bargaining power of the foreign investor relative to the host government. If the investor has much to offer to the host country, and the host country is in need of these provided issues, the host government is less likely to intervene on the investor's operations in the host country. The company's position in the world industry, regarding for example the reserves and production in home and other countries, also affects the bargaining power and consequently the political risk that the investor faces. The concept of the dependence of a foreign company on the local market vs. the level of firm diversification is also related to the bargaining power through the dependence aspect. The more independent and diversified the company is in terms of operations across countries and/or in terms of its products, the less power the host country has to significantly influence the company's international operations.

The first external firm-level issue is the political and economic relationship between the host and the home government, including security, trade, and aid issues. This issue refers to the fact that a company represents its home country and, depending on the relations between the two countries, is likely to gather good will or hostility from the host government. This is clearly a potential source of political risk. Company dealings with host government refers to the company's individual relations with the host country, which can range from receptive, diplomatic and open to unreceptive, brusque, and unyielding. If the company's relations with the host country are not positive, for

example due to experiences in the past, they may again have an influence on the level of political risk.

At the project-level, the level of technology transfer is an important issue. It refers to the fact that the host country may be in need of technology inflows from abroad, and in this case, in a technologically intensive project, a foreign firm may be able to create a status of "necessary" in the eyes of the host government, which will reduce the occurrence of political risk. The following factors are the size of the project and exports generated by the project, which refer to the project's job creation and export output matters. These matters can help the host country to improve its balance of payments and consequently reduce the political risk. Contribution of the project to the national economy is a risk-reducing phenomenon. Extent of natural resource seeking, in turn, suggests the project's potential to exploit the host country's natural resources. In such a case, the project and especially the operations of the foreign investors involved are likely to be regulated, or at worst, nationalisations or expropriations might take place.

The external project-level issues are congruence with governmental goals and ownership or contractual relationship between the firm and the host. Congruence with governmental goals refers to the fact that projects that are at odds with the host government's policies or priorities in some way, tread on thin ice, as Alon and Herbert (2009, 130–135) describe. Ownership or contractual relationship between the firm and the host refers to the governance structure of the project. If the ownership of the project is primarily held by the foreign investor, the host government could consider the business relationship exploitive, and in an increasing number of cases, such majority positions are not acceptable. Governments demand greater domestic control over foreigners, often through local participation in the project, which gives local firms opportunities to invest and leads the foreign companies to act more in accordance with the interests of the nation. This lowers the risk of negative political outcomes.

All these previously discussed macro and micro sources may lead to ownership or control risk effects or to operational risk effects. **Ownership or control risk** consists firstly of coerced contract renegotiation, i.e. a situation where the host government forces the foreign investor to agree to changes in his contract with the government. Contract revocation refers to the mutual contract's unilateral termination by the host government. Intervention refers to the temporary seizure of foreign-owned property either by the government or by a government-supported private group. Coerced sale or

expropriation is an action by the host government to force foreign investors to sell all or part of their property to a government entity or local nationals, usually at less than market value. Nationalisation is the claiming of foreign owned property by the host government with only a transfer of title.

The operations risk affects the company's everyday operations. This group comprises price controls over the project's products, limits to the foreign staff, requirements related to imports and/or exports, and restrictions on repatriation of dividends, royalties, interest, fees, or capital. Also discrimination regarding taxes, compulsory subcontracting, etc. is included in this group.

To conclude, political risk refers to the probability that the previously discussed source factors will lead to the effect factors, which again may result in an inadequate return on investment for the foreign investor. Attention must be paid, however, to the fact that political risk is dynamic, and in constant change resulting from all the macro and micro factors that contribute to it. If the management finds the risk probability and uncertainty regarding the future – in relation to the expected rate of return – acceptable, the project can move on.

3 RESEARCH DESIGN

This study focuses on the case of the Shtokman gas field project, which is one of the future gas fields in Russia and in which foreign investors are involved. What makes the case especially interesting is the fact that in addition to being an investment project in the top sensitive energy sector, the Shtokman gas field is located in the politically sensitive Arctic area. In this sense, the case provides an extreme example of a politically sensitive investment project for a foreign investor in the Russian energy sector. This study focuses on the Shtokman project and aims at understanding the dynamics of political risk in this case and context. A more specific description of the Shtokman gas field project was presented in Chapter 1.3.

There are two foreign investors involved in the project, the Norwegian Statoil and the French Total, and consequently focusing on the case of Shtokman project limits the focus of the research to these two companies. However, in this study, political risk in the Shtokman project will be examined for both the companies simultaneously, as it was not possible to get interviews from the company representatives within this time frame. Interview requests were sent to several representatives of both Statoil and Total, but no fruitful answers were received during the research process, and there was no opportunity to conduct an interview. Consequently the empirical data will be based on eight expert interviews. It must also be noted that the interviews took place between September 2009 and April 2010, and obviously the expert's were not aware of the information that has been received later in spring 2010, concerning for example the agreement that Russia and Norway reached on the grey zone.

The first expert interviewed was Finpro's representative in Murmansk, Petri Leino. He has studied the Arctic issues in Russia, and has also gained expertise in the area of foreign investments to Russia through his work experience. The Finpro office in Murmansk was established because of the Shtokman project, as it has started to attract foreign investors to Murmansk, which is the closest city to the Shtokman offshore gas fields. The researcher had personally met Petri Leino on his lecture at the Pan-European Institute at Turku School of Economics in April 2009, and had asked for an interview to take place in the autumn. Consequently, it was easy to approach Leino in the autumn 2009 and agree on conducting an interview by telephone in September 2009. To conclude, Leino was chosen to be one of the interviewees firstly because of

his expertise on the matter and secondly because of the previously established contact that the researcher had with him.

The second expert interviewed was Seppo Remes, who has gained years of experience on business in Russia by working there, for example in the boards of several large companies. For instance, he has worked for Swedish investment companies Vostok Energo Investment and Vostok Nafta Investment for several years. These companies focused their investments in shares of Russian energy companies. He has also been the corporate vice president of Neste (Fortum), as well as a member of the board of the world's largest power company RAO UES in 2003–2004. Currently he is the CEO of Kiuru Partners LLC, a consulting firm that specializes in economic and financial matters in Russia, and a member of the board in ZAO FIM, a Finnish financial services company that operates in Russia. He is also a member of the board in several Russian companies, such as OAO OMZ, Severstal-Auto, OAO SIBUR, and OAO Kirovsky Zavod.

Consequently, Remes has valuable experience on the strategic sectors and especially on the gas industry in Russia, and a large contact network among government officials, politicians, economists, journalists and business people both in Russia and abroad. Thus, Remes was able to provide very practical viewpoints on political risk in the Russian strategic sectors, in addition to the particular information concerning the development of the Shtokman project. Remes visited the Pan-European Institute in January 2010 and also gave a lecture at the Turku School of Economics. During his visit, the researcher was able to discuss the Shtokman project with him at the Institute for half an hour.

The third expert interviewed was Lotta Numminen from the Finnish Institute of International Affairs. She works as a researcher in the International Politics of Natural Resources and the Environment research programme, and her areas of expertise are the new geopolitical situation, climate change and environmental issues of the Arctic Ocean. Consequently Ms Numminen was chosen to be interviewed for her ability to bring the perspective of Arctic issues to the discussion about the Shtokman project. The researcher had met Ms Numminen in March 2009 at a seminar in the Finnish Institute of International Affairs called Arctic Resource Policies in Russia, and already then presented her the general topic of the research and asked for an interview. They

kept in contact via email, and the interview took place in January 2010 in the Finnish Institute of International Affairs.

The fourth expert interviewed was researcher Peeter Vahtra from the Pan-European Institute. He has worked at the institute for seven years in different research projects, and during the past four years he has focused in particular on investment and energy sector-related matters in Russia and its neighbouring countries. Therefore Vahtra is an expert on the investments in the Russian energy sector. As the researcher also works at the Pan-European Institute, it was easy to approach Vahtra and request an interview. The interview took place in February 2010 at the Pan-European Institute.

The fifth expert interviewed was Arild Moe, deputy director and senior research fellow at the Fridtjof Nansen Institute in Lysaker, Norway. His main research interests include the Russian oil and gas industry, the regional dimension in the Russian petroleum sector, offshore activities in the Barents Sea, and the Norwegian policy in the High North. Moe has published several articles and books regarding northern offshore oil and gas resources, and he has strong expertise about the political issues related to the Shtokman gas field project in the Barents Sea. Moreover, he was able to provide a Norwegian point of view to the discussion. The researcher had read many of Moe's specialised publications beforehand and also received suggestions from the experts she had previously met to interview Arild Moe. She approached him via e-mail in January 2010. Moe agreed to an interview by phone in February 2010.

The sixth expert interviewed was Jakub Godzimirski, head of programme and senior research fellow in the Department of Russian and Eurasian Studies in the Norwegian Institute of International Affairs. His research interests include defence and security policies, foreign policies, conflict-war-peace operations, the EU, the NATO, and post-communist societies. He has published articles on, for instance, the Shtokman project and the new geopolitics of the North, and provided another Norwegian perspective to the discussion. The researcher received a suggestion to interview Godzimirski, contacted him via e-mail in April, and the interview took place during the same month via telephone.

The seventh expert interviewed was Tatiana Romanova, associate professor in the Department of European Studies, School of International Relations at the St. Petersburg State University in Russia. Her areas of expertise include the energy policy

of the EU and the EU-Russia relations, particularly in economic and energy issues. She has published several articles on the EU-Russian energy dialogue, the EU's energy security, and the EU-Russian economic relations. In addition to her high level of expertise, she was able to provide a Russian perspective into the discussion. The researcher contacted Romanova via e-mail and the interview took place by phone in mid-April 2010.

The eighth expert interviewed was Susanne Nies, senior research fellow from the French Institute of International Relations (IFRI) in France. She is currently the head of IFRI Brussels office and is in charge of the EU relations of IFRI. Her research interests include the gas supply and its security between the EU and Russia, the future of Nabucco and South Stream pipelines, and the role of the transit countries in the supply system. Moreover, she sees the Shtokman project from a French perspective. The researcher contacted Nies via e-mail in April, and also this interview took place by phone in April 2010.

In this study, the interviews were conducted as semi-structured interviews, because the researcher wanted to ask certain questions while allowing the interviewee to speak freely about his opinions and experiences. In addition, in a semi-structured interview it was possible for the researcher to add additional questions if necessary. The interview questions were based on the themes of the theoretical framework of the research, but some issues were discussed in more detail depending on the interviewee's expertise. The interview questions are presented in Appendix 6.

The interviews of Leino, Remes, Numminen, Vahtra took place in Finnish, as that was the native language of both the interviewer and the interviewee and thus the discussion was easier in Finnish. The quotations presented in Chapter 4 have been translated word by word into English by the researcher. In the cases of Godzimirski, Moe, Nies and Romanova, the interview was conducted in English, which was neither the interviewee's nor the researcher's native language, but both spoke fluently enough to get their messages across well. All the interviews took 30–60 minutes, except for the interview of Nies. Due to her busy schedule, she had only approximately 15 minutes for discussion, but even in that short time, she got to present her general views about the themes of the interview. After the discussions, the researcher asked if she could contact the interviewees later in case further questions appeared. They agreed to answer further questions via e-mail, but this did not appear to be necessary.

To conclude, these interviewees have a high level of expertise concerning the research topic, and they all provide slightly different perspectives to the discussion. However, additional expert interviews and company interviews would probably have further contributed to the research findings. In fact, interview requests were sent also to several other experts in Finland, Russia, Norway and France, but some of them politely refused to give an interview referring to the lack of competence, and the rest of them could not be reached within the time frame of the research.

In this research, the data was organised by themes that were identified based on the theoretical framework, and then analysed in the same order. The themes based on the theoretical framework are presented in the operationalisation table in Table 6.

Table 6 The operationalisation table for assessing macro political risk in the case of Shtokman project

Research objective	Themes	Questions
Political risk in the Shtokman gas field project	Macro-level sources of political risk	1, 2, 3, 4, 5, 6
	Industry-level sources of political risk	7, 8, 9, 10, 11, 12, 13, 14, 15
	Firm-level sources of political risk	16, 17, 18, 19
	Project-related sources of political risk	20, 21, 22, 23
	Effects of political risk in the project	24, 25, 26

With the help of the operationalisation table, the theoretical and empirical parts of the research can be brought together logically. The table describes the research objective, which has been divided into themes. On the basis of the theories, the phenomenon can be described on a general level. Through the interview questions, the empirical data was collected to answer the problems regarding the phenomenon in this case. The research findings will be analysed in depth in the following chapter.

4 POLITICAL RISK IN THE SHTOKMAN PROJECT

The empirical data of this research consists of eight expert interviews. The persons interviewed were Petri Leino from Finpro, researcher Lotta Numminen from the Finnish Institute of Foreign Affairs, Seppo Remes from Kiuru Partners LLC and ZAO FIM, researcher Peeter Vahtra from the Pan-European Institute, senior research fellow Arild Moe from the Fridtjof Nansen Institute, senior research fellow Jakub Godzimirski from the Norwegian Institute of International Affairs, associate professor Tatiana Romanova from the St. Petersburg State University, and senior research fellow Susanne Nies from the French Institute of International Relations. The findings of the expert interviews are presented and analysed in this chapter in the order of the sub-problems of the study: the sources of political risk, and the effects of political risk on business. The sources of political risk will be further divided to the macro-level, industry-level, company-level, and project-level sources of political risk.

4.1 Macro-level sources

To begin with the general investment climate in Russia, the situation can be characterised as rather ambivalent. According to Vahtra, the economic-political situation regarding foreign investments has remained quite stable during the last three to four years. When the state-led economy began to gain strength, some sectors of the economy were defined as strategically important, and consequently, certain restrictions concerning investments were set for foreign investors. This policy has continued, and in that sense the investment climate has remained rather stable. However, the recent economic crisis has resulted in several changes in this policy, particularly in terms of state-owned companies. Vahtra clarifies that after the crisis, it has been stated several times in Russia that part of the hundreds of state-owned companies will be privatised already in 2010. This creates new opportunities for foreign investors, even though these privatisations will not mean selling whole energy companies to foreigners, but instead collecting capital by selling minority shares of companies from certain sectors.

Leino and Godzimirski also define the Russian investment climate as ambivalent. Leino states that the need for new investments is recognised, but at the same time there is strong reluctance to surrender power and control of strategic industries. According to Godzimirski, the state wants to retain and maintain control of the strategic assets, but it cannot cope with the new problems on its own – capital and expertise are needed in order to develop the new gas fields. According to Romanova, Russia has became more

open to foreign investment since the financial crisis, at least as regards the idea of foreign investment. In oil and gas sectors the investments are restricted, but she believes the application might become more flexible due to the need for capital and technology as well as due to President Medvedev's more liberal policy towards foreign investment.

Moe, in turn, describes that foreign investment has not been generally welcomed by the broader political spectrum in Russia. According to him, the problem is that foreign investment is regarded with suspicion. Moe continues that foreign investment is something that is permitted when it is absolutely needed; when operations cannot be financed domestically or when there is a lack of the necessary skills or technology. Moe further clarifies the issue as follows:

> *"…governments perfectly understand that foreign investment is necessary. But policies are being paid out against this, I would say, general negative background. That does not necessarily mean that it is dangerous to invest in Russia, it just means that you always have to take it into consideration, the sort of general negative attitude."*

What kind of political risks can this kind of business environment then encompass for foreign investors? Leino sees political risks as radical changes in the governance or law interpretation, and in Russia this means, in particular, replacements in the governing bodies or regime change. He continues that constant changes in different kinds of procedures are the most significant political risks from the business point of view. As regards the government-related risk issues, he notes the growing role of the central government in Russia. Leino describes the issue in the following way:

> *"It [the growing role of the central government] can be seen, for example, in the Murmansk region in the Kremlin putting their own man to the governor's position. Yury Yevdokimov […] was very popular, and originally elected in local elections, but apparently he worked too well hand in glove with Norwegians and some other foreigners. This did not seem to be good from the Kremlin's point of view, and [their] own man was put in place. Governor appointments are in the direct control of the president; they are not elected in national elections, which was the case a few years ago."*

As a result of this appointment, almost all the local ministers were replaced. Leino continues that companies are now forced to create these personal relationships all over again, but he has not heard about these changes directly affecting the actual investment climate.

Remes argues that it is only certain sectors and large investment projects that can face political risk – in other businesses, the risk is economic. For instance, when looking for partners or loan for investing in Russia, the process may be more difficult and more expensive due to the so-called Russia-risk. Remes continues that risk in Russia may also be related to the malfunctioning of governance and infrastructure, and furthermore, to the changes in promises and agreements made earlier, concerning, for example, tax benefits. These issues are largely related to the local and regional governance, not to the central governance.

In certain sectors of the economy, particularly in the strategic sectors, large investments are always flavoured with the perception that if an agreement has been made, at some point it will not be followed any more. Uncertainty regarding large investment projects is thus, according to Remes, understandable and legitimate. At this level, the risk can also be seen as being more related to the central governance. Leino states that at the moment the use of power in Russia is largely personified in Vladimir Putin. His falling seriously ill, getting into an accident, or being murdered, although unlikely, might be such a radical change that it would increase political risk in Russia. Also Vahtra sees the current leadership and particularly the prime minister as essential actors in maintaining or even in the tightening of the current economic-political policy. On the other hand, Vahtra argues that the person leading Russia in the future will also come from the current leadership group. Thus, it is very unlikely that there would be such significant changes in the leadership in the next ten years that they would affect foreign investors' position in the country, at least in a negative way.

When discussing issues that affect the political risk faced by foreign investors, Vahtra considers Russia's strength as an international player to be one of the most important issues. The position of Russia in the world economy gives the basis for the kind of game that Russia can afford to and is capable of playing with foreigners. Therefore the only thing that could suddenly reduce the potential for political risk in Russia would be a sudden event that would significantly reduce Russia's position in the world economy, which is largely tied to its energy sector. Such an issue might be the alternative ways to

produce gas, which could weaken Russia's position as an international gas producer, and simultaneously its power as an actor in the world economy would be reduced as well.

Otherwise, if nothing that dramatic occurs, it will require foreign investors having several years of positive experiences in the country before the trust in Russia's political investment environment can be achieved. Vahtra notes that the fact that foreign investors have recently been invited to Russia again does not eliminate the fact that political risk still exists – it is not a guarantee that the cycle would not begin again in some five years, with the foreign investors facing such troubles as the oil companies a few years ago. Not any internal event in Russia, such as a change in leadership, could remove the deeply rooted suspicion which foreign investors hold towards the country. Moreover, Moe specifies that even though there have been announcements about the need and hope for foreign investment in Russia, not much has happened in practice regarding the strict legal framework for foreign investment which was put into law in 2008. The framework still limits the size and scope of investments particularly in the energy sector.

Vahtra argues that a possible increase in political risk, in turn, would most probably be caused by Russia's growing power in the world economy. The country's international position defines the rules of the game. Moe states that to some extent, there is a link between the economic situation of the country and the conditions of foreign investors in it. Vahtra continues that on the side of increasing risk, also the person leading the country may also have an effect on the political risk faced by foreign investors, as different persons have different levels of courage and nerve.

International relations between Russia and the investor's home country may also have to do with the political risk faced by a foreign investor. Moe discusses the unfortunate experiences that British Petroleum had in Russia, and notes that at the same time, there has been a very negative development in Russia's political relations with the Great Britain. One might say that the British affiliation is unlikely to have helped the company very much. However, another example of a company currently facing

problems in Russia is the Norwegian Telenor[13], even though Norway and Russia seem to have quite good political relations. In the light of this case, Moe, as well as Vahtra, argue that the national affiliation of a company is not a very significant matter when analysing the sources of political risk. Moe states that what matters more is the sector and the company involved. According to Vahtra, the unfavourable experiences that foreign investors have had in Russia during the past five years were due to economic reasons concerning the reduction of projects which were unfavourable for Russia. The political relations were not an explaining factor in those cases.

As a consequence, Vahtra and Remes do not see the affiliation of a company as a a source of increase in political risk, but they argue that it might result in a reduction of risk when country relations are good. Remes discusses German companies, saying that they have an advantage in the Russian market because of the good political relations between the countries. They have managed to create business forums through which they can efficiently solve difficulties that companies may face in their mutual business. Remes summarises that German companies know how to effectively benefit from good economic relations.

According to Romanova, Russia's international relations are fairly stable and fairly pragmatic with the main investor countries at the moment. Russia's international political dialogue supports foreign investments, and particularly in the field of oil and gas exploration, most of the strategically significant decisions need the support of political powers. Vahtra adds that even in strategically less significant sectors, foreign investments are based on some kind of political discussions. When it comes to more important sectors, such as energy industries, Vahtra does not see a situation where political relations between the countries would not affect the investment projects. However, there does not seem to be much reason for concern for Russia even if the relations were not that good. During the past ten years, Russia's behaviour in foreign politics has been quite defiant, but this has not had much effect on foreign investments

[13] Telenor has faced problems in Russia concerning telecommunications company VimpelCom. The majority owners of the company are Telenor (29.9 %) and Russian Alfa Group (44.0 %). In April 2008, Farimex, which owns less than a percent of VimpelCom shares, sued Telenor alleging that Telenor's representatives on the VimpelCom Board had delayed VimpelCom's acquisition of the Ukrainian Radio Systems (URS) and consequently caused losses for the company. Telenor denied the accusation and refused to pay the USD 1.7 billion fine as a compensation for lost profits. Telenor suspects Farimex is controlled by Alfa Group, with which Telenor has had a lengthy dispute about how Vimpelcom should expand its markets. In April 2009, the court told Telenor to pay the fine, or its shares could be sold at auction. Telenor made an appeal against the court's ruling, and after several delays, the battle is expected to continue in court in April 2010 (Reuters 2009c, WF 2010).

in the country. Vahtra says that even though for instance the Dutch and the British investors in the energy sector have faced troubles in Russia, they have not affected their planned investments or interest in Russia. This results from the fact that European gas and oil companies do not have many alternatives for production and investment. Vahtra explains the situation as follows:

> *"...Of course at least until today Russia has been the least risky and most free environment [for investment] among the alternatives, if we compare for example with the Arabic countries in general, where foreign ownership has been often limited to minimum and where the role of particularly European companies has been quite small. European companies have not had much choice in where to do the production. […] After recognising its position, Russia has been quite strong and this way also able to defy politically without any serious consequences so far. But of course, if there are foreseeable changes in Russia's global position, it will have a rather straight effect on the possibilities of how far the limits can be pushed."*

4.2 Industry-level sources

Remes states that in the Russian gas industry, the main actors are the president and the prime minister. The vice prime minister and the vice prime minister's office are also important actors as they control the energy sector. The vice prime minister's position is significant and held by Sechyn at the moment. Another important actor is Gazprom, and for a foreign company, entering the Russian gas industry is possible only through the acceptance of Gazprom. A foreigner does not necessarily have to be Gazprom's partner, but its silent acceptance is required. That is not a regulatory issue, but rather a practice in Russia. Remes notes that there are also other companies that have licenses to Russian gas fields, such as Novatek, which, however, is partly controlled by Gazprom, and several other smaller independent producers, although they are producing in areas that are not of interest to Gazprom. Consequently the Russian gas sector is ultimately a triangle of the president, the prime minister, and Gazprom. The sector is run from the top level of the state, and every significant decision is made on that level. As a consequence, the risks for foreign investors in the Russian gas sector stem from the top level of governance, not from issues related to the governance or authorities at the regional level.

Vahtra states that as the gas sector in Russia is very concentrated and affects the country's position in the world economy and international politics, the main actor in the Russian gas business is the highest state leadership. Under the state's authority, Gazprom is an influential actor as well. Vahtra, however, argues that in Western analyses the state's role in Gazprom's practical and operational decision-making is often over-emphasized – not all the actions of the company are politically motivated or directed from the state-level. Vahtra continues that in a sense, the question of which actions can be considered as having a political tone is a philosophical one. In principle, all the actions in the energy sector politically motivated to a certain extent. No country's state-owned energy company operates on a purely economic basis; there are always political factors involved. However, in the case of Gazprom's everyday operations, the state does not dictate how it should operate in its markets. Vahtra says that there are many myths and prejudices related to Gazprom, which shade the discussion on its operations.

Romanova also defines the government as the main actor in the Russian gas industry as it is the primary holder of stakes in the industry. In addition, she notes the oil and gas companies, which, according to her, also have their own interests – they do not necessarily repeat the interests of the state. The state is the main stakeholder in national oil and gas companies, and naturally interested in profit making, in a stable cash flow and in the use of national gas fields in ways that are beneficial to the country. At the same time, the national gas companies do have their own interests and investment needs, and sometimes they contradict the business interests. Romanova assumes that it is possible that we will see more of those contradictions in the future.

Moe, in turn, states that operating in the Russian gas sector always means cooperation with Gazprom. Moe says that when discussing political risk, a large part of it results from the risk associated to running a project with a partner. Some foreign investors in Russia have had serious problems with their Russian partners. Godzimirski states that there is reluctance in the West to have substantial investments in the Russian gas sector due to the fact that there is only one big player that controls the industry in addition to the fact that as we have seen in cases of Sakhalin-I and Kovykta, Russia can employ certain measures in order to give control of the resources to Gazprom. However, Moe continues that Gazprom can be seen as a rather reliable partner because it has a more or less monopolist position in the Russian oil and gas industry. Nevertheless, even Gazprom does not have limitless power – it, too, is affected by

regional and political developments. When it comes to the leadership of the country, Moe states that the conditions of foreign investors in the gas industry and in the Shtokman project in particular are not tied to the persons leading the country at present. The project would have large attention from any leader. However, President Putin has been especially focused on and involved in the gas industry.

As a conclusion to the statements of Moe, Romanova and Vahtra, Gazprom's actions are always somewhat politically motivated, but the state does not command the company in its everyday operations. Moreover, there are external issues affecting the operations of Gazprom and its partners. One of the most important issues is the future development of the Russian gas industry. Vahtra states that at the moment, the demand for natural gas is not very high due to the financial crisis, but the demand is expected to increase as the world recovers from the crisis. However, uncertainties have appeared concerning the gas business because of the unconventional gas resources, shale gas being one of them. Systematic search for alternative sources of energy is going on in Europe. Vahtra does not believe that the position of Russia as an energy producer would suddenly decrease significantly, but in the long run, neither is it going to increase. Unconventional gas production is a serious potential risk to Russia's position as a gas producer. This alternative for conventional gas production has risen more strongly than any other alternative during the past 15 years. However, information on shale gas, for instance in Europe, still remains very controversial and speculative. Vahtra states that even though the Russian authorities are depreciating the phenomenon, it can be assumed that Russia is far more involved in this research than it has announced publicly, and that it is attempting to get shares of foreign companies that have know-how related to shale gas, only to ensure access to the potential European shale gas resources in case that they prove to be profitable.

Moe also discusses the issue of unconventional gas, which has created uncertainties regarding future Russian gas exports. If the role of unconventional gas increases, at least those projects which are intended to supply the American market will have to find other markets. Moe says that the situation is very different from what was thought only a year or two ago, and it is changing the outlook of several projects. However, even if Russia loses some of its prospects regarding the LNG production, it still needs gas to supply to Europe and also to its domestic consumption. As a consequence, Russia has to renew the production and open new fields if it cannot start conserving energy.

Opening new fields, such as the project in the Yamal Peninsula, is very expensive, and it would be wise to share the financial investment and risk with other actors.

According to Remes, the future of the Russian gas industry depends on several issues. One of those is the fact that there are two fields of the industry in which foreign technology is extremely important: the offshore gas production, especially in the Arctic areas, and LNG. Roughly speaking, Russia has the required expertise to be able to develop the fields, except the Arctic offshore and LNG-related know-how. Foreign technology will be necessary also to develop the less productive layers of the old gas fields. Remes continues that one can always buy technology, but what is needed more is the skills to use it; those cannot be bought. Western companies have to be involved. Moreover, the pay-back time in investment projects this large can be 40 to 50 years, and therefore it is obviously reasonable to share the risk.

Vahtra states that Russia is now facing the factual impossibility of developing the fields alone on its own resources – foreign companies have to be admitted in. It is possible to play the political game about whether foreign companies and which ones will get into the project as long as it is at the planning stage, but it is a fact that Gazprom cannot effectively implement any large-scale gas field project on its own. Moreover, Russia no longer makes such unfavourable deals that could result in actions as dramatic as the ones a couple of years ago. Vahtra states that the deals signed today are not so favourable for foreigners or so unfavourable for Russia that there would be a need to renegotiate them after few years. In that sense, the position of foreign companies in the Russian gas industry is rather good, as the future position of Russia as an international gas producer is faced with uncertainty. At present, foreign capital and technology are needed in this strategic sector.

The Arctic location of the future gas fields adds a whole new aspect to the discussion. According to Moe, there are large gas resources in the Russian offshore areas, in the Barents Sea and in the Kara Sea. They are costly to develop and require extremely advanced technology, and consequently developing those fields definitely requires cooperation with foreign companies. Shtokman is the first large offshore development project in Russia. According to Numminen, the international interest towards the Arctic was reduced along with the recession and reducing oil prices, but as the economy begins to run again, the interest is expected to increase. She states that exploiting the Arctic resources is not a question of the melting ice; it is a question of money. The use

of the Arctic sea routes is likely to start in the coast of the Arctic Ocean in the Russian North-West for the transportation of the energy resources produced in the Yamal Peninsula. According to her, the sea route on the Russian North-East coast is not so important that it would be taken into more extensive use in the near future, as there are neither harbours nor infrastructure for reports on the movement of the ice, etc. Numminen says that the increasing use of the route from the Barents Sea to Yamal is rather probable.

Moe[14] argues that the security problems in the area have been very much exaggerated. The resources in the Arctic are located in the continental shelves of the Arctic states, and consequently they are more or less uncontested. The only potentially resource-rich area is between Norway and Russia, but there is no visible sign of conflict. Negotiations about the augmentation of the continental shelf are ongoing, and so far both parties are conducting exploration in the area. Moe does not see that there is potential for serious tensions regarding disputed energy reserves – on the contrary, the resources that are expected to be found in the Arctic are on the continental shelves of the Arctic states; they are not free for competition. He continues that there is a great deal of discussion on the Arctic competition, race, and conflict, but when looking at the issue more closely, it is difficult to say whether there is a basis for such assessments.

Numminen also states that there is no actual competition going on about the Arctic reserves – all the Arctic states, except the USA, are following the United Nations' Convention on the Law of the Sea, according to which each Arctic state can leave claims about the areas of the sea shelf that the state considers to belong to its area. The claims have to be submitted to the UN committee 10 years after the ratification at the latest. The process is clear for every party. However, Numminen notes that when all the Arctic states have submitted their area claims, it is likely that the claims of Norway, Canada and Russia will overlap to some extent. According to the convention, these kinds of issues are to be solved in negotiations between the countries involved. Numminen states that the so-called grey zone between Norway and Russia is an interesting case, as it is a very important area for fishing, in addition to vast energy resources having been discovered in the area. This can result in tough negotiations and tensions in the relations between Norway and Russia. The relationship is very

[14] Please note that the interview of Moe took place on the 3rd of February in 2010 and the interview of Numminen took place on the 22nd of January in 2010, both of which were before Norway and Russia suddenly reached an agreement on the delimitation of the grey zone in April 2010.

interesting to begin with, because without Norwegian technology Russia is unable to develop the resources in the area – cooperation is needed in any case. As an energy state, Norway will not be willing to concede in the negotiations, and neither will Russia. If the negotiations do not turn to be successful, Numminen assumes that such a diplomatic dispute is likely to have an effect in the Arctic areas as well. For example it could have an effect in the operations of the Norwegian Statoil in the Shtokman project. It is not probable, but it is possible.

According to Numminen, as regards the common areas in the middle of the Arctic Sea, the Arctic states are exploring what is to be found under the melting ice. It has been estimated that most of the undiscovered resources will be found in the states' own economic zones, not in the no-man's land in the middle of the Arctic Sea. However, even if nothing is to be found, all the states have to be involved just in case as part of their international policies. Especially Russia and Canada react strongly to each other's actions regarding the claims over those areas. The USA still remains outside the convention, which seems to be its strategy in other international agreements as well. The USA is a member in the Arctic Council, but according to Numminen it has made the council's operations very difficult and thus this kind of border issues cannot be discussed in that forum. The council now focuses on environmental and research cooperation.

Numminen believes that Russia finds it irritating that the USA has not yet ratified the Convention on the Law of the Sea, and this causes tensions and suspicions from the Russian side in the Arctic areas. In addition, all the other Arctic states except for Russia are NATO members. These issues may cause Russia's provocative behaviour – it is a question of image. One issue causing tensions, especially on the side of the other Arctic states, is the threat of environmental problems in the Arctic Sea. As there are no rules for the political game on the sea, the risks in oil and gas shipments increase with traffic, and there is no authority to control the condition of the ships, particularly the Russian ones. No one is responsible, and in addition to the danger to nature in general, the shipments pose a serious threat to the valuable fish swarms. This issue raises tensions especially in Norway and Iceland, to whose fishing industries the purity of the fish is the core of the brand and thus a significant concern. However, Numminen notes that the Arctic countries are neighbouring countries, and that they all benefit from stability on the area. Thus, there is no reason for a severe dispute over the areas, even though the tensions might increase.

Leino[15] also argues that the international relations may increase tensions in the Arctic areas. As an example, he notes the cat-and-mouse game of Russia with Norway in fishing issues – both countries in turn arrest the other country's trawlers for fishing in the wrong place. Simultaneously, however, the Norwegians are involved in the Shtokman project. Thus, it can be said that the political relationship between Norway and Russia is somewhat tricky, but the countries still work together in the gas field and this relationship is not seen as a significant risk issue for foreign direct investment in Russia, not even from a Norwegian company's point of view.

Leino also mentions the missile competition in Europe, and sees this as an influencing factor in the international relations. If the tensions increase and Russia feels somehow threatened, the political risk for foreign investors may increase. Leino describes the issue as follows:

> *"[…] if for example the USA […] starts to invest in [its] military presence in Europe or in the Arctic areas, it is clear that Russia will answer that. That is, it will put its own [military] equipment and restrictions on that area. […] a military conflict between the East and the West, not meaning a full war, but for example announcements of new missile bases or something like that, might, if not prevent, but at least complicate the [investors'] operating there."*

However, Leino continues that strong economic ties and common economic interests with other countries are a strong stabilising factor, as starting a conflict or even a war, in the extreme case, would be so expensive that no country could afford it. Nevertheless, Leino points out that the military political significance of the Russian Arctic has increased. In Murmansk, this can be seen in the renewal of the local military equipment and technology, and also in the tightening restrictions on terms of moving in the area. For example, a new regulation was introduced in 2008 according to which the Northern coastline is considered to be the border zone. Thus, one must have a permission from the FSB in order to go closer than 15 km off the coast.

The importance of security and military issues has increased in the Russian Arctic areas. Both Remes and Vahtra state that the Arctic location is likely to bring an

[15] Please note that the interview of Leino took place on the 5th of September in 2009, which was before Norway and Russia reached an agreement on the delimitation of the grey zone in April 2010.

additional dimension and extra tensions to the operations in the offshore projects. Remes believes that the tensions might result in practical problems regarding, for example, working permits for foreigners in the area, but those kinds of issues can be solved. In addition, as the Shtokman field, for example, is clearly owned by Russia, the Arctic tensions should not have any direct impact on the Shtokman project.

4.3 Company-level sources

In the case of the Shtokman project, Remes states that technology-related know-how increases the bargaining power of the foreign companies, the Norwegian Statoil and the French Total. Statoil has experience in operating offshore fields in the harsh Arctic conditions. Moe mentions the same fact – Statoil has unique technology and also the experience and ability to run this kind of projects. Gazprom does not have such experience and it realises that. Vahtra adds that in addition to having the required technology and experience, Statoil can be considered a rather politically neutral company. As a result, the bargaining power of Statoil can be considered quite strong, and Vahtra says that it would not seem a very reasonable decision to leave Statoil out of the project in any case.

In the case of Total, Remes believes the company has two advantages; firstly, Total has experience of LNG operations, and secondly, Russians like to make deals with the French. They understand each other, and Remes argues that accepting Total into the project was a purely political deal. Remes points out that French companies are at least as political as the Russian ones, and in that sense they speak the same language. According to Nies, the relations between France and Russia are very good, and France has sold Russia military planes, for example. She notes that between France and Germany there is even competition about the Russian projects, not only in the energy sector, but also for instance concerning the transport infrastructure and high-speed trains. When it comes to the question of why Total was chosen to the Shtokman project, Nies says that the EU is a major market for Russia, and thus it is very interested in having good relationships with the major EU countries like France – it is a common interest. In this way, the international relations of countries can have an effect on business deals. Nevertheless, Nies states that even though Total as well as Statoil are strong players in the European and international scene, neither of them is a strong player in Russia. According to Vahtra, the technical know-how of Total is not anything out of the ordinary when compared to for example Shell or BP, and therefore

it does not seem to have as strong bargaining power as Statoil. Vahtra also states that Total being in the Shtokman project seems to be more of a matter of political negotiations than of technical dependence.

According to Godzimirski, the decision to invite Total and Statoil to the project instead of other potential companies was based on a combination of technological, financial and political factors. Both Statoil and Total have state-of-the-art technology, expertise and experience, and consequently Gazprom wanted them to play an active role in the process of managing the project. Moreover, the idea was not only to have French and Norwegian expertise but also to somehow diversify both technological and economic risks. Godzimirski notes that when the project is finally put online, its costs are likely to have doubled from the initial estimation, and having partners enables Gazprom to share these risks. The project is so complicated and so complex that it is almost impossible to realise it within the planned economic framework. He agrees with Nies, Remes and Vahtra by saying that as for the political aspect, there has been a great amount of contacts and goodwill in the relations between both Russia and France and Russia and Norway. Cooperation with Total was presented as a political deal between Nicholas Sarkozy and Vladimir Putin, and likewise, the decision to invite StatoilHydro was not announced by the head of Gazprom but by President Putin in a telephone call to the Prime Minister of Norway, Jens Stoltenberg. Godzimirski concludes that in addition to the expertise and risk-sharing matters, inviting Total and Statoil was clearly a political decision.

Both the foreign partners are important to Gazprom and to the project. How important is the project, then, to Russia and to Gazprom – how strong is Gazprom's bargaining power? Remes, Vahtra, Godzimirski and Moe argue that the Shtokman project as such is not that important to Russia, because the Yamal project is more important at the moment. Remes explains that Russia has the required technology for Yamal, it is less expensive in the long run, and the project has already proceeded quite far – Yamal will be the priority, and this reduces the bargaining power of the Western partners in the Shtokman project. Accoding to Romanova, the importance of Shtokman to Gazprom depends on the external demand – on how much the EU and European partners in general will rely on Russian gas in comparison with other sources of energy. There is no point in bringing too much gas to the market. Vahtra notes that as long as Russia is not in an immediate need of gas, the Shtokman project will, when implemented, be more important to the foreign partners than to Gazprom. If the project was very

important for Russia and required immediate implementation, the bargaining power of the foreign partners would increase. Vahtra concludes that at the moment, however, the bargaining power of the foreign partners is not very strong. Romanova states that since the foreign companies are in the project for profit-making and looking for the Russian resources, Russia is in as stronger bargaining position at the moment, as the field is not likely to be developed in the near future.

According to Remes, Russia has the power to delay the project, and prior to its start, Russia has full control of it. Nevertheless, Remes continues that if the decision to implement Shtokman is made at some point, the bargaining power of Statoil and Total will increase considerably. Due to this Russia will delay the final decision for as long as possible – it is a question of manoeuvring. Remes continues that delaying the implementation of Shtokman is of course also a question of the international gas markets and of the estimated demand for gas. According to Moe, Shtokman has been very important to Gazprom because it is linked to the company's aspiration of becoming a leading LNG supplier, but now this whole strategy is under pressure. Remes notes that it is why also the foreign partners are not pushing the huge project forward at the moment.

Remes assumes that the project is not a matter of life and death for Statoil or Total either. For them, it is very important to be involved in a significant gas project in Russia, and simultaneously they are able to meet important people, learn what is happening in the Russian gas business, etc. For them, involvement in the project matters more than the actual realisation of it. Moe notes that developing this vast project would give them new experience and thus they might become natural partners in further projects in the expansion of the Arctic continental shelf. The foreign investors obviously expected profit from the project, but were probably willing to accept a lesser rate of return and a less favourable position in the project because of the long-term strategic advantages. Godzimirski also states that Total and Statoil are not so dependent on the Russian market – their involvement is not due to a need to have shares of the Russian gas market, but due to the desire to be active, to develop their expertise, and to sell the expertise to those who need it. They wish to extend the lifespan of their companies as providers of state-of-the-art technological solutions. Neither Total nor Statoil were promised ownership of the gas that is located in the Shtokman gas field; they were invited as parties to develop the field.

Moe argues that for Statoil the cancellation of the project would not mean a crisis, but obviously it would be a setback. According to Godzimirski, the main focus of Statoil has been on the Norwegian continental shelf, but at some point it realised that it had to go global in order to stay and play among the leading providers of state-of-the-art technology solutions, and Shtokman provided a good opportunity in the neighbourhood. Remes notes that to the Norwegians it is also important to follow the development of Shtokman closely as it might become a rival for Norway's own gas fields. Norwegians are continuously moving higher and higher in the North, and Remes says that if the project is continuously delayed, the Norwegians will approach the grey zone while Shtokman's implementation is yet to begin. Remes estimates that eventually the gas from the Shtokman field could be distributed down south through a ready Norwegian pipeline, if the implementation of the project will move forward approximately 10 to 20 years, and if there is no pipeline on the Russian side but there are empty pipes on the Norwegian side. Numminen adds that Norway's membership in the NATO can also be an issue affecting the international relations between Norway and Russia. However, Numminen continues that due to the common interests of Norway and Russia, Norway is eager to retain good relations with Russia and consequently willing to cooperate and find solutions that are beneficial to both parties.

According to Moe, the Shtokman project is probably less important to Total than to Statoil, as Total is a larger company and has more international projects and engagements. Godzimirski notes that in relation to the globally operating Total, Statoil is a newcomer among the big international oil companies. Total has been playing this game for decades. Remes assumes that for Total, it is important to be involved in several projects, and that it can probably value its share in this project even though it is not an equity-owner in the project – it is about finance techniques.

Remes states that one issue which could cause disagreements between Russia and the foreign partners if the field was implemented is the fact that Russia would be likely to be willing to sell part of the Shtokman gas in its domestic markets for a lower price than it could be sold abroad. Another issue is the price Russia must pay for the Western technology. Remes says that Russians are unwilling to pay for technology, especially in projects with shared ownership, and moreover Western companies tend to charge, as Remes puts it, astronomical sums for it. Nevertheless, these issues can be solved via negotiations. They cannot be seen as political risks, but as ordinary business negotiation risks.

4.4 Project-level sources

Moe notes that the Shtokman Development Company has a very peculiar assignment, as it is not going to sell the gas – that is left to Gazprom. The building of the field is believed to take 3–5 years, and after that the foreign partners could be involved in the production for some 20 years. As the ownership of the field is to be moved to Gazprom after 25 years, Moe wonders how the foreign partners will be compensated at that point, and to what extent their earnings will be connected to the gas sales. Godzimirski believes that it will be discussed in detail along with the implementation decision, and that Gazprom will propose a suggestion which will be either accepted or rejected by Total and Statoil. If they reject the solution, the Russian owners of the field will have to see if they can find other actors who might be willing to accept the suggestion. Nies says that in this sector there are different types of possible contracts, from service contracts to PSAs, but if the contract will not satisfy all the parties, none of them can proceed with the project.

Romanova expects that while they are developing the field, Statoil and Total will make profit through dividends and other payments. Vahtra assumes that even though Gazprom is to take control over the operation of the field, the foreign partners must have a guaranteed share of the gas supplies, but he does not know whether there could be room for changes in these shares in the future. Moe states that at the moment this is not the best arrangement from the perspective of the foreign companies, and explains the situation as follows:

> *"[…] Total and StatoilHydro, which was the name of the company at the time, they came to this at the point, at the time when it looked like the owners of the gas were in a very strong position. It was more like the seller's market and it seemed to continue that way. Now the market is changing, buyer's side is stronger again, so you know, this particular setup is even less attractive in today's market. Many had questions already then, but at least Total and Statoil found it sufficiently interesting to go in. […] So to what extent they are trying to renegotiate that… It is a peculiar setup because it gives the foreign companies a secondary role since they do not own the license and they do not sell the gas. They are more like technical operators."*

Furthermore, Moe notes that due to the current uncertainties about the future of the gas market, one should not rule out the possibility that the Shtokman project might never materialise. Nevertheless, Moe assumes that the partners in the project will not easily abandon it – instead they will indicate that they need more time. However, waiting is costly, as they have a large organisation running all the time. One cannot keep an organisation running for nothing.

Remes states that at the moment there is no reason to develop the Shtokman project further, as the estimates for future gas demand have been overly optimistic as Europe is considering alternative sources of energy. According to Godzimirski, Shtokman was to provide gas to be shipped to Nordstream as well as to the American markets as LNG. The idea was to build an LNG facility near Murmansk and then ship the LNG to the USA and Europe. However, according to last estimates the USA will be self-sufficient in gas production and the LNG will not be needed in the American market. Godzimirski expects that without the LNG option, Shtokman will experience numerous problems. Unconventional gas resources might change the logic of the gas markets, not only in the USA but also globally, if there was a sudden oversupply of LNG. Due to this, the volatility of prices is high and no-one knows how the shale gas will impact the industry in the long term. Statoil, Total and Gazprom need a project which is economically viable. Godzimirski assumes that starting the production in 2016 or 2017 is not realistic, but depending on the global development of the industry, it might not take decades either. Nies says that the field's development could start in five or ten years, but not before and not in the current schedule. She notes that at the moment Yamal is not developing very rapidly either. Remes believes that the Shtokman field will start the production in about 15 years, unless a real technical breakthrough regarding alternative energy sources takes place. Romanova also believes that the field will be implemented, but it will take years as it is not among the current priorities of Gazprom or the Russian government.

Vahtra states that currently Russia does not need extra gas, and if the Yamal field proceeds as planned, there will not be need for it in a long time. The gas reserves are full, and currently there is no demand for more in the market. Vahtra notes that it can be even be said that it has been wise of Russia not to develop all these fields quickly. If this had been done and the fields were already in production, closing them now because of the market situation would have caused massive losses. Taking into consideration the uncertainties around the project, he assumes that no gas will be

produced at Shtokman until after some ten years. As the Yamal gas is likely to replace the reducing production from the West Siberian fields, and as Europe is exploring possibilities related to unconventional gas, the Shtokman project might be delayed far into the future.

Vahtra states that the fate of the project depends on Russia's predictions about the long-term need for and alternative supplies of gas, as well as about the resulting development of its own position in the market in five or ten years. He continues that the Western media often strongly criticises Gazprom for its choices, such as choosing to invest in new fields instead of developing the domestic production. Vahtra states that the critique easily goes too far, and we forget that any researcher is unlikely to be better aware of those issues than the management of such a company. Vahtra says that Russia has a rather comprehensive understanding of the natural gas sector, alternative production possibilities, and the development of the global demand for gas. Therefore Gazprom is in no hurry with this project. Vahtra assumes that all these energy companies have known about the potential of unconventional gas for long and made long-term decisions based on that knowledge already years ago. At the moment, they all want to wait and see more clearly what is coming.

4.5 Effects of political risk on business

When it comes to the political risk that foreign investors might face in the Shtokman project, Leino states that some examples of the realisation of political risks have been seen in the Russian energy sector a few years ago. He mentions the case of Shakhalin-I:

> *"[…] the Western companies were smoked out [of the Shakhalin-I Project], not only for military political reasons, but more because the business started to get too profitable for foreigners. Environmental issues were used as a pretext to make Gazprom the main actor in the project."*

According to Leino, the foreign partners who had the production sharing agreement were placed in a contributor's or assistant's role in a sense. Russian authorities have not stated this, but Leino believes that as the price of energy was at its highest at the time, the operations were thought to be too profitable for the Western companies. He argues that the environmental accusations were not very credible, as anyone can

evaluate whether the environmental conditions in the region will improve if BP or Shell is forced to leave and Gazprom is put in its place. Nies notes that referring to the experiences of Sakhalin, many companies are still reluctant to engage in large projects in the fear of loosing their investments.

Leino continues that the French Total and the Norwegian Statoil have made a contract, according to which they will be involved in the project for 25 years, and after that the whole property will pass under Gazprom's full control. Gazprom has the license to develop the field, and Total and Statoil have the minority shares of the Shtokman Development to start with. Leino assumes that the warranties will probably be agreed on away from the media at the top political level. He continues that the same political risks are present in the Shtokman project as in the Russian energy sector in general.

Leino believes that if Russia would want the foreign partners out of the project, the state would slowly complicate their operations in the area, like in the previous case. In an extreme case, the political risk in the Shtokman project could result in foreign companies losing their investment, but Leino sees that as very unlikely, and some compensation would be paid, but it is another question whether it would be sufficient. In such a case, from the perspective of foreign investors, the project would mean wasting time and money for nothing.

Godzimirski notes that before the foreign partners decide to move the project forward, there is a number of factors that must be taken into account regarding the mutual working framework between the partners. There are economical, political, technological and also legal considerations, such as the question of what kind of say the partners will have in the company when it makes long-term strategic decisions with huge economic and maybe even political consequences. He further explains the issue as follows:

> *"[There are] not only political risks, but also a lot of financial risks, economic risks, technological risks, legal risks. If they [Total and Statoil] are not able to negotiate a good… to agree on a kind of good legal framework for the project, then they may also face lot of problems. Another state-owned Norwegian company Telenor has been experiencing problems when it comes to the ownership. […] So they are very well aware that there are different types of risks that are connected with recent investments in Russia. I always used to say*

that if you don't take a risk, you cannot expect good economic results."

Remes, in turn, discusses three possibilities of high-level political risk in the project. Firstly, after the implementation, one of the partners could be removed from the project. Prior experience shows that Russia may do that, regardless of the contract made. Secondly, Gazprom may decide to change the ownership shares. Thirdly, Russia might let one more company into the project, which would also mean reduction in some other partner's shares. It is quite obvious that in such a case, the shares of the foreign partners would be reduced, as Gazprom wants to maintain the 51 percent share of the company. Remes explains that an additional partner could be needed if some extra know-how would be required. Such a partner could come for instance from Germany or the Netherlands, or theoretically from the USA, as well.

Remes says that these scenarios are possible, but still very unlikely. The contracts have been formed as well as possible, and such an event would result in a conflict in the relations of France and Russia or Norway and Russia. Remes continues that forcing some of the partners fully out of the project would be too much; it would be rather impossible. Foreign companies are needed in Shtokman because of the technology, even if the Russians were able to cover the financing by themselves. Nevertheless, changes in the ownership shares are possible.

Leino also argues that the possibility of a sudden termination of the contract or sudden takeover are not very likely scenarios in the Shtokman project. Vahtra agrees by stating that Russia no longer makes such unfavourable deals that could result in actions as dramatic as the ones a couple of years ago. The deals signed today are not that favourable for foreigners or unfavourable for Russia that there would be a need to renegotiate them after few years. Vahtra does not consider it very likely that the field would be fully implemented and that Russia would subsequently force the foreign partners out of the project on some pretext. Neither does he consider it probable that Russia would at some point change the project contract or the shares of the foreign partners unilaterally. The position of Russia is not strong enough at the moment that it could afford to do such things, even though foreign energy companies have returned to Russia in the absence of alternatives. Vahtra states as follows:

> *"[…] They know in Russia as well that especially if there is any potential chance for a real increase in alternative supplies [of gas], the risk will decrease considerably. Then it will be a whole new ball game. In a sense, the power relations are changing there."*

Romanova believes that while foreign investments in the Russian gas industry remain restricted, the investment environment is more predictable than before and the investors can feel more secure about their investments. She explains that the problem with Sakhalin, for example, was that the deals were made in 1990s, when the Russian state was seen as weak, and companies made agreements which were beneficial for them but not for Russia as a whole. She describes the Russian state today as follows:

> *"Currently the authorities in Moscow are much more confident. They would not conclude in agreement which is detrimental for Russia. And because they will not conclude any agreement of that kind, foreign investors can be more sure about their future in Russia and more sure about the investments that they will make. [...] If they [the authorities] think that this is a good agreement for them, that will also mean stability for foreign investors. [...] It takes two to tango."*

According to Leino, the government is strongly involved in the economy in Russia, and consequently these kinds of deals are usual business not only among companies, but also among political leaders. It can be concluded that international relations play an important role in the Shtokman project, and that the countries involved attempt to minimise the political risk already on that level. Consequently, tensions and especially a conflict in the relations of the countries involved might seriously harm the businesses. Leino states that the mutual understanding between Sarkozy, Putin, and Medvedev regarding the operating principles plays a key role. He continues:

> *"The foreign operators and above all also foreign financiers certainly require a rather vast spectrum of top-level signatures before the funding of the project will start on a large scale, meaning on the billion-scale."*

When discussing political risk and international relations, Leino brings up the military issues. He says that it is possible that the FSB or the Russian army will be opposed to

the operation of a certain international company in a certain region, and that such a situation can lead to the stalling of the operations. As a concrete example, an offshore oil rig cannot be in the way of military submarines. However, he notes that it remains to be seen how these issues will actualise themselves, as there are currently no oil drilling operations yet which would be run by foreigners. Nevertheless, Leino considers it probable that the importance of security and military political issues will be rather significant in the future. For example, he assumes that tensions related to the no-man's land areas of the Arctic can possibly increase, but they are not likely to lead to any military actions, but instead heated discussions may take place at some point. Currently the Arctic areas are not a hot topic in Russia. Leino describes the issue as follows:

> *"It might cause clanking of weapons and patrolling of military boats and alike, but I cannot see firing shots over that in near future… But it will cause this kind of muscle parade at some point."*

At a less severe level, political risk could be realised in issues such as taxation and tariffs so that, for example, some raw material tax is increased so that the project is not as profitable as was calculated in advance. Leino sees the most probable political risks as being related to taxation, to import or export licenses, or to changes in legislation that might disturb a company's operations or, in the worst case, make them impossible. Price controls can also be a significant issue. Raising the prices of gas, oil, and electricity would be economically justified, but politically it is a troublesome issue, as it would be likely to cause social tensions, which the country is not easily willing to face.

Moe discusses the implementation of a gas field project in more detail, and notes that to carry out such a project, many industrial partners need to be involved, and there might appear a fierce competition between these partners – there are many people who want to have a share of the business opportunities. Moe describes the situation in the following way:

> *"…The question is that could someone […] create problems if they do not get what they perceive as their actual share, which is […] related to corruption issues. There are many people who, and many institutions who can create trouble for the implementation of such a big project. That, I think, is a very big risk in Russia. And this is*

corruption, you have to, maybe, pay off a lot of intermediaries to be able to carry out the project fast enough, that of course increases the cost of the risk."

Moe continues that the corruption level in Russia is very high at the moment, and it is very often connected to the implementation of such investment projects. That is a very difficult risk to assess as one has to look not only at the forces that are able to delay the project but also at the forces that are supporting the project. It can both delay the project and increase the costs of it. Moe says that he would rate corruption as a much more difficult problem than what one can term overall political risk. However, in the case of Shtokman, it at least seems that the project has very strong backing and attention from the top level of the state, which is likely to be able to force things in favour of Shtokman Development AG. Romanova also states that if the government needs these resources and the resulting cash flow, it will support the companies and whenever any political support is needed, it will be provided. Moe continues that in addition to the offshore implementation, starting the production requires bringing together different suppliers, getting through the bureaucracy, and getting things running. Furthermore, with such a capital intensive project one must act fast, as every lost hour results in the loss of thousands and thousands of dollars. Moe notes that if he was investing in a sector which did not have that much attention from the state but which involved a lot of capital-intensive construction, he would be very afraid.

Nevertheless, according to Vahtra, the highest risk at the moment is the question whether the whole project will be implemented, and if so, when that will happen. The foreign investors have already put a lot of money in the project, but is it possible that at some point, despite the expensive explorations, a decision will be made that Shtokman will not be implemented. Moreover, will this decision be made solely by the Russian side? Vahtra also discusses the possibility that the expensive implementation of the project would start, and only after that, the market situation would change so radically that the project would have to be cancelled. However, Vahtra also notes that this kind of risk is more market-related than political by nature, even though the decision to cancel would be political. Political decisions are affected by the development of the market.

As well as Vahtra, Moe argues that the highest risk in the project is commercial, and it is much higher than it seemed to be a year or two ago. He assumes that at the

moment, the Shtokman Development is reassessing the situation and will move the investment decision forward. Nevertheless, the foreign partners, as well as Gazprom, have already made significant investments in the project. Moe says that any official numbers have not been published, but according to some assessments, a total sum of around 800 million dollars had been used by the end of 2009. Therefore, the cancellation of the project would mean losses, but would still be better than developing an unprofitable project.

According to Godzimirski, the most important questions now are whether the Shtokman project will be economically viable, and whether it will be technologically doable. He also notes that the only risk the foreign partners have taken so far is that they have spent a huge amount of money in preparing the feasibility study. He points out that normally, when a company is about to embark on a difficult project, it has to spend money and time in order to assess the investment and to prepare for possible problems that might emerge. Then, if they decide to continue, all the partners have to agree on the common framework for this project. Godzimirski concludes:

> *"They [the foreign partners] are not going to do this project due to the fact that they like Vladimir Putin, Dmitri Medvedev or Alexei Miller – they are going to make a decision that is based on the cost and benefit analysis, both in economic and political terms."*

4.6 The main empirical findings

It can be concluded that the interviewees had largely similar views of political risk in the Shtokman gas field project, but some of them saw the level of risk higher than others. According to Romanova, in the oil and gas sectors the investments are restricted, but the state policy towards foreign investment seems to be becoming more liberal. The investment risks are much lower, as the state will no longer accept deals that are unfavourable to the country. She notes that the state being satisfied means stability for foreign investors. According to Vahtra, investors are welcome in Russia, but they are not allowed to own majority shares in energy projects. Consequently, the rules of the game are clear, and there should not be risks for which the foreign investors could not prepare. He does not find it likely that the investors would in the current situation face similar experiences as foreign investors faced in the Sakhalin project.

According to Leino, the balancing between the need for investment and the will to control the industry will continue for years. He does not believe that any radical events would occur, but if the foreign investors were wanted out of the project, their operations would slowly get more and more complicated in Russia. Moe, in turn, sees that foreign investment is in Russia regarded with suspicion, but also he believes that it is not a very high risk that the rules of the game would be changed as in the case of Sakhalin. However, he discussed the project's contractual relationship, and noted that it does not currently look very favourable to foreign companies, even though it remains unknown how they are going to be compensated for developing the field.

Godzimirski stated that foreign investors are well aware of the risks related to recent investments in Russia. However, if they in the case of Shtokman will not be able to negotiate a good legal framework for the project, they may face numerous problems. According to Numminen, Russia controls the foreign investors' ability to access the Arctic area and the gas industry by licenses etc., and similarly controls in which operations the investors can be involved. She notes that for example Russia having a dispute with the NATO could have negative effects on the political situation in the Arctic, and believes that in the worst case, changes in the project's ownership shares could be possible.

According to Nies, foreign companies are reluctant to engage in large projects in Russia due to the experiences of foreign companies in Sakhalin. Nobody can predict the outcomes of the Shtokman project while even the investment decision remains to be made. Also Remes discussed that based on the experiences of Shell and BP, suspicion regarding the safety of investments in the Russian gas industry is justified – it is possible that even though a mutual agreement has been made about something with Russia, it will not hold in the future. Promises and agreements made earlier may be unilaterally changed. As well as Numminen, Remes stated that the risk of changes in ownership shares exists.

Although the experts had somewhat differing views about the risk level, none of them considered the political risk extremely high, and their views of the sources of political risk were largely similar. The main empirical findings regarding political risk in the Shtokman gas field project are presented in Figure 5.

Figure 5 The main empirical findings of the research

1. The investment climate in Russia is ambivalent – foreign investors are needed because of capital and technology, but the state wants to retain control over large investment projects, especially in the strategic sectors.

2. In the Russian gas industry, the main actors are the president, the prime minister, and Gazprom. As a consequence, the political risk in this sector stems from the top level of governance, not from issues at the regional level.

3. International relations between the investor's home and host country can affect the political risk faced by the investor, particularly in the gas business, where deals are made at the top level of governance.

4. In the gas sector, European companies do not have many alternatives where to invest, and this enables Russia to behave arbitrarily, relying on its current position as a global energy power. But is this power going to last?

5. Particularly the area claims might increase tensions in the Arctic. This may have an impact on the international relations between the Arctic states, for instance between Norway and Russia, even though they seem to be willing to increase cooperation at the moment.

6. In the Shtokman gas field project, the bargaining power of the foreign partners versus the power of Gazprom affects the political risk. Technology and know-how enhance the bargaining power of Statoil, and for Total, it seems to be more based on the political relations between France and Russia. However, the Shtokman project is not currently that important to Russia, and thus, the bargaining power of the foreign partners is not very strong at the moment.

7. Potential disagreements between the partners in the project could be caused by Russia's possible intention to sell a part of the gas at a low price in its domestic markets and by the price that the foreign partners charge for the technology required in the project. However, the most interesting issue to be negotiated is the compensation that the foreign partners will get for developing the field.

8. The highest risk for the foreign investors in this project is the nationalisation or a forced sale of their shares in the Shtokman Development AG. This risk is, however, very unlikely, as Gazprom has the majority share to start with, and 25 years after starting the implementation Gazprom will receive full control over the field's operations and gas sales.

9. The political risk could more likely be realised in operational issues such as taxation, import or export licenses, changes in legislation, and price controls. Nevertheless, assuming that the project is in the interests of the Kremlin, the most practical difficulties regarding the project implementation are likely to be solved easily with the help of the central governance's authority.

10. Because of the current uncertainties related to the future of the gas market, it is possible that Shtokman will never materialise, or that it will be moved decades forward. At the moment, all the partners in Shtokman Development are willing to see what will happen before they proceed with the project. A serious issue at the moment is whether the Shtokman gas field will be developed, or whether all the investments in the project have gone to waste.

To summarise the experts' views, the Russian energy sector can be challenging for foreign investors because of the ambivalent investment climate, but it does not seem that the political risk would be as high in the Shtokman project as it seemed to be for foreign investors in the gas business few years ago. The project cannot be implemented without the technological and financial contribution of the foreign partners, and moreover, maintaining peaceful and cooperative relations between Russia, France and Norway is very important for all these countries.

It seems that political risks are most likely to take place in the form of operational risks. However, as the investment deals are political and negotiated at the level of presidents and prime ministers, this kind of issues are likely to be solved – in this sector practical issues should not become insurmountable risks, if Russia wants to get the joint project running. In this sense, it can be beneficial that the project is overlooked by the state.

Based on the interviews, it can be stated that political risk in this case is not extremely high, particularly when the highest risk is now caused by uncertainties regarding the future of the global gas markets. The unconventional resources might replace the conventional natural gas to some extent in the future, which would mean a catastrophe for Russia's current position as an international gas power. If the USA and later also the EU and Asian markets will have alternative and even cheaper ways to produce gas, the demand for Russian gas will decrease considerably, and developing the Shtokman gas field will not be reasonable. The Yamal fields will be prioritized in replacing the depleting fields of Siberia, instead of the challenging Shtokman field.

At the moment, all the partners in Shtokman Development AG wait to see what will happen in the gas markets in the near future. There is no hurry to implement the expensive and challenging offshore field in the Arctic before it is proven to be profitable. As a consequence, discussions about political risk in the project are not very topical in that sense. However, if the decision of starting the implementation is made, the power game regarding the positions in the project will start right away as there is, however, plenty of room for disagreements in the project. The market situation influences the foreign companies' bargaining power against Gazprom, and consequently also the level of political risk for the foreign investors.

The findings of the interviews will be further concluded in relation to the theoretical framework in the following chapter.

5 CONCLUSIONS

This chapter presents the empirical findings together with the earlier literature and theoretical framework. Firstly, the theoretical implications of the study regarding political risk in the Russian gas industry will be presented, the case examined being the Shtokman gas field project. Secondly, the political risk in the Shtokman project and the future of the project shall be further assessed. Finally, the limitations of the study and suggestions for further research shall be discussed.

5.1 Theoretical implications

The theoretical framework for this study, which was discussed in detail in Chapter 2, comprises internal and external sources of political risk, divided into macro-level, industry-level, firm-level and project-level sources, and the effects of political risk on business, which are divided into ownership or control risks and operational risks. This construct will be discussed in the light of the empirical findings, and finally the political risk construct for the Shtokman project shall be presented in Figure 6.

The continuity and changes in leadership and in the perspectives of other major political leaders and/or parties was an issue discussed by Lax (1983, 112–113). Alon and Martin (1998, 15) discussed the same issue as the likelihood of regime change, referring to a possible policy fallout, which would require the assessment of the likely successor regime. Closely related is the concept presented by Alon and Herbert (2009, 130–135), the level of governmental control over the economy. It refers to the fact that the more extensive the government's control of the economy is, the greater the firm's political risk exposure grows, as it becomes more likely that economic decisions are made for political rather than economic reasons.

Regarding the case of Shtokman, the persons leading the country have an effect on the political risk through their policies and attitudes towards foreign investment. The interviewees discussed the ambivalence of the Russian investment climate, referring to the state's somewhat controversial goals. The top leadership, i.e. the president and the prime minister, have control of the economy, but simultaneously foreign capital and technology are needed. This issue is most obvious in strategic sectors, because many projects cannot be implemented without foreign partners, and at the same time, the state would prefer to maintain full control of these projects. The controversial situation regarding FDI in Russia resulted in unfavourable events for foreign investors in the

Russian gas industry a few years ago because of the PSAs signed in 1990s, but according to the interviewees, the risk of the state's interference in similar large projects may still exist. It is, however, very unlikely, as Russia is no longer likely to make such deals that would be seen as unfair from the state's perspective. However, the interviewees had somewhat differing views about the Kremlin's current attitude towards FDI. For example, according to Moe, foreign investments are regarded with suspicion in Russia, whereas Romanova states that President Medvedev now has a rather liberal policy of foreign investment. Nevertheless, it can be stated that the continuity and changes in host leadership, and the resulting policy towards FDI, can be a significant source of political risk. The persons in the top leadership and their control over the foreign investments affect political risk in Russia. Moreover, it must not be forgotten that for example Exxon continues to have problems with Gazprom over the gas of Sakhalin-I.

Institutional development is discussed by Lax (1983, 112–113). He uses the concept to refer to the strength of the legal system and to the degree of bureaucratisation and corruption, all of which can decrease or increase the experienced political risk. When it comes to the case of Shtokman, the institutional development, especially corruption, was discussed in some of the interviews. However, at the same time, there were assumptions that such an important project as Shtokman benefits from high attention from the Kremlin, and therefore risk issues related to corruption and bureaucracy can supposedly be solved rather quickly if the state wants the project to proceed fast. Moreover, those issues are a part of the Russian business environment and culture and not created on purpose by the government. Nevertheless, if there is no intention of letting the project proceed, corruption and bureaucracy-related issues are easy ways for the state to hinder the progress of the project. If the decision to implement the Shtokman field will be made, it can be assumed that the state will have a strong interest in developing the field, and consequently the institutional development solely is not seen as a potential source of risk for the investment in this case.

From the international point of view, there are several issues in the theoretical framework which were seen to have an effect on political risks faced by foreign investors. Involvement of the host in international conflicts is the most severe issue regarding external relations, and it was discussed by Alon and Martin (1998, 15) as well as Lax (1983, 112–113). According to the empirical findings of this study, general tensions in Russia's international relations may result in tighter control of foreign

companies in the country. In particular, the host country's involvement in international conflicts can be a source of political risk for a foreign investor. Moreover, in the case of a state-owned foreign company, international relations are likely to have an even larger impact – if the host government is in dispute with the state-owned investor's home government, it is likely to send messages to the investor's home government through the way in which it treats the foreign investor.

Differing views were presented concerning Russia's international relations. According to Romanova, Russia's political relations with the main investor countries are good, whereas according to Vahtra, Russia's lately behaviour in foreign politics has been rather defiant. An issue discussed at length in the interviews was the Arctic, and particularly the tensions related to the area claims in the disputed areas. However, it became clear that there are no reasons for a severe conflict to appear, but the tensions might still affect the operating possibilities in the area, and furthermore, if the negotiations will be difficult, companies coming from other Arctic states may experience changes in their treatment in the Russian business environment. Consequently, international conflicts may have an effect on political risk.

The concept of foreign policies (goals and policy changes) was presented by Lax (1983, 112–113), and it is closely related to the concept of host government participation in international treaties, conventions and organisations, which was noted by Robock (1971, 7), Alon and Martin (1998, 15), and Alon and Herbert (2009, 130–135). The issue of host government participation in international treaties was not brought up in the interviews – Russia does not seem to be a member of any treaty which could be a source of political risk for foreign investors. However, on the contrary, Russia being outside some international alliances, such as the NATO, was considered a source of tensions between Russia and the member countries. This issue is present also in the Arctic disputes, as all the Arctic states are members of the NATO except for Russia. Russia feels the need to show its power to the others, and consequently has lately been behaving rather provocatively in the area. Nevertheless, the issue of whether Russia is involved or not in certain treaties is not a direct source of political risk for foreign investors, even though it can be an issue contributing to the rise of tensions and an issue complicating the international relations of Russia and some member countries.

When it comes to the industry-level sources of political risk, the concepts domestic gas reserves and production and strength of the national gas company were both presented by Lax (1983, 112–113). They refer to the business environment in the host country's gas industry, and also to the bargaining power that the host government may have directly or through a state-owned gas company against a foreign investor. The external industry-level factor, the world petroleum market conditions, which was also presented by Lax (1983, 112–113), is closely related to the previously mentioned internal industry-level factors. In this case, the situation is very complicated at the moment due to the uncertainties related to the future of the international gas markets. According to some of the interviewees, Russia has been a strong energy power for long because it has been the seller's market in the gas business. Thus Russia has been able to afford to select the foreign investors to participate in its projects and also to afford to treat them as it wishes, because the European energy companies have not had other investment alternatives. At the same time, the position of the state-owned Gazprom has been very strong. As a consequence, this power of Russia's has been a source of political risk for foreign investors in the gas industry, and it still is.

At the moment, however, uncertainties regarding the future of the conventional gas business might begin to undermine Russia's power. Due to the new possibilities related to the unconventional gas resources, the power balance might change in the near future, and the role of foreigners could become stronger. As a consequence, the factors presented in the theoretical framework – domestic gas reserves and production, strength of the national gas company, and world gas market conditions – are very important potential sources of political risk, as they have a strong effect on how Russia is able to treat foreign investors in its gas industry. As was concluded in earlier studies, a comprehensive assessment of political risk cannot be made without assessing also the market situation, because the market situation has a strong effect on the host country's power against the foreign investors.

When moving forward to the firm-level, the concepts of bargaining advantages and the investor company's position in the world industry were discussed by Lax (1983, 112–113). The concept of dependence of a foreign company on the local market vs. the level of firm diversification was adopted from Alon and Herbert (2009, 130–135). As was discussed in the theoretical framework, all these issues affect the investor's bargaining power against the host government. Regarding the foreign partners' bargaining advantages in the case, particularly technology, know-how and capital were

issues brought up in the interviews. If a foreign company possesses the resources which Russia currently needs, the company's bargaining power increases considerably. However, at the end it is the state that controls the sector and most of the fields, and consequently its bargaining power remains very strong in any case. The high bargaining power of the host state is obviously a source of political risk, as then the foreign investors are more likely to accept less favourable behaviour from Russia's side, in order to remain in the project. The foreign investor's position in the global gas business, however, affects the issue, because the foreign investor may have several fields and projects going on at the same time, which means that it does not have to bend in front of Russia but can rather decide to abandon the project. This is related to the issue of how important the project is for a foreign investor. If the foreign investor is not dependent on the market in question, it can threaten to leave the project, if there is an attempt to change the terms of the contract, for example. In the Shtokman project, however, the foreign companies are not very independent due to the lack of investment alternatives in Europe – all the interviewees agreed that Russia and Gazprom are presently in a stronger bargaining position. Consequently, despite the bargaining advantages, the importance of the project can be an important source of political risk for these companies.

When it comes to the external firm-level sources of political risk, the relationship between the host and the home government plays an influencing role. This issue was mentioned by Lax (1983, 112–113) and Alon and Herbert (2009, 130–135). However, in the interviews, poor relations were not seen as a considerable source of political risk, but instead, good relations might decrease political risk. In the gas industry, deals are often negotiated at the head-of-state-level, and so, treating a foreign investor disrespectfully might ruin or at least increase tensions in Russia's international relations with the investor's home country. As was mentioned earlier, severe tensions or a conflict between Russia and some other country could have an effect on the operating possibilities of the companies coming from this country. This is the case particularly in the energy sector, where Russia largely decides which companies get to enter the business and where the deals are made at state-level. Consequently, the political and economic relationship between the host and the home government can be a source of political risk for a foreign investor. For Statoil this is, however, quite unlikely at the moment, as not even the Arctic negotiations are likely to rise any significant tensions between Norway and Russia in the near future. For Total there are no signs of such a threat either.

The concept of company dealings with the host government was presented by Lax (1983, 112–113). This issue was not mentioned in the interviews because the political relationship between the host and home state was seen to be a more important issue in the gas industry. Practical issues concerning the project are negotiated between the foreign energy company and Gazprom after the general lines have been discussed at the state-level.

At the project-level, discussion focuses on the political risk for the project, on the actual investment. The concepts of the extent of natural resource seeking, the size of the project, and the exports generated by the project were presented by Alon and Herbert (2009, 130–135). In the case of Shtokman, the extent of natural resource seeking is the highest possible, which increases the political risk – the gas sector is top sensitive in Russia. The size of the project and the expected exports potential also have an effect on the risk level – if the project is large and important for Russia, it is less likely to be interrupted by political matters. The level of technology transfer was discussed both by Schmidt (2001, 47, 49) and Alon and Herbert (2009, 130–135). This issue was not, however, discussed in the interviews of this study. It is still presumably a factor which can reduce the political risk as Russians might learn something in the project from the foreign partners that bring in the technology – the partners are valuable for the project. However, technology transfer can also be seen as a risk-increasing factor, as if the technology possessed by the foreign investor is transferred to the host along the process, the investor may slowly lose technology as a bargaining advantage. Consequently, technology transfer is an important issue when analysing political risk. At the moment, however, the most important issue is related to the exports, because if there is no demand abroad for the gas, it is not profitable to continue the project and implement the field. A valuable project would be in the interests and under the protection of the host country, but at the moment the value of the Shtokman field in relation to the implementation costs remains uncertain. This way market risk and political risk are closely related.

External issues from the project's point of view were congruence with governmental goals, discussed by Alon and Herbert (2009, 130–135), and the ownership or contractual relationship between the investor and the host country, discussed by Schmidt (2001, 47, 49–50) and Alon and Herbert (2009, 130–135). When it comes to the findings of this study, first of all, the Shtokman project will not materialise unless Russia is willing to implement it – the state and Gazprom have the control of the field.

Secondly, a threat to the foreign partners' investment is the contractual relationship. It has been seen in the experiences of foreign investors a few years ago that a project where Russia does not hold the majority of the shares is in serious risk. Gazprom wants to keep control over all the projects that are strategically important for the country's economy, and the gas and oil businesses are among the priorities. Consequently, the cooperation contract itself can be a serious source of political risk if it is seen as unfavourable for Gazprom and Russia. In the case of Shtokman, however, the situation is not that serious because the foreign partners have clear minorities to begin with, they do not own the gas at any phase, and 25 years after the production has started, the ownership of the field will be transferred to Gazprom in any case. The starting point seems rather favourable for Russia, which reduces the probability of sudden risk events for the foreign investors.

Several concepts were presented in the theoretical framework regarding the effects that all these sources of political risk can cause to the investor company or to the project. The ownership or control risk effects, coerced contract renegotiation, contract revocation, intervention, coerced sale, and nationalisation, were all presented by Root (1987, 133). Contract revocation, coerced sale and nationalisation were, however, also discussed by Robock (1971, 7). In the empirical findings of this research, it was not seen as a likely scenario that one or both of the foreign investors could be forced out of the project by nationalisation or coerced sale. Such a scenario would not be reasonable as Gazprom cannot implement the project on its own; it has neither the required technology nor enough capital for it. Furthermore, such an event would probably have serious effects on the political relations between the investors' home countries and Russia. Nevertheless, the interviewees pointed out that nothing is impossible; it is still a risk. More probable risks are coerced contract renegotiation and contract revocation. It could be possible that Russia wanted to reduce the ownership shares of the foreign partners, but also that was seen as a rather unlikely scenario because Gazprom is in control of the gas sales during the whole project, and the foreign investors agreed to this deal when they joined the project. However, due to the previous experiences, contract renegotiation or revocation are risks to be taken seriously. Intervention was not mentioned in the interviews, but it can be stated that in this case it is not likely, but it is possible.

A more important question at the moment is that how the foreign partners will be compensated for developing the field. According to Godzimirski, it is a matter of mutual

negotiations and agreement before the project implementation starts and thus it cannot be considered as a direct political risk. Another question is whether it is possible that Russia would not hold on to this agreement in the future, but as both Godzimirski and Romanova noted, Russia is not likely to make such a deal that would be unfavourable to it. Coerced contract renegotiation in this sense is not seen as a very likely scenario. Instead, if the compensation is to take place for instance in the form of a share of the gas supplies or dividends from the sales, a worst case scenario would be that Gazprom could hinder the field from full-capacity production until the foreign partners have left the project after the first phase.

The operational risk effects comprised price controls of the project's products, limits to the foreign staff, requirements related to imports and/or exports, and restrictions on repatriation of dividends, royalties, interest, fees, or capital (Root 1987, 132). Also discrimination regarding taxes, compulsory subcontracting, etc. (Robock 1971, 7), was discussed in the theoretical framework. The price controls and export controls were mentioned in the interviews conducted for the study. Russia might want to sell part of the gas on its domestic markets, which would mean lower prices for that share of the Shtokman gas as it would not be exported abroad, and if the foreign investors are to be compensated in the form of dividends or such, it would mean lesser profits for them. Taxation and sudden changes in legislation were also mentioned, but no interviewees mentioned foreign staff limits or restrictions on repatriation of dividends, royalties, interest, fees, or capital. Operational risks were seen as more probable to occur than ownership-related risks, but simultaneously they are also easier to deal with and are presumably less harmful than ownership-related risks, particularly as the state is to be parenting the project.

It can be stated that no source factors of political risk were seen to be extremely serious at the moment, but it is possible that altogether, they will result in rather severe effects on the investment. The risk construct for the Shtokman project is presented in Figure 6.

Figure 6 The political risk construct for a foreign direct investment in the Shtokman gas field project

SOURCES OF POLITICAL RISK			
		INTERNAL	**EXTERNAL**
MACRO SOURCES		• Continuity and changes in the top leadership • Level of governmental control over the economy and especially over strategic sectors	• Foreign policies and international relations of the host government • Involvement of the host in international conflicts
MICRO SOURCES	**INDUSTRY**	• Domestic gas reserves and production • Strength of the national gas company	• Current and future world petroleum market conditions (prices and demand)
	FIRM	• Bargaining advantages (technology and capital) • Importance of the project (dependence of a foreign firm on the local market vs. the level of firm diversification)	• Political/economic relationship between the host and the home government (security, trade, and aid issues)
	PROJECT	• Extent of natural resource seeking • Exports generated by the project • The size of the project	• Congruence with governmental goals • Ownership/contractual relationship between the firm and the host

EFFECTS OF POLITICAL RISK ON BUSINESS	
OWNERSHIP/CONTROL RISK	**OPERATIONS RISK**
• Coerced contract renegotiation • Contract revocation • Intervention • Coerced sale • Nationalisation	• Price controls • Export requirements • Changes in taxation or legislation

It can be concluded that in the case of the Shtokman project the political risk construct is basically similar to the initial framework of the study. Consequently it can be stated that the individual theories presented in Chapter 2 would not have been comprehensive enough for analysing political risk in this kind of a project: the new political risk construct combines the most useful conceptualisations of the earlier political risk models, such as the division of political risk factors into sources and effects (see Robock 1971), the division of sources of political risk into micro and macro factors and into internal and external factors (see Simon 1984; Alon & Martin 1998), and the division of effects of political risk into ownership and operational risks (see Root 1987).

In the case of the Shtokman project, no new concepts were added to the framework, but some factors which were seen as sources of political risk in the theoretical discussion, were not seen as significant in the Russian gas sector and in the Shtokman project in particular. Every project has unique features which affect its risk-level, but it can be stated that the political risk construct of this study provides a rather comprehensive starting point for political risk analysis in any project in the Russian gas industry, and possibly also for projects in other energy industries or countries.

5.2 Political risk in the Shtokman project

The experts interviewed for the research had somewhat differing views on the level of political risk of foreign direct investment in the Russian gas industry. For example according to Romanova, the level of political risk has significantly reduced during the past couple of years, whereas for instance Remes says that foreign investors' suspicion towards Russia is justified. However, none of the experts stated that political risk would not exist at all, or that the foreign investors would be making a mistake when investing in the Shtokman project – no extreme opinions were presented.

It can be concluded that based on the empirical findings of this study, the investors should not be highly concerned about political risks in the Shtokman project. This is mainly a result of three issues: (1) Gazprom will not be able to implement the project without the help of foreign partners, (2) all the involved countries are presumably willing to maintain good mutual relations, which encourages to peaceful solutions in problem situations, and (3) the ownership arrangements in the Shtokman Development are seen to be favourable for Russia to start with – at the moment there does not seem to be any reason for Russia to make unilateral political rearrangements in the project.

However, the researcher wishes to note that for managers in the Shtokman project it is very important to remember that also more negative developments and outcomes are possible. As the risk factors presented in the political risk construct develop, the whole situation develops with them and may change to worse suddenly. The risk factors may not remain stable during the project implementation, and moreover, the start of the implementation may be years ahead. The current estimates of when the gas production will begin do not seem realistic because merely the construction of the field and the required pipelines will take years – for example in the case of Statoil's Snøhvit field it took over five years, and consequently the construction of Shtokman should start immediately in order to meet the current schedule of the field being in production in 2016. Moreover, further exploration and feasibility studies are required in order to determine whether developing this challenging field in the current market situation is profitable and reasonable in the near future. Consequently, before the Shtokman field will be in production, many factors can change, and even a single change can have drastic consequences for foreign investors' operating possibilities in Russia.

For example, the state leadership may and will change at some point in the future, and this may have a significant impact on the state's control over the economy and on Russia's FDI policy. In addition, Russia's foreign relations may change significantly in, for instance, ten years. In 2020, the situation concerning the Arctic tensions will certainly be very different from the currently expectant situation. At the moment, the Arctic states are in the process of submitting their area claims, and the negotiations concerning the potentially disputable areas are ahead. Also the development of other significant international issues, such as Russia's relations with the EU and the NATO, as well as the American missile shield and terrorism, may have significant impacts on how Russia sees and treats the world outside its borders. If the international tensions in Russia's neighbourhood increase, the role of the Russian army as an actor affecting the foreign investors' operations might grow.

In addition, the foreign investors' position in the Shtokman project may change significantly if Gazprom's position as a state-led monopoly changes. The position of Novatek, which, however, is partly owned by Gazprom, seems to have increased recently in the Russian gas industry. Having two or even more rival actors in the industry would totally change Gazprom's position and plans in full control of the economy under the state's support. When it comes to the domestic gas reserves, the Yamal field's development, which has been prioritised over Shtokman, is crucial for

Russia's future as a gas producer. If the field's development will not proceed as planned, it will have serious consequences on the country's economy and similarly on Russia's whole existence, as energy production is the country's source of both internal and external power. In such a case, the Shtokman gas would be highly needed. The development of the global gas markets may have similar impacts: if the Russian energy is not needed abroad, Russia's economy will face a crisis, which will certainly have unpredictable consequences on the Russian investment environment as well.

In the Shtokman project in particular, one of the most uncertain and potentially threatening issues is the sustainability of the foreign partners' bargaining power. The Norwegian Statoil lacks the clear political advantage, as it has been invited to the project mainly because of its technological experience and expertise. Moreover, is technology a sustainable advantage? If the Norwegian know-how gradually transfers to the Russians in the project, Statoil's bargaining advantage decreases. On the other hand, Total's invitation into the project relies heavily on the political relations between Russia and France, which can possibly also become fragile in the future. In addition, project-specific issues, such as the project's congruence with governmental goals, may change and consequently affect the level of political risk in the project.

Many factors may develop in unpredictable directions before the Shtokman field is in operation and at least before the project's first phase is over. Nevertheless, if we consider the currently foreseeable risks related to the project, one of the most interesting issues at the moment is definitely the question of how Statoil and Total will be compensated for developing the field with Gazprom. Obviously it is still a matter of the partners' mutual negotiations – whether it is dividends, a portion of the gas, or something else. As the foreign investors do not own the gas in any phase of the project, the risk of losing the field's ownership is not a risk in this case, but instead the risk is to invest enormous sums of money into developing the field and then end up not being compensated as was promised. For example, if the foreign partners were to be compensated by giving them a share of the gas sales during the first phase of the field's production, Russia could decide to implement the field soon but somehow hinder the level of production until the foreign partners were out of the project, consequently minimising the sums to be paid for the partners. It is also possible that even though the decision to implement the field was made next spring, the fields in Yamal might start producing so much gas that the Shtokman field's gas would not be needed

immediately, resulting in lower production and sales rates during the first decades of the project.

Moreover, the price of gas is a crucial issue in the implementation decision. The future of the global gas business and the expected average price for the project's first 25 years are essential determinants in this decision-making. Figure 7 demonstrates the influence of the gas price in the Shtokman project.

Figure 7 A fictional calculation of the Shtokman field's profit with different gas prices

- During the Phase 1 (the first 25 years) the field is expected to produce 592.5 billion cubic meters of natural gas, with the average annual production of 23.7 billion cubic meters.
- The costs of the Phase 1 are to reach USD 15 billion. Altogether the project's costs are expected to amount to USD 30 billion.

The average price of gas during the project's Phase 1 (USD per 1000 cubic meters)	The profit for the Shtokman Development after Phase 1 (USD billion)	Shares of the profit for the partners after Phase 1 (USD billion)		
		Gazprom	Total	Statoil
300	162.8	83.0	40.7	39.1
200	103.5	52.8	25.9	24.8
100	44.3	22.6	11.1	10.6
60	20.6	10.5	5.2	4.9

It is extremely difficult to forecast the development of gas prices in this market situation, and it makes a significant difference whether the gas will be sold, for instance, at the price of USD 200 or USD 100 per thousand cubic meters. It is also possible that Gazprom wanted to sell at least part of the gas in its domestic markets, where the price of gas is likely to remain lower than in the European markets for years to come. If Gazprom wanted the Shtokman Development to sell the gas to the domestic market, it might further lower the profits that Total and Statoil can receive from the project, assuming that the compensation would be given as shares of the gas sales. It is also very difficult to estimate the costs of such a unique project. Does the estimation of USD 15 billion include both the onshore and offshore infrastructures? Who will build and sponsor the pipeline from Shtokman to Murmansk, and from Murmansk to further

south, and for what price? If the costs will end up being significantly higher than assessed today, the profits might suddenly decrease again.

In addition, the whole project setup seems interesting as the foreign partners are involved in the project only during the Phase 1 – according to the reported plans, half of the project's costs are to be paid during this phase, but the field's peak production is to be achieved only at some point after the first 25 years. Are the foreign partners going to build the field and let Gazprom collect the highest profits alone after the first phase?

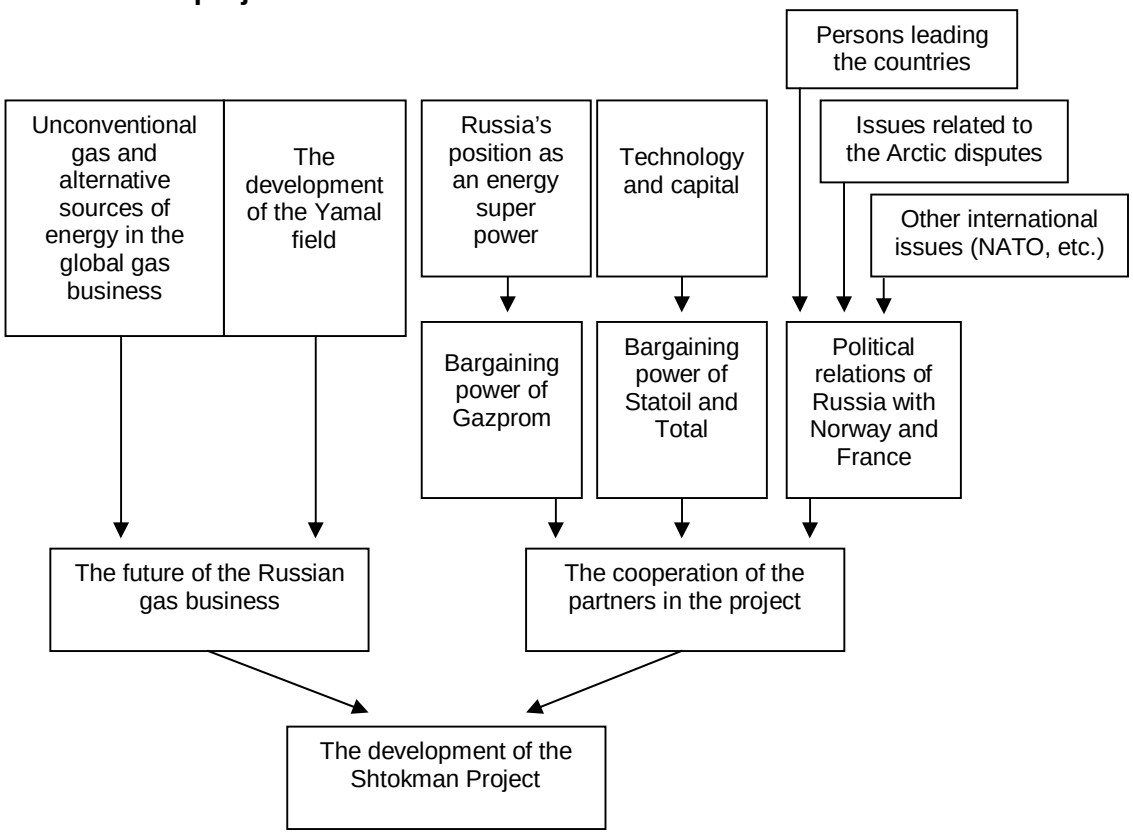
Nevertheless, the details of the contract remain unclear to the public, and it is possible that they are still under discussion and have to be negotiated before the implementation decision can be made. The foreign investors will certainly do their best to minimise both political and economic risks in negotiating the final cooperation contract. At least the operational risks can presumably be largely controlled by creating a solid contract about the details of the project implementation.

Through the risk factors, both political and economical, which are closely related, the situation may change dramatically already before the Shtokman field is in production, not to mention the day when the first phase ends. Even though the situation does not look very risky at the moment, in the middle of such significant uncertainties, one has to also prepare for less favourable outcomes. The managers of Total and Statoil must be prepared for political risks, as the earlier experiences have shown that no matter how necessary a partner one is, how important the international relations are, and what kind of a contract one has, the situation of the investment project may suddenly change. Thus, the development of factors contributing to political risk needs to be under continuous analysis.

5.3 The future development of the Shtokman field

As the final investment decision has not been made yet, the most essential question remains open – when will the Shtokman field be implemented, if it ever will? Based on the empirical findings, the factors affecting the future of the Shtokman project have been summarised in Figure 8.

Figure 8 Factors affecting the development of the Shtokman gas field project



All the partners in the project seem to agree on waiting to see what is going to happen in the international gas markets – the potential for unconventional gas, which caused a revolution in the gas industry of the USA already a few years ago, is now under exploration in Europe. At the moment, European markets buy a large part of the Russian natural gas, and if the unconventional gas reserves are found to the profitable in Europe, that might have serious effects in the demand and prices of Russian gas – not only in Europe, but similarly in the increasingly energy-consuming Asian countries, such as China. A significant issue is also the development of the Yamal fields, because if their implementation will not proceed as planned, the importance of Shtokman will increase considerably in the Russian gas industry. On the contrary, if the Yamal's implementation will be a success, the importance of Shtokman will decrease.

These uncertainties also raise questions about the positions of the foreign partners and Gazprom in the investment project – who can now afford to do what? The position of foreign investors has not been very strong in Russia, but if Russia's position as an energy superpower is weakening, its power to rule the operations of foreign investors in

Russia weakens at the same time. Russia's power against foreign investors has been based on the fact that the European energy companies have not had many alternatives where to invest in. At the moment, it is a fact that without foreign technology and capital, no one will get gas out of these new fields. If Russia persists in the commanding attitude towards foreign investors in the energy business that it has maintained for the past several years, and if the investors feel uncomfortable about operating in Russia, they would be increasingly driven to explore investment possibilities in alternative gas production projects. The foreign investors would become competitors for the Russian gas companies, and the foreigners developing the unconventional gas production would also reduce the demand for the Russian gas in Europe. Russia cannot afford this, and from this point of view, it is highly unlikely that Russia would, in this market situation, treat the foreign partners in the gas business unfairly and disrespectfully. If Russia's position as an energy superpower is shaking, it will strengthen the position of foreign investors and can even result in a start of a whole new game in the global energy business.

As a consequence, in addition to the future of the global gas business, an issue clearly affecting the implementation of Shtokman project is the cooperation of the three partners, Gazprom, Statoil and Total. The future of the project is a result of the partners' convergent or divergent interests and of the decisions achieved in mutual negotiations. Russia's position in the global energy markets affects Gazprom's authority and bargaining power against the foreign partners. The bargaining power of the foreign partners results mainly from the technology and capital that they can bring to the project.

Moreover, Russia's international relations with Norway and France affect the cooperation. At the moment it is in the interests of all these countries to maintain good and cooperative relations, as they all benefit from them. The interests and relations of the persons leading the countries are obviously very important, and currently it seems that all of them are willing to contribute to these companies' cooperation in the project and give their support to the project at the state-level. Developments in general international politics have also effects on the relations of these countries – for example, Russia seems to be rather suspicious towards the NATO members, but so far this has not had significant effects on Norway's relations with Russia.

In addition, the Arctic was believed to increase tensions particularly in the relations of Russia and Norway, as they had overlapping interests towards the grey zone. It is an area in the Arctic, the ownership of which has not yet been legally determined. The area has significant oil, gas, and fish resources, all of which are very important to both countries. However, suddenly in April 2010, an agreement on dividing the area between Norway and Russia was signed, which indicates strong will for cooperation from both sides. However, it must be remembered that the agreement still is not a detailed and legally binding contract; it is only a step towards one. Reaching this agreement took 40 years, and it remains to be seen when a technically detailed treaty will be signed. Another potential issue to increase tensions in the Arctic is the protection of the environment. As traffic on the Arctic Sea increases, it poses a threat to the nature and consequently also to the valuable fish resources, which are important to the economies of Russia and Norway, although obviously at a significantly lower level than oil and gas resources.

Nevertheless, no serious conflict is expected to take place in the Arctic, because mutual cooperation is presently extremely important for Russia and Norway. If the offshore fields are to be developed, Russia cannot develop its own offshore gas reserves without the Norwegian technology and fluent cooperation, and for Norway, it is important to be involved in those projects as well. Moreover, even if the fields were not to be implemented in near future, Russia and Norway would always be neighbouring countries, and peaceful cooperation would be beneficial for both of them. Also Russia's relations with France are very important for both the countries. France is one of the most important links that Russia currently has to the EU, and simultaneously France benefits from bilateral deals with Russia.

To conclude, the future of the Shtokman project is a result of the development of the Russian gas business and of the cooperation of Gazprom, Total and Statoil. These issues are further influenced by several factors, which are also dependent on each other. Consequently, on the basis of the empirical findings, assessing the probability or schedule of the development of the Shtokman field requires following and evaluating these factors. This analysis is not necessarily comprehensive, as there are certainly numerous additional factors which may affect the project's future, but this presentation presumably introduced the most significant of them. The implementation schedule of the Shtokman project remains to be seen in the future. The final investment decision is

scheduled to take place before March 2011, and regarding LNG before the end of 2011.

For managers in the Shtokman project and also in other projects in the Russian gas industry, it is important to follow the development of these issues in order to be able to predict the future of the industry and the future of this particular project. At least general predictions about the future are necessary, as on the day the field will be implemented, if it ever will, the political investment climate for foreign investment in the Russian gas industry can be very different from what it seems to be today.

5.4 Limitations and suggestions for further research

The empirical material of this study consisted only of interviews of experts, who have conducted research on this topic for several years or who have years of work experience related to the Russian gas business or to the Arctic region. Thus, this study lacks the perspective of the representatives of the foreign investors – how do they see political risk? What do they consider as factors influencing it? How are they prepared for it? Nevertheless, it may also be assumed that the company representatives would have given subjective and possibly also somewhat limited answers. The experts were expected to provide more objective and open viewpoints, even though also they can be assumed to see the Shtokman project from their own perspectives, which are likely to be influenced by their national backgrounds.

The study also lacks the perspective of the Russian top leadership as well as that of Gazprom, which may, at least in principle, differ from each other. However, in these cases the answers could also have been limited due to strategic reasons. The analysis and conclusions of this study are merely based on the views that are external to the project, although experienced and professional. In further research it could be beneficial to clarify the views and opinions of the foreign investors and compare them with the views of the Russian side in the project.

In addition, this study sees the project only as taking place in the future, and consequently it is largely based on assumptions and predictions, although on well-argued ones. However, it would be interesting to follow how the views regarding political risk develop as the project proceeds and when the production finally begins. As it could be seen while conducting this study, the situation evolves continuously through unpredictable events, of which an example is the sudden agreement concerning the

grey zone. As a consequence, the perspective can be radically different after five or ten years. As time passes, we will also have more information of the future development of the global gas industry, of the direction of state control over the Russian economy, and of the future of the Arctic issues and disputes. Conducting a similar research again later would enable a comparison with the source factors of political risk that are perceived as significant in different times – which factors are the same, which are no longer relevant, and what new factors have appeared?

In further research, it would also be interesting to follow several projects simultaneously, and compare the perceptions and future assessments of political risk in those projects. Are there similar factors, or are the factors causing political risk notably different in different projects and why? This would give an increased understanding of which factors are generalizable and which ones are particular to different projects.

Furthermore, this study focused on political risks in the case of Shtokman project. The case provided interesting issues which, unfortunately, could not be studied more closely in this study, but could provide a deeper understanding of the project's development if studied in detail. For example, the future development of the Yamal gas fields and the Russian gas industry in general are essential issues in the development of the Shtokman field, and within the range of this study, only general issues regarding them could be discussed. In addition, the Arctic provides a very interesting area for further studies, for instance regarding the tensions within the Arctic states and their potential effect on international business. These tensions could only be discussed at a very general level, even though they can have significant effects on the international relations of the surrounding countries as well as on the economic development of the Arctic areas.

It can be stated that one can assess political risk and also the development of the Shtokman project through the risk factors identified in this study. Nevertheless, a deeper look into the previously discussed issues will certainly provide a more comprehensive understanding about political risk in the Russian gas industry.

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APPENDICES

Appendix 1 Proved natural gas reserves

			At the end 2008		
	At the end 1988 (trillion cubic meters)	At the end 1998 (trillion cubic meters)	trillion cubic meters	share of total (%)	R/P ratio
European Union	**3.65**	**3.77**	**2.87**	**1.6**	**15.1**
Azerbaijan	n/a	0.81	1.20	0.6	81.3
Denmark	0.08	0.10	0.06	*	0.1
Germany	0.36	0.26	0.12	0.1	0.1
Italy	0.33	0.27	0.12	0.1	14.2
Kazakhstan	n/a	1.81	1.82	1.0	60.3
Netherlands	1.73	1.77	1.39	0.8	20.6
Norway	2.30	3.79	2.91	1.6	29.3
Poland	0.17	0.14	0.11	0.1	27.1
Romania	0.17	0.36	0.63	0.3	54.6
Russian Federation	**n/a**	**43.51**	**43.30**	**23.4**	**72.0**
Turkmenistan	n/a	2.51	7.94	4.3	•
Ukraine	n/a	1.02	0.92	0.5	49.2
United Kingdom	0.59	0.76	0.34	0.2	4.9
Uzbekistan	n/a	1.58	1.58	0.9	25.4
Other Europe & Eurasia	38.81	0.40	0.44	0.2	43.2
Total Europe & Eurasia	44.53	59.09	62.89	34.0	57.8
Total North America	9.51	7.24	8.87	4.8	10.9
Total S. & Cent. America	4.79	6.35	7.31	4.0	46.0
Total Middle East	34.34	53.17	75.91	41.0	•
Total Africa	7.68	10.77	14.65	7.9	68.2
Total Asia Pacific	8.86	11.39	15.39	8.3	37.4
Total World	**109.72**	**148.01**	**185.02**	**100.0**	**60.4**

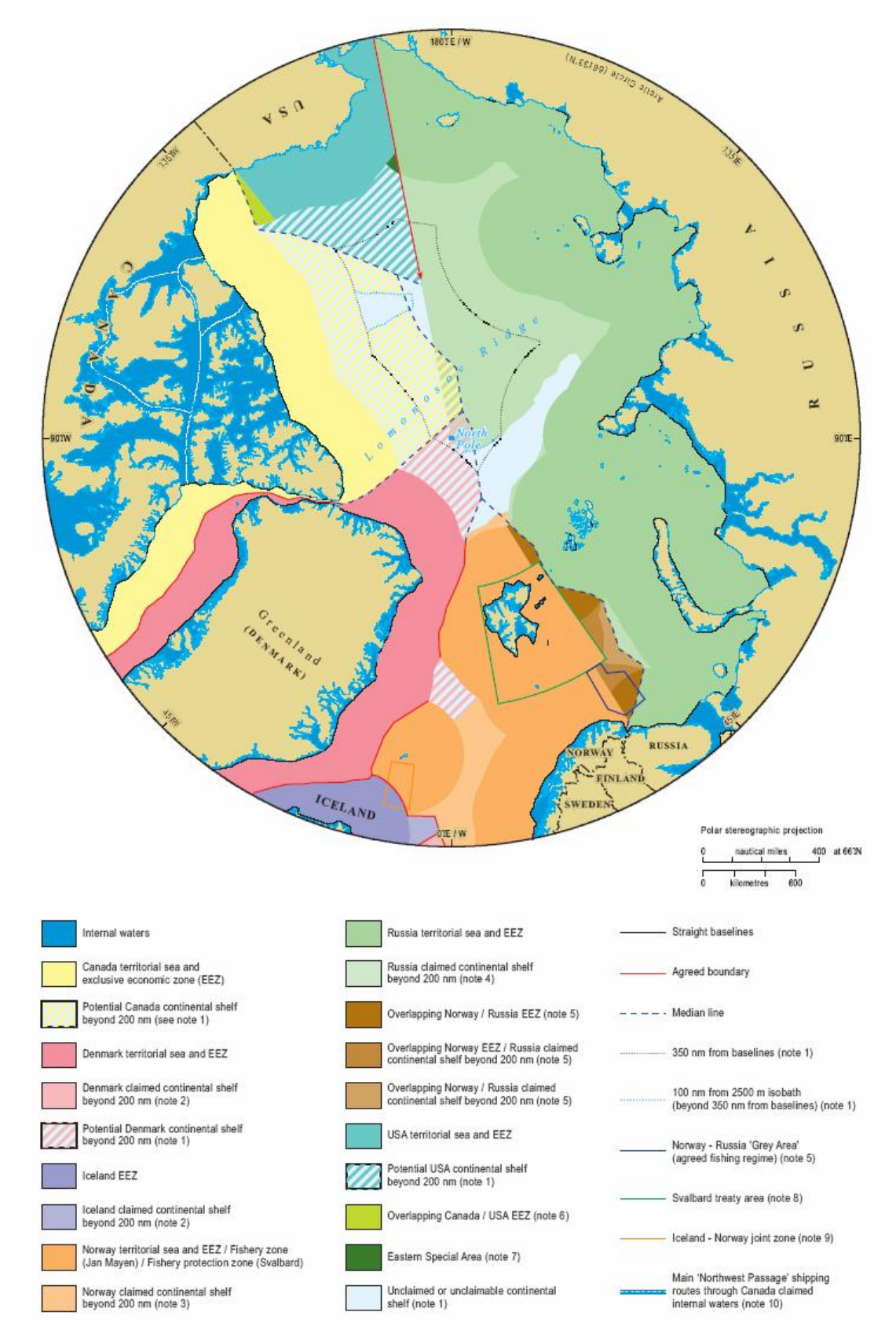
* Less than 0.05%
• More than 100 years

Source: BP Review of World Energy (2009), 22.

Appendix 2 Russian oil and natural gas at a glance

Source: IEA (2007)

Appendix 3 Maritime jurisdiction and boundaries in the Arctic region



Source: IBRU (2008)

Appendix 4 Summary of earlier studies on political risk in Russia

Researcher	Title	Research method	Purpose of the study/main findings
Mögel (1999)	The political risk in Russian regions	Desk research, quantitative analysis, data from several statistical databases	The purpose of the study was to investigate the political investment risk in the Russian regions. The political risk was determined by an index system, and the regions were divided into 7 classes by their investment climate. The most favourable regions were found to be located in the western part of the country.
Jones, Fallon and Golov (2000)	Obstacles to foreign direct investment in Russia	Desk research	The purpose of the study was to explore the obstacles faced by trans-national corporations considering FDI in Russia. The findings suggest that Russia's relative lack of success in attracting FDI can be attributed to its national infrastructural factors and governmental policies.
Aleshin (2001)	Risk management of international projects in Russia	Quantitative document analysis (diaries and reports)	The purpose of the study was to identify, classify and assess risks inherent to joint projects in Russia and to make practical recommendations for risk management. 16 dwelling projects were studied regarding their experienced internal risks, and the analysis suggests that for example establishing closer contacts with operational services of the city and developing information systems within the project participants could reduce the risk events.
Broadman and Recanatini (2001)	Where has all the foreign investment gone in Russia?	Desk research, quantitative analysis, data from several statistical databases	This research studies the determinants of the geographic distribution within Russia. The findings suggest that factors associated with market size, infrastructure development, and the policy environment seem to explain much of the observed variation in FDI flows to regions in Russia.
Zarkana-Fraser and Fraser (2001)	Risk perception by UK firms towards the Russian market	Quantitative analysis of questionnaire data	The research studied the perceptions of UK construction firms have of political risk and market potential in Russia, in comparison with other overseas markets. The analysis shows that firms do not treat Russia any differently than other markets, but nevertheless, the respondents were found to be highly concerned about the Russian political environment and about the uncertainty regarding the future of the reforms.

Fabry and Zeghni (2002)	Foreign direct investment in Russia: how the investment climate matters	Desk research, quantitative analysis	The study explores the paradox of Russia being one of the largest countries in terms of natural resources, well-educated labour force and market potential, but at the same time being one of the least attractive host countries for FDI. The researchers conclude that as modern industrial sectors able to boost modernisation, transfer of knowledge and Western best practices are discouraged, foreign investors still perceive the business climate as unstable and risky.
Click and Weiner (2007)	Does the shadow of political risk fall on asset prices?	Quantitative analysis based on a database of 1655 mergers and acquisitions in which pertoleum reserves were traded in 2000-2006	The purpose of the study was to investigate the effect of political risk on the value of petroleum reserves associated with the country in which the reserves are located. The study demonstrates the value-desruction of political risk, and estimates the asset discount for 37 countries. The study also shows that the discount depends on market conditions.
Patton (2008)	Russian Federation energy policies and risks to international joint ventures in the oil and gas industry	Desk research	The purpose of the research was to study the energy policies of Russia and risks to international joint ventures in the oil and gas industry. Study suggests that many of the existing international joint ventures are experiencing additional business risks as Russia exploits its natural gas resources to become an assertive superpower.
Barchietto (2009)	Russia: a political and economic issue	Desk research	The purpose of the study was to investigate the expropriation risk in Russia, and assess the attractiveness and profitability of FDI particularly in strategic natural resources sector. The main conclusion is that despite the worsening expropriation risk over the past few years, Russia remains a high-return potential market, in which investors should, however, protect their projects by implementing hedging tools.
Liuhto (2009)	Who doesn't risk, never gets to drink champagne… but how much one has to drink just to have a relaxed drink in Russia	Desk research	The purpose of the study was to explore the political risk faced by foreign investors in Russia. The researcher concludes that political risk varies largely across industries. At the moment, telecommunications sector is the most risky for foreign investment, but also in the oil and gas business the state consolidation has continued.

Appendix 5 The key variables in analysing political risks in oil and gas industry

1. **Host political risk variables**
   a. Governmental/political
      - dominant ideology and possible changes
      - institutional development, including the strength of the legal system, the legitimacy of the government, and the degree of bureaucratisation
      - instability, including the existence of disaffected groups, governmental use of coercion and suppression, and the outbreak of violence
      - continuity and changes in leadership and in the perspectives of other major political leaders and/or parties
      - nationalism
      - domestic and foreign policies, including goals and policy changes
      - governmental corruption

   b. Economic
      - economic performance, including levels and growth in GNP per capita and inflation
      - balance-of-payments and import/export concerns
      - foreign exchange position
      - public/private sector mix
      - level of development and development plans
      - government debt
      - distribution of wealth
      - role of the foreign oil firm in the domestic economy
      - integration between petroleum/gas industries and the remainder of the national economy
      - importance of petroleum to government revenues and the overall economy

   c. Sociocultural
      - homogeneity: ethnic, linguistic, radical, and national
      - standard of living
      - receptiveness to foreign influences

   d. Petroleum-specific
      - ownership
      - domestic reserves/production
      - host's relative market position
      - level and destination of exports
      - strength of the national oil company
      - role of the foreign firm in the national oil industry
      - prices
      - domestic ability to operate the industry, including commanding the necessary skills, technology, know-how, and capital
      - ownership/contractual relationship between the firm and the host

2. **Corporate political risk variables**
      - nationality of the company
      - position in the world industry, including sources of crude, reserves, production, and market outlets
      - special bargaining advantages: technology, managerial skills, services, and capital.
      - dealings with host government: receptive, diplomatic, and open, or unreceptive, brusque, and unyielding

3. **External/international political risk variables**
      - host government participation in international treaties, conventions and organisations
      - political/economic relationship between the host and the home government, including security, trade, and aid issues
      - involvement of the host in international conflicts and potential results of conflicts not involving the host directly
      - world petroleum market conditions: prices, supply and demand
      - world economic conditions, including economic growth and energy consumption
      - developments in other oil-exporting countries (demonstration effect)

Source: Lax (1983, 112–113).

Appendix 6 The interview questions

Themes	Questions
Macro-level sources of political risk	1. What are the largest political problems in Russia at the moment? 2. How would you describe the state's role in the Russian economy? 3. How are Russia's international relations with the main investor countries? 4. Do these issues affect foreign investors' operations and political risk faced in Russia? How? 5. How is the investment climate for foreign investors in Russia in general? 6. What kind of issues might decrease or increase political risk in Russia?
Industry-level sources of political risk	7. Which or whom do you consider to be the most important actors in the Russian gas industry? 8. What kind of opportunities and challenges do foreign investors face in the Russian gas industry? 9. How strongly is the future of the Russian gas industry tied to the persons leading the country, or how strongly is it tied to the country's general economic situation? 10. What does the future of the Russian gas industry look like from the perspective of a foreign investor? 11. Do you think that the fact that several future gas fields are located in the arctic offshore areas has an effect in the future of the Russian gas industry? What kind of an effect? 12. How important are the contested Arctic areas for the neighbouring countries? 13. Do the tensions related to the Arctic areas affect the international relations of these countries, such as Norway and Russia? 14. Do you think that the Arctic tensions could have an effect on the foreign companies' operations in the Russian gas industry? 15. How do you see the future regarding the Arctic tensions?
Firm-level sources of political risk	16. How do you see the position of Statoil and Total in the Russian gas industry? 17. How are the relations of Russia with Norway and France? Do these relations have an effect on the operations of Statoil and Total in Russia? 18. How strong is their bargaining power in relation to the state? (How needed are they because of their resources and knowledge vs. how much do they depend on the Russian market?) 19. How do you expect the bargaining power to develop in the future?
Project-related sources of political risk	20. How important is the Shtokman project for Statoil and Total? Why? 21. How important is the project for Russia and Gazprom? Why? 22. To which extent are the goals of Gazprom, Statoil and Total congruent or different? 23. How do you see the future of the project?
Effects of political risk in the project	24. What kind of political risks do you think the foreign investors have in the Shtokman project? 25. What kind of effects may these risks have on the development of the project? 26. What kind of effects may they have on Statoil, Total, and Gazprom?

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