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**RUSSIAN INVESTMENTS IN THE CIS –  
SCOPE, MOTIVATIONS AND LEVERAGE**

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## **1 INTRODUCTION**

The current paper aims to provide insight into Russian business expansion to the neighbouring countries of Commonwealth of Independent States (CIS), employing the company-level approach to the subject. Although the extent of Russian investments in the region is commonly recognised, fewer contributions can be found discussing the economic and political leverage of Russian companies “near abroad”. This paper provides examples from several industrial sectors and discusses both the extent of Russian investments in the CIS countries and the related economic and political leverage driven by these investments in the target economies.

All the CIS countries accommodate considerable amount of Russian capital, either in form of direct or portfolio investments or as a result of capital round-tripping through third countries. In addition, after the collapse of Soviet Union, many of the CIS economies were left with industrial assets formerly in possession of Soviet enterprises that were often inherited by present-day Russian companies. One should keep in mind this particular feature when estimating the extent of Russian investments in the CIS countries, and the extent of newborn FDI in particular.

Due to the lack of accurate and consistent statistical data, estimating the extent of Russian investments in the CIS becomes essentially problematic. According to official FDI statistics, Russia is not among the top investors in the CIS countries. However, as we shall discuss in the later chapters, the Russian entities have invested considerable amounts in the CIS region through their offshore units. Due to the statistical discrepancies, the author has chosen a micro-level approach in analysing the Russian investments in the CIS region.

In addition to the large volume of investments, what makes Russia a significant investor in the CIS, is the nature of her investments, more often than not targeted to the strategic sectors of target economies. Besides being the prominent energy and raw-material supplier to all the countries in the CIS, Russian companies hold considerable stakes in

numerous oil, natural gas, and power companies in the region. The investments in the strategic natural resource-based sectors often provide Russia with significant economic and political leverage in the target countries.

In following chapters, an overview of Russia's investments in her neighbouring regions will be given, along with related discussion concerning the relevance and accuracy of statistical data on FDI in the region. Consequently, discussion will be provided on Russia's economic and political influence leveraged by her investments in the CIS. In the later sections of the study, Russian investments in the region are analysed through company cases from electricity, oil, and telecommunication industries, with adjacent discussion on their motivations and impact on target economies.

## 2 UPWARD TRENDS IN RUSSIAN OUTWARD INVESTMENTS

In the last years, Russia has emerged as one of the leading capital exporting countries of the world. Russian outward foreign direct investments (OFDI) have increased significantly since the end of 1990s and the country currently ranks among the top transition economies in the world when measured by the value of OFDI. Behind are left countries such as China and Brazil, traditionally regarded as advanced foreign investors among the transition economies. Although Russian OFDI are still marginal compared to that of USA or the leading EU countries UK, Germany and France, the year 2004 saw the exceeding of \$ 100 billion-landmark in Russian OFDI stock (Central Bank of Russia 2005).

**Table 1 OFDI stock from Russia, \$ million**

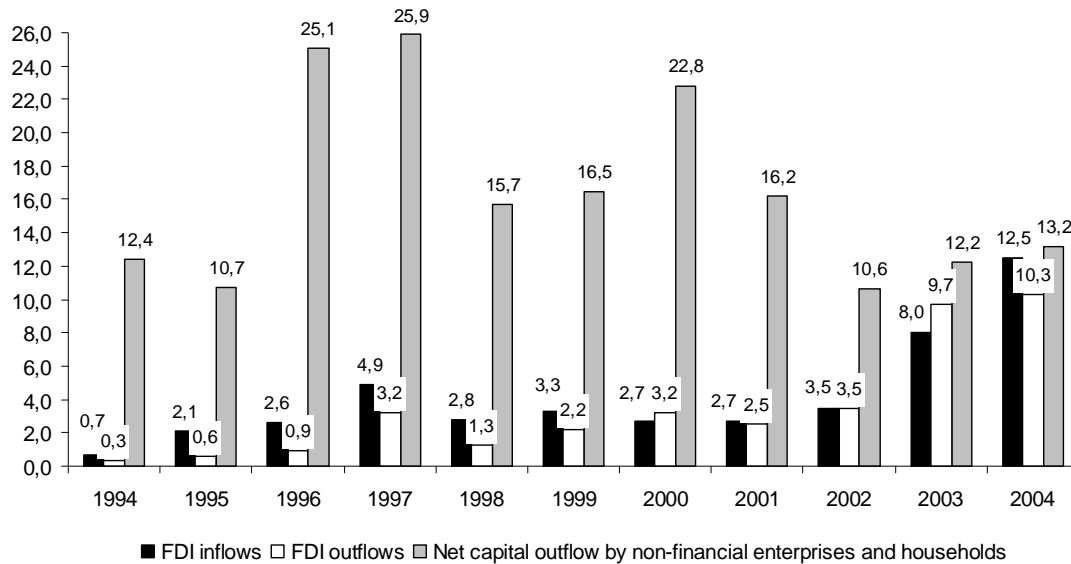
	2000	2001	2002	2003	2004
<b>Direct investments abroad</b>	<b>20,141</b>	<b>44,219</b>	<b>62,348</b>	<b>90,873</b>	<b>103,692</b>
Equity capital and reinvested earnings	18,47	42,167	58,357	86,532	96,804
Other capital	1,671	2,053	3,992	4,341	6,888

Source: Bank of Russia (<http://www.cbr.ru/eng/statistics>).

Besides FDI, Russian capital has flown abroad through numerous capital transfer schemes, including both legitimate and illegal measures. Various estimates exist on total amount of Russian capital abroad; recently increasing consensus has been witnessed in various estimations on annual capital flight from Russia. Particularly, recent improvements in reporting of balance of payments data by the Central Bank of Russia have led to more reliable estimations on the capital outflows. According to the Central Bank, net capital outflow by non-financial enterprises and households from Russia exceeded \$ 180 billion between 1994 and 2004 (Figure 1). When this total amount of capital outflow is considered, Russia ranks among the 10 largest investors and capital exporting countries in the world (Kalotáy 2005; Central Bank of Russia 2005). However,

this figure only provides vague estimation on Russian capital and purchasing power abroad<sup>1</sup>.

**Figure 1 Russian FDI flows and net capital outflows, \$ billion**



Sources: Central Bank of Russia 2005.

When discussing the issue of Russian outward investments, several particularities should be pointed out. First, Russian companies have invested substantial amounts of capital through third countries and offshore investment units. United Kingdom, Cyprus, and Netherlands are among the most popular target countries, to which the Russian companies have established their investment subsidiaries. For instance, the continuously high rank of Cyprus among the investing countries to Russia and other CEE and CIS countries is widely believed to indicate the existence of investment units of Russian origin in Cyprus. In other words, Russian entities utilise investment companies registered to Cyprus, through which funds are either brought back to Russia in form of FDI, to obtain tax and other benefits offered to foreign investors, or, alternatively, reinvested in other countries especially in the CEE region. Certainly, Cyprus is not the only country

<sup>1</sup> Various estimates are provided on additional capital flight from Russia. According to the European Commission, the non-recorded capital flight from Russia totaled \$ 245 billion in 1992-2002. One can, thus, only estimate the total amount of capital that has left the country under registered and non-registered investing and capital exporting schemes. The author believes the actual amount of capital transferred abroad from Russia to be manifold to the registered transfers and investments.

through which Russian capital is trans-shipped, but there are a number of factors supporting the assumption that to a significant degree the capital conveyed out of the country is the source of foreign investments to Russia from many investing countries.

Second, besides the capital round-tripping, the FDI inconsistencies root to the operations of Soviet enterprises abroad, the assets of which were often inherited by contemporary Russian companies. Understandably, reliable valuation of these assets becomes essentially problematic.

Third, the composition of capital outflows from Russia highlights widespread misreporting and undervaluation of revenues from abroad. Put differently, Russian companies systematically undervalue their export earnings and report remittances against fictitious imports and transactions in securities. Only in 2004, this item on the balance of payments<sup>2</sup> sheet of the Russian Federation accounted for almost \$ 26 billion. In comparison, the foreign direct investments by non-financial enterprises and households amounted to \$ 9.6 billion in 2004. It appears reasonable to argue that at least part of these massive unregistered capital outflows has been used for investment purposes abroad by Russian entities.

Notwithstanding the illegitimate capital exporting schemes, one must recognize the increasing international activity of Russian enterprises what comes both to exports and foreign investments. Several Russian industrial conglomerates already rank among the world's leading companies in their industries, with oil, natural gas, and ferrous and non-ferrous metal producers currently leading the internationalisation race. The leading Russian companies have acquired considerable foreign assets around the world, partially to support their extensive export activities, and even more so to become truly global players to cope with increasing competition on the world markets.

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<sup>2</sup> The item "Non-repatriation of exports proceeds, non-supply of goods and services against import contracts, remittances against fictitious transactions in securities" appears on the asset side of the financial account of the Russian Federation, and was valued at \$ 25.9 billion in 2004. In comparison, total assets of non-financial enterprises and households under financial account amounted to \$ 32.8 billion in 2004.

The energy and metal producers have traditionally been the most active Russian companies to internationalise; the process has often been supported by their massive export revenues. The majority of Russian foreign investments have been carried out by large conglomerates in the aforementioned sectors. In estimation, oil & gas sector covers nearly 60% of the value of OFDI by Russian companies. In fact, this ratio also reflects the country's export structure. The ferrous and non-ferrous metals' sectors account for around one fourth of Russian companies' investments abroad. The metal sector is currently by degree the fastest-growing industry in Russia when measured by the extent of foreign activities of its leading enterprises. In addition, the value of investment projects carried out by energy and metal conglomerates used to be manifold to these by other sectors.

Apart from traditional natural resource-based industries, the Russian telecommunication companies have started to aggressively seek markets and assets abroad, and especially so in the neighbouring CIS countries. In addition, more recently, the leading Russian producers of dairy products and the largest corporations in machine-building industries have followed the suit acquiring production and marketing outlets abroad. Table 2 outlines the leading Russian companies in terms of their foreign assets and sales.

**Table 2 Russian top foreign investors ranked by foreign assets in 2003, \$ mln**

Company	Industry	Assets		Sales	
		Total	Foreign	Total	Foreign
Gazprom	Oil & Gas	90 197	...	28 678	17 916
Lukoil <sup>3</sup>	Oil & Gas	29 150	8 901	24 217	18 816
Russian Aluminium	Metals	11 500	2 465	4 550	3 707
Norilsk Nickel	Metals	12 700	2 355	5 196	4 532
Mobile TeleSystems	Telecom	5 627	1 153	3 887	859
Severstal	Metals	3 844	652	3 202	1 343
Yukos <sup>4</sup>	Oil & Gas	18 514	607	16 566	12 546
Alrosa	Mining	4 630	462	2 037	923
Rosneft	Oil & Gas	3 641	319	6 797	2 650
OMZ <sup>5</sup>	Heavy engineering	815	217	176	73

Source: Company information, Troika Dialog 2005, author's calculations.

<sup>3</sup> As of 30 September 2004/ 9M04

<sup>4</sup> As of September 2003/ 9M03

<sup>5</sup> As of 30 June 2004/ 1H04



Recent development in geographical distribution of Russian outward investments has been twofold. On one hand, the Russian investments have found new targets around the world and several Russian enterprises have expanded beyond the traditional locations of CIS and CEE. On the other hand, the share of CIS countries among the target economies for Russian investments has again grown in the recent years. Particularly, the investments in the CIS region have become more strategic in nature when Russian companies have acquired significant assets in the neighbouring countries' energy, metal, and communication sectors.

The increasing share of CIS countries among the target markets of Russian investments is also shown in UNCTAD (2005) statistics on cross-border mergers and acquisitions (M&A) by Russian companies, presented in Table 3. As shown in the table, Ukraine has been the most popular destination for Russian investments among the CIS countries.

**Table 3 Geographic distribution of cross-border M&A purchases by Russian companies, 1995-2004, no. of deals**

<b>Economy</b>	<b>1995-1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2000-2004</b>	<b>1995-2004</b>
<b>Total world</b>	<b>32</b>	<b>12</b>	<b>22</b>	<b>21</b>	<b>31</b>	<b>25</b>	<b>111</b>	<b>143</b>
<b>Developed countries</b>	<b>14</b>	<b>4</b>	<b>12</b>	<b>10</b>	<b>10</b>	<b>13</b>	<b>49</b>	<b>63</b>
Lithuania	-	2	-	3	2	2	9	9
United Kingdom	1	1	1	1	1	1	5	6
United States	-	-	1	1	1	3	6	6
Czech Republic	1	-	-	-	-	4	4	5
Germany	1	-	1	2	1	-	4	5
Latvia	2	-	1	-	1	-	2	4
Netherlands	1	-	2	-	-	1	3	4
<b>Developing economies</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2</b>	<b>1</b>	<b>1</b>	<b>4</b>	<b>4</b>
Mongolia	-	-	-	2	-	-	2	2
Turkey	-	-	-	-	-	1	1	1
China	-	-	-	-	1	-	1	1
<b>Transition economies</b>	<b>18</b>	<b>8</b>	<b>10</b>	<b>9</b>	<b>20</b>	<b>11</b>	<b>58</b>	<b>76</b>
Ukraine	3	7	2	6	3	4	22	25
Armenia	-	-	-	-	6	2	8	8
Belarus	2	1	3	-	-	1	5	7
Uzbekistan	-	-	1	1	3	2	7	7
Bulgaria	3	-	1	1	1	-	3	6
Georgia	3	-	1	-	-	-	1	4
Kazakhstan	1	-	1	-	-	2	3	4

Source: UNCTAD 2005.

### **3 OVERVIEW ON RUSSIAN INVESTMENTS IN THE CIS**

For many Russian companies, the CIS region has been the first step on their way towards the global markets. The Russian natural resource-based companies already hold a strong grip on some particular segments of the CIS markets and have moved their focus beyond the CIS, whereas the manufacturing and telecommunication companies have more recently entered into their first investment projects in the CIS region. However, in several instances, the CIS markets are as strategic a target for Russian companies as the Western markets. In many occasions, the assets controlled by Russian companies in the CIS countries also tend to be more controversial in nature, such as energy and infrastructure assets. In addition, the Russian companies tend to be dominant players in several CIS markets, whereas in developed economies they often hold smaller market shares and leverage in respective industries. One should give further attention to the fact that the investments into CIS region by the Russian companies have dramatically increased in value during the recent years.

The official statistics on Russian investments in the CIS give an essentially misleading image of the reality. According to the somewhat differing Russian and CIS statistics, the CIS region accounts for between 1 and 5 per cent of the Russia's total OFDI. In this respect, thus, one might regard Russia as a negligible investor in the region. To achieve a more realistic overview, we shall look at the following example. According to the Russian Federal State Service (Goskomstat 2005), the country's OFDI flows to the entire CIS region totalled \$ 713 million in 2004 (Table 4). In contrast, the recent years have witnessed several acquisitions in the CIS by Russian energy and telecommunication majors with many of the individual transactions valued more than the total investments from Russia as reported by Goskomstat. This discrepancy can be explained by the fact that the major Russian companies invest abroad through offshore investment units and the investments are thus not shown on the balance of payments sheet of the Russian Federation.

**Table 4 Russian annual FDI flows to the CIS countries 2000-2004.**

	<b>2000</b>		<b>2002</b>		<b>2003</b>		<b>2004</b>	
	\$ '000	%	\$ '000	%	\$ '000	%	\$ '000	%
<b>Total</b>	<b>130,981</b>	<b>100</b>	<b>239,692</b>	<b>100</b>	<b>544,141</b>	<b>100</b>	<b>713,016</b>	<b>100</b>
<b>Azerbaijan</b>	26	0.2	92	0.0	1,613	0.3	2,379	0.3
<b>Armenia</b>	5	0.0	4,321	1.8	7,650	1.4	1,033	0.2
<b>Belarus</b>	77,238	58.9	98,292	41.0	243,355	44.7	280,193	39.3
<b>Georgia</b>	133	0.1	-	-	1,182	0.2	284	0.0
<b>Kazakhstan</b>	3,453	2.6	6,143	2.6	27,135	5.0	84,104	11.8
<b>Kyrgyzstan</b>	7	0.0	1,400	0.6	608	0.1	628	0.1
<b>Moldova</b>	31,224	23.8	192	0.1	372	0.1	6,600	0.9
<b>Tajikistan</b>	-	-	71	0.0	18	0.0	3,067	0.4
<b>Turkmenistan</b>	2,934	2.2	855	0.4	857	0.2	1,865	0.3
<b>Uzbekistan</b>	929	0.7	2,027	0.8	582	0.1	138,547	19.4
<b>Ukraine</b>	15,032	11.5	126,299	52.7	260,769	47.9	194,316	27.3

Source: Goskomstat 2005.

According to Goskomstat (2005), Belarus has been the largest recipient of Russian investments over the past years, followed by Ukraine. According to the latest data provided by the State Statistics committee of Ukraine (2005), Russia was the 7<sup>th</sup> largest foreign investor in the country with total FDI stock of \$ 546 mln (Table 5).

**Table 5 FDI stock in Ukraine by selected investor countries, 2003-2005.**

	<b>as of 1.1.2003</b>		<b>as of 1.1.2004</b>		<b>as of 1.7.2005</b>	
	\$ mln	%	\$ mln	%	\$ mln	%
<b>Total</b>	<b>5339.0</b>	<b>100.0</b>	<b>6657.6</b>	<b>100.0</b>	<b>9061.4</b>	<b>100.0</b>
<b>Cyprus</b>	602.6	11.3	779.2	11.7	1272.1	12.4
<b>USA</b>	898.0	16.8	1074.8	16.1	1218.8	13.8
<b>UK</b>	510.5	9.6	686.1	10.3	948.4	10.7
<b>Virgin Islands</b>	337.0	6.3	381.0	5.7	689.2	6.5
<b>Netherlands</b>	398.8	7.5	463.9	7.0	594.3	6.6
<b>Germany</b>	312.1	5.8	441.4	6.6	568.8	7.6
<b>Russia</b>	322.6	6.0	377.6	5.7	546.0	5.5

Source: State Statistics Committee of Ukraine 2005.

In author's view, the data provided both by Goskomstat and Ukrainian Statistics Committee dramatically underestimate the scope of Russian investments in Ukraine, where many Russian companies have invested through their offshore units. As further discussion will show, several Russian companies have invested greater amounts of capital in the country than indicated by the FDI statistics.

Largely due to capital round-tripping and use of investment units in third countries by the Russian investors, one may further notice considerable statistical inconsistencies in FDI statistics provided by different countries. For instance, according to Goskomstat (2005), the Russian FDI in Kazakhstan amounted to mere \$ 84 million in 2004, whereas the respective figure provided by the National Bank of Kazakhstan (2005) is \$ 200 million (Tables 4 and 6).

**Table 6 FDI inflows in Kazakhstan by selected investor countries, 1993-2004.**

Country	1993-1999		2000		2001		2002		2003		2004	
	\$ mln	%	\$ mln	%	\$ mln	%	\$ mln	%	\$ mln	%	\$ mln	%
<b>UK</b>	1 220.1	12.5	481.8	17.3	600.6	13.2	622.7	15.2	591.4	12.8	924.6	11.1
<b>China</b>	461.3	4.7	90.1	3.2	211.9	4.7	64.7	1.6	248.6	5.4	397.7	4.8
<b>Netherlands</b>	283.8	2.9	114.4	4.1	211.1	4.6	401.2	9.8	612.2	13.2	1 782.2	21.5
<b>Russia</b>	<b>n.a.</b>	<b>n.a.</b>	<b>162.9</b>	<b>5.9</b>	<b>211.7</b>	<b>4.6</b>	<b>214.4</b>	<b>5.2</b>	<b>198.0</b>	<b>4.3</b>	<b>200.6</b>	<b>2.4</b>
<b>USA</b>	3 210.1	32.8	951.2	34.2	1 460.4	32.1	1 011.3	24.6	1 105.5	23.9	2 970.6	35.8
<b>Total</b>	<b>9 781.0</b>	100.0	<b>2 781.2</b>	100.0	<b>4 556.6</b>	1000	<b>4 106.4</b>	100.0	<b>4 624.5</b>	100.0	<b>8 293.0</b>	100.0

Source: National Bank of Kazakhstan 2005.

However, one only needs to consider, for instance, the single acquisition of the leading Kazakh telecommunication company in 2004 by the Russian mobile operator, VimpelCom, for more than \$ 400 million, to notice that the official figures reported by either side are of relatively little use in determining the actual presence of Russian companies in the country. Hence, while the statistical discrepancy can be addressed to differing registering practices of FDI, we still lack reliable estimations on Russian investments in the region.

As will be illustrated in the later chapter of the current paper, the actual presence of Russian companies in the CIS is manifold to official investment statistics. To some extent, we can blame the inconsistency on both the undeveloped registering system of investments and investment round tripping discussed above. However, one must note that for instance in Kazakhstan, the majority of investments by Russian companies are not regarded as FDI by definition. In particular, this goes for the massive investments in the energy sector exploration and infrastructure projects, operated by existing subsidiaries or joint ventures in the country. After a company or joint venture is established, the further investments in this company are not regarded as FDI, but categorised as 'other

investments' in the balance of payment sheet. However, although these investments do not appear in the FDI statistics, we claim that the estimated \$ 2 billion-investments by the Russian energy companies in Kazakhstan during 2004-2005 significantly add to the leverage of investing companies in the target country. This, and other related issues will be addressed in more detail in the later chapters.

#### **4 MOTIVATIONS BEHIND THE RUSSIAN INVESTMENTS IN THE CIS**

While the cross-border investments in the CIS region advance the economic co-operation and integration, there is inevitably the turn side to the current development, with many countries in the region becoming economically and, to some extent, politically subservient to Russia. Most of the countries are already seriously indebted to Russia due massive energy imports and record-high energy prices. When combined to Russian ownership of many strategic industrial assets in the CIS countries, the economic and, consequently, political leverage of Russia in the region becomes apparent. Given the growing influence of Russian companies in the region, the motivations behind Russian companies' expansion in the region are of increasing relevance for the policy-makers in many CIS countries. In following, we discuss some of the main motivations, driving the large-scale Russian investments in her neighbouring regions.

The motivations behind Russian companies' foreign expansion in the CIS are naturally varied. The common discussion often highlights the political motivations behind the expansion of Russian enterprises the CIS, and the state-owned conglomerates, in particular. The Russian energy resources serve as a considerable foreign policy tool in the CIS, and by supporting the active expansion of her leading enterprises, Russia effectively manages her interests in the region. The two state-owned energy giants, natural gas producer Gazprom and the Russian power industry monopoly, RAO UES, have acquired strong foothold in the CIS region, with their expansion more often than not based on intergovernmental agreements.

However, one must recognise the growing share of market-oriented investments and increasingly sophisticated business practices of Russian companies operating abroad. Especially for the companies in other than strategic natural resource-based sectors, the CIS countries represent economically lucrative market area with considerably lower entry barriers than the Western markets.

For the Russian oil and gas companies, many CIS countries offer lucrative targets for resource-seeking investments. Although the Russian companies are generally well endowed with natural resources, the low recovery rates of existing domestic resources have led to increasing depletion of currently operated fields. The most lucrative domestic oil reserves are mainly located in remote areas of East-Siberia lacking proper infrastructure. Development of these resources would require considerable long-term investments and may not often appear as lucrative as the more easily accessible resources in the CIS region.

Through their foreign expansion, the Russian energy companies also seek to control their whole value chains internationally. By acquiring upstream assets, refineries and sales outlets abroad, Russian companies have achieved better control over foreign markets and demand, processing oil in their own refineries and selling the products via their own petroleum stations. In the oil sector, the infrastructure assets are naturally of vital importance and Russian oil companies have gained control over several strategic infrastructure assets in the CIS, including seaports and oil pipelines delivering crude oil and products to the European and the US markets.

An example of market-seeking acquisitions by the Russian companies can be found from the telecommunication sector. Through active expansion, Russian telecom companies have considerably strengthened their positions in the neighbouring region. In the CIS, Russian companies lead the race for market shares, pioneering the expansion of foreign companies to this lucrative market area.

However, even when not considering the motivations behind the Russian companies' expansion in the CIS, the present-day Russian enterprises are a strong bearer of Russian economic influence in her neighbouring regions. In the following chapter, we concentrate on Russia's growing influence in the CIS region, increasingly leveraged by foreign operations of her leading enterprises.

## **5 THE RUSSIAN ENERGY EMPIRE AND SOFT POWER IN THE CIS**

Throughout the 1990s, Russia lost significant share of its leverage in the former Soviet countries. As a result of domestic economic downturn and political upheavals, Russia ran short in its capacity to subsidise other countries in the region. With very few economic initiatives left to provide to other countries in the region, Russia temporarily attempted to uphold its leverage in newly independent states (NIS) through her military resources. The strategy soon ran out of steam when many of the countries successfully sought for the assistance of international community in their political difficulties with Russia. Only handful of former Soviet Republics including Belarus, Armenia and Tajikistan, remained their close connections with Moscow, whereas the majority of NIS quickly reoriented their economic and political preferences towards the EU and the USA.

The 21<sup>st</sup> century has brought along considerable shift in Russia's policies towards its near abroad. The former hard power regime backed with military forces has efficiently been transferred into that of soft power, leveraged by Russia's economic resources.

After the 1998 economic crisis, Russia's economic revival was backed by soaring energy prices. From the year 1999 onwards, the Russian economy has shown impressive growth that can almost exclusively be addressed to the record-high world oil prices. The reflections of the oil sector boom have been witnessed throughout the Russian economy and in the 21<sup>st</sup> century, Russia has become an attractive business partner for many CIS countries. Along with its strong economic growth and resulting growth in consumption, Russia has re-emerged as the most feasible export market for many of the countries in the region due to the low level of competitiveness of their manufactured products in the western markets. On the other hand, the new Russian consumer products considerably cheaper than the goods imported from the West have become increasingly popular in the CIS region.

The global energy price hike has naturally had positive effects on other oil and natural gas-rich countries similar to these on Russia. Kazakhstan, for instance, has posted two-



digit economic growth figures for several years in a row. As industrial production and trade of the energy-rich countries have grown in result of strengthening of domestic economies, these countries increasingly look for external markets of their production. For many, the growing Russian economy seems to have been the most viable target market. Vice versa, many Russian producers have found increasing demand for their products in the neighbouring countries, advanced by their economic growth. Understandably, this type of development has further strengthened the cross-border economic ties between Russia and other CIS countries. On the other hand, the countries not in possession of considerable energy resources have seen themselves falling more and more indebted to Russia along with the record-high oil and gas prices. Obviously, given the lack of alternative energy resources, the massive indebtedness has considerably weakened the political bargaining power of many such countries against Russia.

While many of the CIS countries would not essentially prefer to see themselves in a closer alliance with Russia, the alternatives might be scarce. Given the political and geographical realities, none of the CIS countries are in the position to hope for widespread and large-scale investments from the EU or the USA or closer political and economic integration with the West in the foreseeable future. Besides investments in few high-profile energy projects, limited bilateral assistance, and international trade credits or loans, the USA and Europe thus far have had little to offer to the CIS economies. Apart from the Baltic States, none of the former Soviet countries can be regarded as viable membership candidates for EU or NATO for the time to come; the opportunities for closer economic, political, or military integration with the West are, hence, limited. Adding to the consideration the current trade structure of the CIS countries, heavily relying on Russia both in imports and exports, the geopolitical picture in the region begins to take shape. Even with the latest political developments and strengthening of pro-western attitude in Ukraine and Georgia, the CIS countries are more dependent on Russia than many of them are willing to admit.

## **6 RUSSIAN ENERGY COMPANIES IN THE CIS**

### **6.1 Russian state-owned conglomerates: strong influence in the CIS markets**

In supplement to trade dependency, much of Russia's power in the CIS countries is being delivered by the strong presence of Russian energy companies in the region. Among the Russian energy giants, the world's largest natural gas producer, Gazprom, and the Russia's electrical energy monopoly, United Energy Systems (UES) of Russia, are the most influential bearers of Russia's leverage in the CIS. Apart from being the sole natural gas supplier to many of the countries in the region, Gazprom has equity investments in many of the CIS countries, where the company is the principal owner of national gas distribution companies. The operations of UES in the CIS region are discussed in more details in the following subchapter.

#### ***6.1.1 Case: RAO UES of Russia in the CIS***

Besides Gazprom, the Russian electrical energy giant RAO UES of Russia is a powerful bearer of Russian influence in the CIS region. UES is preparing to launch several energy projects in the CIS, including expansion of electricity exports and operation of national energy companies. Exports to CIS countries are the priority of UES' foreign economic activities and one of the primary sources of funding of the investment projects.

In the former Soviet territory UES has established a single energy area and operates parallel with the energy systems of nearly all the former Soviet Republics. The expansion of the Russian energy giant in the CIS has been controversial in many occasions. On one hand, the system considerably increases the reliability of our CIS countries' energy systems maintaining high quality of electricity based on common technical standards. On the other hand, the arrangement offers UES indisputable access to neighboring countries energy networks making many of the countries in the region subservient to Russia's energy policy interests. In several instances, political motivations are seen to have driven the expansion of UES in the neighbouring countries.

Since 2003 UES has enhanced the activities of its subsidiaries directly operating on the foreign markets, enabling UES to switch from wholesale electricity sales to foreign energy companies to supplying electricity to end consumers. The subsidiaries of UES act both as retailers of Russian electricity and as organisers of electricity supplies to third countries, exports to which directly from Russia is inefficient due to high electricity transit tariffs.

In Georgia, UES purchase of shares in several energy facilities in 2004. The acquisitions include a 75 per cent stake in a power grid company, AES Telasi; sole ownership of the energy supplier to Georgian capital Tbilisi, AES Mtkvari; 50 per cent stake in energy exporter AES Transenergy; and management two hydroelectric power plants owned by AO Khramesi. Altogether, the deal puts UES in control of 20 per cent of Georgia's power generation capacity and some 35 per cent of electricity supplies to domestic consumers. Besides the prominent position in the Georgian market, the arrangement provides UES with possibility to expand its electricity exports to Georgia's lucrative neighboring markets of Turkey.

Among UES' further interests in Georgia are the updating and management rights of the Inguri HPP hydroelectric plant in the country. In addition, UES has been reported of eyeing the possibility of restoring power plants in Abkhazia, requiring dozens of millions USD in investments. According to industry experts, resuming the operation of these facilities would provide further options for feasible electricity exports to Turkey and Azerbaijan.

In Armenia, UES manages several power facilities, including Razdanskaya TPP, Armenian NPP, and five hydroelectric plants part of Sevar-Razdansk HPP chain. In addition, UES is eyeing the possibility of gaining control over cross-border transmission lines linking Armenia with Georgia, Iran, and Turkey, all operating on common technical standards. The transmission lines would make it economically feasible to sell excess electricity from Armenia's energy system to the above-mentioned countries.

In Moldova, UES controls the power plant of Moldavskaya TPP. The current upgrade of the power plant will make it possible to export up to 5 TWh of electricity to Romania and Bulgaria.

In Ukraine, UES is reportedly seeking potential targets for acquisition. Currently, UES operates a trading company in the country. According to industry experts, Ukraine would offer UES business opportunities not only in bilateral trade operations and electricity transit, but also in implementing joint projects to export electricity to European countries.

In Belarus UES operates a power facility, Berezovskaya TPP, supplying electricity to Poland. The ongoing upgrade of the facility is to considerably increase its capacity.

In Kazakhstan UES operates several projects, which primarily involve mutual supplies and electricity transit.

## **6.2 Leading the internationalisation: Russian oil companies in the CIS**

Besides the state-owned conglomerates, the Russian oil companies have gained a strong foothold in the CIS region. The upturn in global energy prices has fuelled the expansion of both domestic and foreign activities of Russian oil companies, which have traditionally been the most active to internationalise among the Russian corporations. Especially in the CIS region, the Russian oil companies hold traditionally strong positions operating several facilities and projects inherited from the Soviet era. On the other hand, the new independent CIS markets provide lucrative options for internationalisation for almost all Russian oil producers. The Russian oil companies are active both in upstream (oil exploration and production) and downstream (refining and marketing) in the CIS region.

The Russian giants are the primary importers of oil in many of the CIS countries, in several occasions also controlling considerable shares of their retail networks. In oil-rich countries of CIS, the Russian entities are among the leading foreign investors in upstream exploration projects. The Russian oil companies' presence is currently strongest in

Ukraine and Kazakhstan. In Ukraine, Lukoil, TNK-BP, and Tatneft together control over 80 per cent of the country's petroleum market. In addition to extensive petroleum retail chains, Lukoil and TNK-BP operate updated oil refineries in the country.

Besides Ukraine, Russian oil producers are established strong presence in Kazakhstan, well endorsed with oil and gas resources. Currently, Lukoil, Gazprom, Rosneft, and Yukos have invested in exploration and production ventures in the country. Among the Russian companies, Lukoil is best positioned in the race for lucrative Kazakh oil assets against the Western and, more recently, the Chinese oil giants.

The recent consolidation of State power in the Russian oil sector is likely to advance Russia's influence on the CIS energy markets. During the past year, two major events have been witnessed in the Russian oil sector, strengthening the role of the Russian State in the industry. First, the conclusion for two-year long campaign against one of Russia's leading oil producer and foreign investor, Yukos, draws to its end. In late 2004, the company was deprived of its main production outlet, which ended up under the control of state-owned Rosneft, now Russia's second-largest oil producer. In the same vein, the main shareholders of Yukos were sentenced to several years in prison, charged by tax evasion and money laundering. In addition, the Russian tax authorities lay further claims on Yukos' remaining production units. The likely outcome is the eventual break-up of what is left of Yukos with the company's remaining assets falling under control of state-owned enterprises, and Rosneft in particular. With considerable increase in its resource base, Rosneft is likely to advance its downstream (oil refining and retail marketing) presence in the CIS region, where the company already operates several upstream projects.

Another major event in the Russian energy sector, indicating the shift in control over the country's energy industry relates to the natural gas giant, Gazprom. In late 2005, the company acquired Russia's fifth-largest oil producer, Sibneft, for \$ 13 billion, in the largest M&A deal in Russia's history. The acquisition granted Gazprom a position among the country's largest oil producers, and, more importantly, when combined with

Rosneft's output, made the Russian State the country's largest oil producer responsible for one third of total production.

#### **6.2.1 Case: Lukoil in Kazakhstan**

Since mid-1990s, Lukoil has been actively engaged in oil exploration projects in Kazakhstan. Kazakhstan, the second-largest oil producer in the CIS region after Russia, is exceptionally well-endowed with oil and natural gas resources, making it a lucrative investment target for the world's leading oil companies. In estimation, nearly 90 per cent of Kazakhstan's inward FDI is targeted in oil and gas exploration and production. Besides Lukoil, the world's leading oil companies, including ExxonMobil, BP, Shell, Chevron Texaco, and ConocoPhillips are participating in Kazakh energy projects. Among the most recent entrants in the race for Kazakh energy resources are the Chinese companies, with CNPC having recently announced the takeover of Kazakh oil major, PetroKazakhstan.

Lukoil is one of the leading investors and oil producers in Kazakhstan. The company is involved in seven upstream projects in Kazakhstan, combined investments to which total nearly \$ 2 billion. Kazakhstan accommodates around 60 per cent of Lukoil's proven reserves abroad and over 50 per cent of the company's probable reserves abroad. In addition, the company's foreign natural gas reserves lie exclusively in Kazakhstan.

The most recent evidence of Lukoil's preference on Kazakh oil projects was the announcement of \$ 2-billion acquisition of Canadian-based Nelson Resources, operating several exploration and production sites in Kazakhstan. The acquisition is the single largest foreign acquisition made by a Russian company and is to considerably enhance Lukoil's position in the Kazakh oil industry.

According to expert opinions, the motivations of the acquisition lie not only on the lucrative profits but also on the Russian Government's pursuit of Kazakh oil wealth. Kazakhstan is the only country in the CIS possessing oil and resources comparable to those of Russia, and, hereby the only country in the region holding potential for altering

Russia's position of a dominant energy provider in the CIS. Currently, the Russian companies are fiercely competing on stakes in Kazakh energy sector; besides Lukoil, Rosneft, Gazprom and Yukos are operating exploration and production ventures in the country.

The bulk of LUKoil's capital expenditures in Kazakhstan are in the Karachaganak oil and gas condensate field, which contains more than 1.2 bln tons of liquid hydrocarbons and 1.335 trn cm of gas. LUKoil participates in the Karachaganak Petroleum Operating consortium via its subsidiary LUKoil Overseas.

LUKoil is also involved in the project to develop the Kumkol oil field in the southern section of the Turgai oil and gas basin. LUKoil Overseas and PetroKazakhstan formed the 50:50 joint venture TurgaiPetroleum to develop Kumkol, which holds a proven 219.2 mln barrels of oil.

LUKoil also participates in Kazakhstan projects via the Russian-American joint venture LUKArco, which owns 5 per cent of the equity in major oil producer TengizChevrOil. TengizChevrOil will produce around 12.5 mln tons of oil this year. It exports oil via the CPC pipeline, in which LUKArco owns a 12.5 per cent-stake.

Under the Dostyk project, LUKoil Overseas signed the contract with KazMunaiGaz in early 2005, to study two Kazakh offshore properties, Tyub-Karagan and the Atashskaya area. The estimated investments in the project stand around \$ 3 bln.

In July 2003, LUKoil and Gazprom signed an agreement to found the 50:50 TsentrKaspiiNefteGaz joint venture, which will represent the Russian Federation in the development of the Tsentralnaya structure in the Caspian Sea jointly with KazMunaiGaz. The estimated investments in Tsentralnaya project are \$ 1 - 1.2 bln.

## **7 CONQUERING THE TELECOMMUNICATION SECTOR**

In recent years, the Russian leading telecommunication service providers have established prominent positions throughout the CIS countries. For the Russian mobile operators, the CIS region represents a relatively unsaturated and rapidly growing market. With the domestic mobile penetration rate nearing 80 per cent, the Russian operators are eagerly eyeing the lucrative neighbouring markets. The largest Russian telecom companies have already expressed their further interests to expand beyond the CIS markets and to India and China in particular.

Currently, the CIS mobile telecom markets are almost exclusively dominated by the Russian companies. In the top of the list is Ukraine, where the Russian operators hold a combined market share of nearly 75 per cent. In future developments, the Russian companies are looking to establish strong positions in the undeveloped mobile markets of Uzbekistan, Tajikistan and Turkmenistan in particular.

Among the most recent developments is the acquisition of the Kazakhstan's second-largest mobile operator, Kar-Tel, by the number two Russian mobile service provider, VimpelCom, for the price of \$ 425 million. The subscriber base of Kar-Tel currently nears one million, representing the market share of over 30 per cent in Kazakhstan.

As elaborated above, similar developments have been witnessed in many CIS countries. In Ukraine, the Russian largest operator, MTS, controls the majority share of Ukraine's leading mobile operator, Ukraine Mobile Communications (UMC), with a subscriber base of 2.5 million. In addition, MTS controls 75 per cent of the largest mobile operator in Uzbekistan, Uzdunorbita. In Belarus, MTS holds a 49 per cent share in MTS Belarus, currently the leading mobile operator in the country.

Adding to the list, Alfa Group, a Russian holding company and the majority owner of VimpelCom, controls 40 per cent of the second-largest mobile service provider of



Ukraine, KyivStar. In 2004, Alfa Group also bought the only mobile operator in Turkmenistan, Bashar Communications Technology, for the price of \$ 55 million.

### ***7.1 Case: VimpelCom in Kazakhstan and Ukraine***

VimpelCom is currently the most active international expander among the Russian telecom companies. Similar to other Russian mobile operators, the CIS region is the initial target for VimpelCom's outward expansion. In September 2004, VimpelCom acquired the second-largest mobile operator in Kazakhstan, Kar-Tel, for \$ 350 million, and took over the company's \$ 75-million debts. VimpelCom bought the Kazakh company through its Cypriot-based subsidiary, Limnotex, which is in turn owned by a Dutch-based company VimpelCom Finance B.V., wholly owned by VimpelCom.

Kar-Tel is the fastest-growing operator in Kazakhstan, with its current subscriber base nearing one million, representing a market share of 31 per cent. Given the strong domestic economy and low mobile penetration rate of 13 per cent, Kazakhstan is considered one of the most promising mobile telecom markets in CIS.

In April 2005, in accordance with its business development strategy to find a partner in Kazakhstan with local market knowledge, VimpelCom agreed to sell a minority share of 50 per cent minus one share in Limnotex, the parent company of Kar-Tel, to shareholders of the fourth-largest bank in Kazakhstan, ATF Bank. As reported by VimpelCom, the company believes the agreement to provide support and local knowledge that would add value to VimpelCom's operations in Kazakhstan. According to VimpelCom, its mid-term strategy includes becoming the number one operator in the country.

More recently, VimpelCom took another and more controversial step in its foreign expansion strategy. In November 2005, the company announced consummation of the purchase of Ukraine's fourth-largest mobile operator, Ukrainian Radio Systems (URS) for the price of \$ 231 million plus \$ 23 million in debts. The acquisition sparked serious controversy between the two largest shareholders of VimpelCom, the Russian Alfa Group

and Norwegian Telenor. The former strongly favored the purchase, whereas the latter opposed the transaction, claiming it to lack business sense. The acquisition is complicated mainly due to the fact that Alfa Group and Telenor already control the second-largest mobile operator in Ukraine, KyivStar, through a joint venture. The Norwegian parent claimed that the purchase of URS by VimpelCom would bring the company in direct competition with KyivStar.

Despite the recent decision to move forward with the acquisition, there are several other challenges related to VimpelCom's expansion to Ukraine. The mobile network of URS is relatively limited and the estimated costs of necessary expansions reach hundreds of millions. In addition, the mobile penetration rate and wireless use is relatively high in Ukraine, forcing VimpelCom to battle for existing customers. The main competitor of VimpelCom in Ukraine is its domestic rival, the number-one Russian mobile operator MTS, controlling the largest mobile company in Ukraine, Ukraine Mobile Communications.

## 8 CONCLUSIONS

Along with the economic upturn of recent years, the Russian enterprises have become more active in their internationalisation ventures. Whereas the current investment trends of Russian companies include increased geographical diversification of investments, the share of CIS countries among the investment targets of Russian enterprises is again in the rise. In the current paper, the phenomenon is discussed through providing corporate examples on Russian investments in the CIS region with related discussion on economic and political influence they leverage in Russia's neighbouring areas.

Due the fact that Russian companies invest abroad through offshore units and investment companies, the official statistics often possess weak explanation power when assessing the Russian investments in the region. The Russian investments in the CIS are largely channelled through third countries, such as Cyprus, Netherlands, and British Virgin Islands. In nearly all the CIS economies, the three countries continuously appear on the list of top foreign investors. Hence, as the statistical data is of little use in determining the Russian business presence in the CIS, the alternative approach was employed, providing several company cases and discussion on the extent and influence of Russian enterprises in the CIS.

During the recent years, Russia has come close of regaining her superpower status, only this time leveraged by her economic resources. The Russian leading enterprises bear strong economic and, in some occasions, political influence in the neighbouring CIS countries. At current, few countries in the world hold the leverage comparable to that of Russia in their neighbouring areas. Employing her vast natural resources and related economic power, Russia has established considerable economic empire near abroad. In several occasions, Russia's leading companies have acquired control over entire industrial sectors of the CIS countries. In Ukraine, for instance, Russian oil companies' estimated share of petroleum market stands between 80 and 90 per cent. Similarly, the country's mobile telecommunication sector is dominated by the Russian mobile companies; currently four out of five leading mobile operators in Ukraine are majority-

owned by Russian entities, accountable for lion's share of Ukraine's subscriber base. One can add to the list the major acquisitions of Gazprom in the CIS countries, in many of which the Russian gas giant is the sole supplier of natural gas and the majority owner of national gas companies, and the giant oil exploration projects by Lukoil in Kazakhstan and Uzbekistan. Further still, the Russian electrical energy monopoly, RAO UES, controls major assets and extensive power grid throughout the CIS.

In the foreseeable future, the Russian energy sector will remain the core of Russia's economy, and, consequently, the main driver of the country's foreign economic policy interests. The growing Russian economic resources and developing enterprise sector are the leading bearers of Russia's influence in her neighbouring regions, in contrast to the military resources of the past. For many of the CIS countries, the present-day Russia is the most viable economic and political partner while others are fighting to shrug off the past dependencies on Russia. Whether the dependencies are broken or strengthened, will increasingly depend on economic developments in the region, among which the cross-border investments play the key role.

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