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ENERGY AS A CONTESTED DOMAIN: EXPLAINING RUSSIA'S POLICY TOWARD FOREIGN DIRECT INVESTMENT IN THE ENERGY SECTOR

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ABSTRACT

This thesis focuses on Russia's policy toward foreign direct investment in the energy sector. The research sets out to explain why, in the presence of an objective need for FDI in the Russian energy sector, Russia's policy toward FDI has not been sufficiently supportive, but has rather been fraught with reversals and inconsistencies. In answering this question, I depart from the view of the Russian government as a unitary actor and instead stress the contested nature of the policy and the multiplicity of actors influencing its formulation. Incorporating such theoretical approaches as Segbers' "patchwork of actors" and North's neo-institutionalism, the work analyzes the legal basis for FDI regulation, official discourses on the subject, and statistical data on the sector's performance. The work also focuses on Russia's large energy corporations and the internal politics within the federal-level executive branch, as well as on the relationship between the two. The research findings show that the policy on FDI in the energy sector lacks coherency due to its nature as the outcome of the struggle of conflicting interests, with the *siloviki* faction and Gazprom being the most influential ones. Additionally, I find that the energy sector is affected by a complex interplay of Soviet legacies and globalizing pressures. Therefore, the analysis of Russia's policy toward FDI should take into account not only its formal legal basis, but also the impact of informal institutions. In conclusion, the thesis discusses the implications of the findings for Russia's future development prospects.

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Introduction

As one of the top producers and exporters of oil and gas in the world, Russia, aided by the high world prices on hydrocarbons, has made an impressive comeback to the international arena. Having enjoyed several consecutive years of high economic growth rates, today's Russia is forcefully trying to reassert its power and influence internationally. Energy is thus becoming to Russia what nuclear arms used to be for the Soviet Union.[1] However, despite the radically increased importance of the energy sector for the nation's economic well-being and its international status, Russia's policy in the area of energy has been anything but clear and predictable.

This work focuses on Russia's policy toward foreign direct investment (FDI) in the energy sector during Vladimir Putin's presidency (2000- present). In doing so, it aims to find explanations for the following puzzle: why, in the presence of an objective need for FDI in the energy sector, Russia's policy toward such investment has not been sufficiently supportive, but has instead featured apparent inconsistencies and repeated reversals of positions? The thesis will argue that in order to understand the complexities of Russia's policy toward FDI, one has to, first, take into account the multiplicity of actors and stakeholders exercising influence on the formulation of the policy, and secondly, examine the impact of path dependencies and legacies from the Soviet era on Russia's adaptation to the realities and challenges of the global economy and to FDI.

This issue area represents an important and exciting area of examination for a number of reasons. First, the question of foreign investment in the so-called "strategic sectors" has always

[1] Isabel Gorst, "Russian Pipeline Strategies: Business vs. Politics," *The James A. Baker III Institute for Public Policy Research Papers of Rice University* (Oct. 2004), 3.

been extremely politicized, which invites the researcher to take a closer look at the internal dynamics of policy-making and the actor constellations in the sphere of energy. Secondly, the Russian energy sector is influenced by the complex interplay of both the legacies from the Soviet times and today's strong globalizing pressures. This dual nature of the most internationalized and at the same time the most protected sector of the Russian economy has important implications for government sectoral policy in the age of globalization. Furthermore, Russia itself represents an interesting case for analysis. Featuring many of the characteristics common for the post-communist economies, it has also differed from the latter in its aspiration to regain a "great power" status and the determination to use its rich natural resources as a means to achieve this goal. As a result, Russia has developed an uneasy attitude toward foreign investment, frequently regarding it as a potential security threat, despite the economic benefits it might bring. Finally, the overall importance of Russia's stance toward FDI in its energy sector lies in its implications for the country's openness and its future path of economic development, as well as for the role Russia will play in issues related to global energy security.

Literature review and research gaps. The idea to conduct research on the subject of the political economy of FDI in the Russian energy sector has stemmed from my conviction that the existing literature on the subject contains several gaps that could be filled with an up-to-date analysis stressing the internal dynamics of policy-making in the area of energy. Certainly, one cannot claim that the Russian energy sector has been neglected by scholars and analysts. For instance, a number of sources focus on the geopolitical importance of the energy sector as an instrument of Russian foreign policy. Locatelli argues that the Russian government has tried to limit foreign ownership in the energy sector in order to preserve its discretion in using energy as a bargaining tool in international politics;[2] while Laurila and Gorst demonstrate how decisions on investment in major new pipeline projects have been influenced by Russia's desire to bypass the territories of former Soviet republics, many of which are considered by Russia to be "unfriendly" regimes. Gorst also analyzes how the preservation of the monopoly position of Transneft, the state-controlled oil pipeline company, is regarded as important for reducing Russia's dependence on Eastern European countries for energy transit.[3]

As far as the analysis of the influence of various actors on Russia's policy toward FDI is concerned, Locatelli finds that the goals of resource-rich regions have frequently contradicted the interests pursued by the federal center, which has resulted in continued controversy over legislation on foreign investment in the energy sector, including the Law on Production-Sharing Agreements (PSAs).[4] Heinrich, Kusznir, and Pleines, as well as Bahgat, also analyze the evolution of the PSA law under the influence of the changing interests of the powerful oil lobby.[5] Several authors, such as Frye, Orttung, and Yakovlev, focus on the changing business-state relationship in Russia during Putin's presidency, making some mention concerning the implications of their findings for the policy on FDI in the energy sector.[6] Finally, the question of the obstacles to natural monopoly reform in the gas sector (including the constituencies affected, the influence of Gazprom on Russian energy policy, and the company's aggressive business strategy in the Russian and CIS markets) has attracted the attention of a number of experts,

[2] Catherine Locatelli, "The Russian Oil Industry between Public and Private Governance: Obstacles to International Oil Companies' Investment Strategies," *Energy Policy* 34 (2006): 1082.
[3] Juhani Laurila, "Transit Transport Between the European Union and Russia in Light of Russian Geopolitics and Economics," *Emerging Markets Finance and Trade* 39, no. 5 (2003): 27–57; *and* Gorst, "Russian Pipeline Strategies: Business versus Politics," 1-26.
[4] Locatelli, "The Russian Oil Industry between Public and Private Governance," 1082.
[5] Andreas Heinrich, Julia Kusznir, and Heiko Pleines, "Foreign Investment and National Interests in the Russian Oil and Gas Industry," *Post-Communist Economies* 14, no. 4 (2002): 495; Gawdat Bahgat, "Russia's Oil Potential: Prospects and Implications," *OPEC Review* (June 2004): 138-139.
[6] Timothy Frye, "Capture or Exchange? Business Lobbying in Russia," *Europe-Asia Studies* 54, no. 7 (2002): 1017–1036; Robert W. Orttung, "Business and Politics in the Russian Regions," *Problems of Post-Communism* 51, no. 2 (March/April 2004): 48–60; *and* Andrei Yakovlev, "The Evolution of Business-State Interaction in Russia: From State Capture to Business Capture?" *Europe-Asia Studies* 58, no. 7 (Nov. 2006): 1033-1056.

including Ahrend and Tompson, Grigoryev, and Milov.[7] However, the reform of another natural monopoly, the electricity sector, has not been sufficiently researched, with the exception of the contributions by Milov.

At the same time, while providing a number of interesting and relevant insights, the current state of research on the determinants of Russia's policy toward FDI in the energy sector leaves much room for improvement. For instance, while the conflict of interests between the regions and the federal centers has been addressed by various authors, virtually no sources take a view of the Russian *federal* government itself as a divided actor in their analysis of Russia's energy policy. The time scope of research is also problematic: given the complex and rapidly changing nature of policy-making and other development in the sector, any research work on the subject has to be regularly revised and updated in order to account for the new tendencies and changes. However, most articles on Russia's stance toward FDI in the energy sector date before 2004, that is, before the pronounced shift in Russia's policy toward FDI in the direction of strengthened state control took place.

Another weakness found in the literature is the common assumption that there exists a single model of the business-state relationship in Russia, be it state capture, business capture, or "elite exchange."[8] This view suggests that the distribution of power between the government and business remains the same at a given period of time. However, one only needs to compare the position and influence of the gas giant Gazprom and an independent private oil company to see the difference in influence between the two.

[7] Rudiger Ahrend and William Tompson, "Unnatural Monopoly: The Endless Wait for Gas Sector Reform in Russia." *Europe-Asia Studies* 57, no. 6 (2005): 801-822; William Tompson, "Putin's Challenge: The Politics of Structural Reform in Russia," *Europe-Asia Studies* 54, no. 6 (2002): 933–957; Yuli Grigoryev, "Today or Not Today: Deregulating the Russian Gas Sector," *Energy Policy* 35 (2007): 3036–3045; Vladimir Milov, various articles, presentations and interviews.
[8] Frye, "Capture or Exchange? Business Lobbying in Russia," 1017.

Finally, little attention has been given to the interplay between the Soviet legacies and the forces of globalization in the Russian energy sector,[9] even though the latter constitutes a perfect object for analysis in the respect. The three-volume work edited by Segbers, with contributions from various Russian and foreign experts, is a welcome exception in this regard, yet, published in 2001, it needs revision. In addition, the general treatment of the impact of globalization on the Russian energy sector has largely been limited to the analysis of the geopolitical situation in Eastern Europe and Central Asia, while neglecting other important implications of Russia's integration into global economic relations.[10]

Lastly, the somewhat simplified (and negative) view of Russia's interests in the energy sector as presented in the Western media, rarely featuring any in-depth policy analysis, seems to lead to the excessive emphasis on ideology, rather than on the objective conflicts of interests, in explaining the evolution of the policy toward FDI.

<u>Theoretical Framework.</u> An in-depth examination of the sheer complexity of the decision-making processes, of the importance attached by Russia to the energy sector and of the ambiguous attitudes toward foreign presence in this sector, and the desire to regain influence in post-Soviet space, possibly by relying on energy as a political instrument, requires going beyond the limits of a single theoretical approach. For this reason, I will frame my research within a combination of theoretical approaches, incorporating two main strands: a) Segbers' model of "patchworks," denoting the variety of actors and networks involved in or affected by policy-making in the energy sector; and b) North's neoinstitutionalist approach to examine the interaction of the Soviet legacies and path dependencies with the pressures of globalization. In

[9] Klaus Segbers, "Institutional Change in Russia," in *Explaining Post-Soviet Patchworks.* Vol. 2, *Pathways from the Past to the Global,* ed. Klaus Segbers (Aldershot, UK: Ashgate Publishing Ltd., 2001), 2.
[10] Bernhard Seliger, "The Impact of Globalization: Chances and Risks for Russia as a Transformation Country," *Eastern European Economics* 42, no. 1 (Jan–Feb 2004): 7-8.

combining these two strands, my analysis is informed by Graham Allison's understanding of policy as "outcomes determined by the preferences and perceptions of specific political players;"[11] as such, this work seeks to depart from the popular view of a unitary-actor government. In my research, I will assume the overall beneficial effect of FDI, especially in view of the objective need to develop technologically challenging projects in Russia in order to sustain future output.

It might be useful to give a brief overview of the theoretical approaches mentioned above. Segbers' "patchwork model" features the complex, multi-level web of interactions between different types of actors, such as networks and flows; regions, republics, and territories; financial industrial groups, sectors, and enterprises; federal agencies and bureaucracies; and finally, societal actors and the media.[12] Segbers emphasizes the need to explore in more detail the "multitude of actors on different levels of action who bypass, erode, contest and transform the traditional concept of the state."[13] As for North, his neoinstitutionalist approach is useful for exploring how the path dependencies from the Soviet past continue to shape Russia's responses to FDI as a manifestation of the forces of globalization. In particular, I will use North's insights concerning the interplay between informal institutions, formal rules and enforcement procedures,[14] since the combination of these factors can explain a number of apparent inconsistencies present in Russia's policy toward FDI.

<u>Methodology</u>. Aside from relying on theoretical literature and empirical analyses, I will examine the legal basis for Russia's policy toward FDI in the energy sector, including the

[11] Graham Allison, "Conceptual Models and the Cuban Missile Crisis," *American Political Science Review* 63, no. 3 (Sept. 1969): 689-718.
[12] Segbers, "Actors and Interests in Changing Russia," in *Explaining Post-Soviet Patchworks,* Vol. 1, *Actors and Sectors Between Accommodation and Resistance*, 7.
[13] Ibid, 5.
[14] Douglass North, *Institutions, Institutional Change and Economic Performance* (New York: Cambridge University Press, 1990), 35.

Subsoil Law (1992) with amendments,[15] the Law on Production-Sharing Agreements (1995),[16] the Energy Strategy of the Russian Federation to 2020 (2003)[17] and the draft law on foreign investment in strategic sectors (2005-2007). Additionally, I will apply the insights gained from a personal interview with a representative of ExxonMobil in Sakhalin, Russia. To assess the level of FDI in the energy sector, I will use statistical data on the sector's performance, including investment and growth rates. In order to better analyze the patchworks of actors influencing Russian policy toward foreign investment in the sector, I will focus on large corporations (such as Gazprom, RAO UES, and Lukoil), as well as on the relationships between these corporations and government regulatory agencies, and of government bodies and agencies among themselves, including the formal hierarchical structure of the executive branch at the federal level. I will also examine the biographies of the individuals heading key organizations and companies which have a stake in Russia's energy policy. Finally, I will analyze the official discourse of the Russian government and of the management of large oil and gas corporations on issues pertaining to FDI in the sector.

Structure. The thesis is structured in the following way. The first chapter provides an overview of the current situation with FDI in the energy sector, describing the existing need for FDI, the international corporations' interest in investing in Russia, and the inconsistent nature of the policy toward FDI in the sector. The second chapter analyzes the "patchworks" of actors who have an influence on this policy, laying emphasis on the divided nature of the Russian government at the federal level, and on the role of Gazprom. The final chapter analyzes the

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[15] "Zakon o nedrah," 21.02.1992 N 2395-1 ("Federal Law on Subsurface Use (1992)," http://www.consultant.ru/popular/nedr/.

[16] Federal Law of December 30, 1995, No. 225-FZ "On Production-Sharing Agreements" (with amendments of January 7, 1999; June 18, 2001; June 29 and December 29, 2004). *In Russian.* http://www.garant.ru/law/10005771-000.htm

[17] "Energeticheskaya Strategiya Rossii do 2020 goda" ("The Energy Strategy of Russia to 2020"), ratified by the decree No. 1234-p, of August 28, 2003, of the Government of the Russian Federation.

interplay between path dependencies from the Soviet era and the pressures of globalization, focusing specifically on the role of informal institutions. The conclusion will summarize the main research findings and establish their broader relevance to Russia's path of economic development and to its future prospects as a market economy and an important international actor.

CHAPTER 1. FDI IN THE RUSSIAN ENERGY SECTOR: THE CURRENT STATE OF AFFAIRS

Before analyzing in detail Russian policy toward FDI in the energy sector, it is necessary to give a brief overview of the current situation in the sector, focusing specifically on the investment needs and prospects. In addition to describing the potential benefits of FDI and the need for such investment in Russia, this part will address the mixed track record of official policies toward FDI.

1.1. Russian Energy Sector: Facts and Figures

In matters related to the production and supply of energy, Russia, without a doubt, is one of the most important global players. Russia contests the number one position in oil production with Saudi Arabia, and while Russia's proven oil reserves constitute presently 6.2% of the world's total (as compared to Saudi Arabia's 22% share), the nation is likely to increase its importance in this sphere in the near future, since Russia is believed to hold substantial reserves in the less explored areas in Eastern Siberia and the offshore.[18] Russia's position in the natural gas sector is even stronger: not only does it possess the world's biggest reserves of natural gas, but it also produces and exports more gas than any other country in the world.[19] For instance, in 2003, Russia produced 22% of the world's natural gas and accounted for 24% of exports (including exports of liquefied natural gas).[20] The European Union and former Soviet republics are particularly dependent on Russian gas supplies to meet their energy needs: Russian gas

[18] Bill Page, "Prospects for Foreign Investment in the Russian Oil and Gas Industry" (Moscow: Deloitte, 2006): 2.
[19] Grigoryev, "Today or Not Today: Deregulating the Russian Gas Sector," 3036.
[20] Ahrend and Tompson, "Unnatural Monopoly: The Endless Wait for Gas Sector Reform in Russia," *Europe-Asia Studies* 57, no. 6 (2005): 802.

imports account for approximately 25% of the EU's gas consumption (with the share being much larger for new EU Member States), and this figure is expected to rise.[21]

The difficult economic transition following the breakup of the Soviet Union had a detrimental impact on the Russian oil and gas industry. However, in the early 1990's, due to the harsh recession, the collapse of the demand for oil both domestically and in the countries of the former Soviet bloc, as well as to the poor state of export infrastructure, oil production experienced a drastic fall. The practices of asset- and cash-stripping, as well as poor oilfield management further exacerbated the problem. As a result, Russia's oil production continued to decline throughout most of the 1990's.[22] The recovery of oil production began only in 1998, aided by the devaluation of the Russian ruble following the 1998 financial crisis, which increased the competitiveness of Russian oil exports; and also the increasing world oil prices. The net profits made from oil exports allowed Russian oil companies to invest new funds in exploration and development, bringing idle wells back into operation and drilling new ones as well.[23] By December 2006, the average daily crude oil output in Russia reached 9.8 mb/d.[24] As for natural gas, the recovery started in 2002, yet production has been growing at rather slow rates.

[21] Jake Benford, "EU Energy Policy: Internal Developments and External Challenges," *The Economic Intelligence Unit Limited, European Policy Analyst* (May 2006): 42.
[22] David Quayat, "The Russian Oil Sector and the Global Oil Economy: A Prospectus," *SAIS Review* 23, no.2 (2003): 4.
[23] Ibid, 3.
[24] Vladimir Milov, "The Rise of State Energy Companies and Its Effect on Oil & Gas Sectors in Russia," Presentation at London International Petroleum Week, February 13, 2007.

1.2. Investment in the Russian Energy Sector

1.2.1. Types of FDI and Associated Benefits

Due to their centrality of investment levels in the discussions concerning the energy sector's performance and development prospects, it would be beneficial for this thesis to discuss the existing needs and tendencies more in detail. While some of the needs of the sector can be met with increased levels of investment in general, other needs necessitate specifically inflows of *foreign direct investment.* Foreign direct investment are private capital flows originating from a parent firm to a location outside of the firm's host nation; they may include equity capital, intercompany debt, and reinvested earnings. FDI is distinguished from portfolio investment by the fact that it gives the investor a certain level of control over the management of the enterprise. As a rule, FDI is used by companies that have long-term considerations in mind and thus are less likely to be used for speculative purposes; some likely objectives of FDI include "serv[ing] domestic markets, exploit[ing] natural resources, or provid[ing] platforms to serve world markets through exports."[25] "Greenfield investments" refer to MNC activities in constructing subsidiaries in foreign locations "from the ground up." Another common form of FDI has been the so-called "brownfield investment," which exists in already established firms and can be effectuated through mergers and acquisitions, or through privatization programs.[26] Heinrich, Kusznir, and Pleines further specify the major types of FDI in the Russian energy sector, dividing them into three main categories: "(1) joint ventures, (2) investment within the framework of a production sharing agreement (PSA) and (3) foreign equity investment."[27]

[25] Nathan M. Jensen, *Nation-States and the Multinational Corporations: A Political Economy of Foreign Direct Investment* (Princeton: Princeton University Press, 2006): 23.
[26] Ibid.
[27] Heinrich, Kusznir, and Pleines, "Foreign Investment and National Interests in the Russian Oil and Gas Industry," 495.

The special role of FDI is well-attested in theoretical literature and empirical studies, particularly in the context of developing countries and transition economies. Not only is FDI is an important source of funds, but it also provides a number of other benefits, such as “access to modern technology, worker training, managerial know-how and accounting practices.”[28] In economies where capital is insufficient and management skills and internationalization experiences are lacking, FDI is usually perceived as a modernizing factor of the production process, capable of bringing improvements in corporate governance and of aiding in the development of an open market economy.[29] As will be shown below, it is rather the foreign companies’ expertise and technologies, rather than financial resources per se, that are lacking in the Russian energy sector today.

1.2.2. Need for Investment in the Russian Energy Sector

Virtually all experts concur that the future development of the sector is contingent on massive levels of investment.[30] According to the estimates provides by the Fitch Ratings agency, the Russian energy sector requires $30-40 billion annually, whereas the actual amount of investment is about 10% of that amount. This situation is seen as seriously endangering not only the sector itself, but also its contribution to the nation’s economic development. In January 2007, the same agency forecast a slowdown of Russia’s economic growth precisely for the reason of insufficient investment in the energy sector.[31]

The first problem requiring greater levels of investment is the poor state of the infrastructure, and more specifically of the oil and gas pipelines. The infrastructure currently

[28] OECD, *Investment Guide for the Russian Federation* (Paris: OECD, 1995): 3.
[29] Nathalie Fabry, “The Role of Inward-FDI in the Transition Countries of Europe: An Analytical Framework,” 4.
[30] Grigoryev, “Deregulating the Russian Gas Sector,” 3039.
[31] Olga Kuvshinova, “Switch off the Light,” *Biznes*, January 31, 2007, 1.

used has been inherited from the Soviet times and finds itself in a state of increasing deterioration. However, the levels of maintenance or replacement have been low.[32] According to the estimates of the International Energy Agency, the maintenance and expansion of the Russian energy infrastructure till year 2030 will require about 935 billion USD, a large portion of which will have to be attracted from transnational companies and international corporations.[33] Additionally, since 2003, export pipelines, sea ports, and railways have been operating to the limits of their capacity,[34] which seriously undermines Russia's export capacity.

Another crucial question that will largely determine the future of the energy sector in Russia is the availability and exploration of new reserves. The oil and gas fields used now are on the verge of depletion, while production has outpaced the addition of new reserves. About two-thirds of current production comes from the already-developed fields in Western Siberia.[35] For this reason, despite the significant size of Russia's oil and gas reserves, the persistently low exploration levels translate into the fact that, absent "massive investment," the total of proven reserves will be reduced by half by 2010.[36] Taken together, these factors once again cast doubt on Russia's ability to comply with its ambitious export commitments.[37] In fact, the current rate of investment in the sector is not even sufficient to maintain current output in the medium term, much less to expand production and exports.[38] On the whole, large investments are needed in all energy-related sectors, not only the cash-generating oil and gas, but just as urgently in electricity.

In view of this situation, most experts agree that there is an objective need not only for increased investment as such, but also specifically for FDI. The ongoing and planned exploration

[32] Grigoryev, "Deregulating the Gas Sector," 3039.
[33] Mark Robinson, "Investment in the Russian Oil and Gas Sector: Time to Reassess the Risks," *Deloitte Consulting*, 2005.
[34] M. Bezuglova, "Razvitie rynka kapitala v energetike," *Vestnik MGU* 9, no. 4 (2006): 579.
[35] Quayat, "The Russian Oil Sector and the Global Oil Economy: A Prospectus," 4.
[36] Locatelli, "The Russian Oil Industry between Public and Private Governance," 1076.
[37] *IHT, Russian energy sector needs foreign funds*
[38] Ahrend and Tompson, "Unnatural Monopoly: The Endless Wait for Gas Sector Reform in Russia," 804.

projects are in most cases very complex, requiring work in harsh climatic conditions in such regions as Eastern Siberia, the Far East, and the offshore areas, and thus necessitating the use of superior technologies. For this reason, the technology and expertise contributed by foreign corporations would be of crucial importance. Even Viktor Khristenko, Russian minister of industry and energy, hardly known for his sympathies toward Western investors, has stated that, while the projected government program to launch major gas fields exploration projects in Eastern Siberia and the Far East can at present be implemented only by Gazprom, the latter "will need help from Russian and foreign corporations."[39] Some other examples of areas where foreign investors can gain a foothold include deepwater offshore oil production, where Russian firms lack know-how and technical capacity, as well as liquefied natural gas (LNG) production. LNG has a clear advantage over natural gas in that it can be transported outside the pipeline infrastructure, and thus is better suited to meet export demand.[40] Foreign investment is also welcome in the area of the gas-to-chemicals (GTC) production chain, since this will allow Russia to export not only raw resources (as is the case today), but also final products.[41] Finally, FDI may be necessary to foster technology and know-how transfers that could aid in reducing the environmental damage caused by the operation of the Russian oil and gas industry.

Yet another problem jeopardizing the future of the energy sector lies in the skewed patterns of the allocation of investment resources. So far, Gazprom has invested little in gas field development, giving preference to such projects as pipeline construction (mainly for export purposes) and asset purchase in oil, electricity, and petro-chemistry industries.[42] Additionally,

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[39] Sergey Pravosudov, "Obrechennye na sotrudnichestvo," *Mirovaya Energiya (World Energy)*, 40, no. 4 (Apr. 2007): 1.
[40] Bezuglova,"Razvitie rynka kapitala v energetike," 579.
[41] Grigoryev, "Today or Not Today: Deregulating the Russian Gas Sector," 3037.
[42] Vladimir Milov, "The State Should Leave the Energy Sector," *Beyond Transition* 17, no. 2 (2006): 13.

Gazprom itself has invested extensively abroad, particularly in Europe.[43] Such behavior can be interpreted as a short-term orientation toward the collection of high profits from lucrative gas exports and increase of the company's monopoly power and international status, rather than a long-term concern about the sustainability of the sector's development. Political factors can also be seen as interfering with investment decisions: for instance, the main rationale behind some of the pipeline projects initiated by Gazprom appears to be the desire to bypass the territory of former socialist countries that are perceived as unfriendly to Russia.[44] As for the Russian oil companies, which are mostly privately owned, they have tended to invest in increasing production in the already existing fields in Western Siberia through the use of enhanced oil recovery techniques (an option promising much faster returns), rather than allocating their financial resources to the much more expensive and technologically challenging projects in less accessible regions.[45] West argues that the solution to the short-sightedness of investment policies would be to allow foreign investors (such as major international oil companies) to participate in major exploration projects, since IOC's possess the necessary skills and capital to manage the exploration risks.[46]

Finally, given the dominance of "insiders" within the Russian energy sector, a number of experts agree that the presence of foreign capital would help prevent the emergence of a closed anti-competitive environment that could in the long run provoke serious economic crises.[47] In the electricity sector in Russia, allowing foreign companies access to the electricity market is crucial

[43] Alexei Kuznetsov, "Dva vektora ekspansii rossiiskih TNK – Evrosoyuz i SNG" ("Two Directions of the Expansion of Russian TNCs: The European Union and the CIS"), *Mirovaya ekonomika i mezhdunarodnye otnosheniya*, no. 2 (2006): 101.
[44] Laurila, "Transit Transport Between the European Union and Russia in Light of Russian Geopolitics and Economics," 27.
[45] Locatelli, "The Russian Oil Industry between Public and Private Governance," 1076.
[46] J. Robinson West, "The Future of Russian Energy," *The National Interest* (Summer 2005): 126.
[47] Vladimir Milov, "Inostrannye investory i vlast" ("Foreign Investors and the State"), *Neftegazovaya Vertikal'*, no. 16 (Nov. 2004): 5.

for ensuring the competitive environment within the sector, which was conceived as the overarching rationale behind the reform itself. If foreign companies are intentionally barred from participating in tenders to purchase power-generating companies, then the latter will be bought by the Russian financial-industrial groups (FIGs); such a development will likely lead to extensive processes of the cartel-type division of the market, a wave of mergers and acquisitions, and non-market mechanisms of price formation. It is only through the participation of foreign companies that it will be possible not only to privatize the assets, but also to achieve the diversification of ownership and the ensuing development of competitive processes.[48]

Thus, on the whole, it is clear that the long-term development of the Russian energy sector is dependent on the sustained high levels of investment, including FDI.

1.2.3. International Energy Companies' Interest in Investing in Russia

On their part, major international oil companies are also interested in investing into the Russian energy sector. Aside from the opportunity to make high profits, there are other important reasons for such an interest. In light of the growing global energy consumption, coupled with the decline of many developed oil reserves in politically stable environments, oil companies search for opportunities to replace their reserves and thus invest in exploration activities in locations that they would previously have considered too costly or politically risky. With the increasing political instability in the Middle East and the renationalization trends present in Latin America (e.g. in Bolivia and Argentina), the former Soviet republics and particularly Russia become an increasingly attractive option for IOC's. One can observe a similar situation with respect to natural gas: Russia, possessing the world's largest gas reserves (particularly in the Barents and

[48] Milov, interview, "Reforma energetiki poka ne prinesla rezul'tatov" ("Energy Reform Has Not Engendered Results Yet"), *RBC Daily,* February 19, 2004.

Pechora Seas and the Sea of Okhotsk)[49] becomes all the more interesting as an investment location for IOC's.[50]

A puzzling situation thus emerges: if there is an objective need for foreign direct investment in the Russian energy sector, and the IOC's themselves would be very much interested in expanding their activities in Russia, then how can we explain the much-publicized tendency on the part of the Russian government to limit foreign investment in the sector? Before we proceed to develop an explanation for this puzzle, let us take a closer look at the actual situation and tendencies with regard to FDI in the energy sector.

1.3. Russia's Policy toward FDI in the Energy Sector: Ambiguities and Inconsistencies

First of all, it is important to note that even though there have been indeed a number of tendencies that have rightfully alarmed foreign investors, the picture created by the Western media may be overly simplified. FDI does have a role to play in the Russian energy sector, and there are examples of official discourse in which FDI is presented in a positive light.

1.3.1. Positive Developments

The history of large-scale foreign investment in the Russian energy sector started in the mid-1990's, when Russia signed three important production-sharing agreements (PSA) concerning expensive oil and gas exploration and development projects: Sakhalin-1 in June 1995 with ExxonMobil; Sakhalin-2 in June 1994 with Royal Dutch/Shell, and Kharyaga in Siberia in

[49] Bezuglova, "Razvitie rynka kapitala v energetike," 578.
[50] Page, "Prospects for Foreign Investment in the Russian Oil and Gas Industry," 2-3.

1995, with the French Total SA, with additional participation of India and Japan.[51] Among other positive examples of FDI in Russia is British Petroleum's purchase in 2003 of a 50% stake in the Tyumen Oil Company (TNK), which has been the largest foreign purchase of Russian equity.[52] In June 2003, Gazprom organized its first joint venture for natural gas production with the German company Wintershall;[53] and in 2006, the government lifted restrictions on foreign ownership of Gazprom shares.[54] Gazprom, the Russian gas giant, has successfully cooperated with E.ON Ruhrgas, which has a 6.4% stake in Gazprom and is the only foreign company on the corporation's board.[55] Lukoil, a major Russian oil company, and Conoco Philips have also established a joint venture in the area of Russian oil production and transport.[56] There have also been some positive developments in the economy at large: early in 2005, Russia was re-rated to investment-grade status by all major credit rating agencies; on July 1, 2006, the Russian ruble was made fully convertible, which, according to OECD, has been a "positive step to strengthening business confidence and increasing investment flows in Russia."[57]

In the electricity sector, Anatolii Chubais, the head of the Russian electricity monopoly RAO UES, has been very vocal in stressing the need for investment, including FDI, in particular in generating capacities, as part of the deregulation reform of this natural monopoly.[58] He has also emphasized the need to attract "strategic" partners from among foreign companies, naming

[51] Deloitte, "Investicii v rossiiskuyu neftegazovuyu otrasl'"
[52] "Not Beyond Petroleum," *Economist,* February 15, 2003.
[53] Structure of gas industry PDF
[54] Benford, "EU Energy Policy: Internal Developments and External Challenges," 45.
[55] Judy Dempsey, "Russian Energy Sector Needs Foreign Funds," *International Herald Tribune,* May 19, 2005.
[56] Ministry of Industry and Energy, "Energodialog – novaya iteraciya" ("The Energy Dialogue – A New Iteration") March 12, 2007.
[57] OECD, "Russia Should Do More to Attract FDI"
[58] Vladimir Zuykov, "V rossiiskuyu energetiku nuzhno smelee privlekat' inostrannye investitsii" (One Must Increase the Inflow of Foreign Investment in the Russian Energy Sector"), *ITAR TASS,* April 3, 2006.

Italy's Enel, Germany's E.ON, the US's AES, and Finland's Fortum as viable options.[59] Up until recently Fortum was the only foreign investor with a blocking stake in a Russian power generating company (TGK-1). Yet on May 24, 2007, the Gazprom-friendly E.ON Ruhrgas and the Russian company STS-Energy announced the creation of a joint venture which will participate in the auction for the Tyumen Power Generating Company later this year (2007).[60]

Finally, high-ranking officials have also made statements to the effect of Russia's being open to foreign investment. In 2002, in the joint statement following the Russia-US Energy Dialogue, Russian President Putin and US President Bush emphasized the following areas: "commercial cooperation in the energy sector… in exploration, production, refining, transportation and marketing of energy, as well as in implementation of joint projects including those in third countries; encourag[ing] investment aimed at the further development and modernization of the fuel and energy sector of Russia, including expansion of oil and gas production in Eastern Siberia, the Far East, and offshore areas."[61] In January 2007 at the World Economic Forum in Davos, Russia's First Deputy Prime Minister and Gazprom Chairman Dmitrii Medvedev made a claim that Russia was interested in promoting private investment in a wide range of activities in the energy sector, stressing the important role of foreign investment in bringing new technologies to the industry. [62]

[59] Nikolay Gorelov, "Bor'ba s monopolizmom Gazproma" ("The Struggle against Gazprom's Monopolist Activities"), *Vremya Novostey Online*, no. 24, February 12, 2007.
[60] «E.ON planiruet investirovat' v Rossiyu 2 mlrd evro" (E.ON Plans to Invest 2 Bln Euros in Russia"), *Neftegaz.ru*, May 24, 2007.
[61] Administration of George W. Bush, "Joint Statement by President George W. Bush and President Vladimir V. Putin on the New U.S.-Russian Energy Dialogue," May 24, 2002, 903-904
[62] "Rossiya budet uvelichivat' rossiiskie i inostrannye investicii v energetiku" ("Russia Will Increase Russian and Foreign Investment in the Energy Sector"), *RosTeplo.Ru*, January 30, 2007.

1.3.2. Negative Developments

At the same time, it is true that foreign investors do face a number of difficulties and restrictions in Russia. First of all, the investment climate in Russia leaves much room for improvement: in 2006, the country was ranked 62nd in 125 in the Global Competitiveness Report produced by the World Economic Forum; while Transparency International ranked it 126th of 159 countries in its Corruption Perceptions Index.[63]

Russian energy policy has generally been characterized by uncertainty and inconsistency: for instance, in the 1990's, the oil and coal industries were liberalized and privatized, while gas and electricity were not; general price liberalization was offset by the continued state regulation of energy prices; and enterprise reform did not touch the large centralized companies, such as Gazprom and RAO UES.[64] While Putin's first presidential term gave hopes for further liberalization of the energy sector, as part of the market-oriented Gref Program was adopted in 2001, during the second term, there has been a tendency toward strengthening state control over the energy sector.

The legal basis of regulation of FDI in Russia also leaves much to be desired. The Energy Strategy of the Russian Federation, adopted in May 2003, lay out broad goals, yet did not specify the means through which these goals were to be achieved, nor did it contain official policy toward foreign companies wishing to conduct their activities in Russia.[65] In 2003, Prime Minister Kasyanov also announced changes in the PSA law, saying that a number of strategically important fields were excluded from foreign participation.[66] Russia has repeatedly refused to

[63] OECD, "Russia Should Do More to Attract FDI."
[64] Institute for Energy Policy, "Problemy energeticheskoy politiki Rossii" ("Problems of Russian Energy Policy"), 23.
[65] Alexei Grivach, "Plus desyat' let bez prava perepiski. Energostrategiyu dlya preemnika Vladimira Putina peredelayut iz staroy." *Vremya Novostey Online* no. 163, September 8, 2006, http://www.vremya.ru/print/160546.html.
[66] Bradshaw, "Foreign Investment in the Russian Oil and Gas Industry: Lessons from Sakhalin," 3.

ratify the European Energy Charter, which would grant foreign companies access to its oil and gas deposits and transit pipelines – a stance reiterated by Putin at the November 2006 EU-Russia Summit.[67] In addition, in January 2007 the Russian government has ratified a draft law on "strategic sectors," under which foreign ownership of Russian companies, particularly in the energy sector, would be limited, and foreign companies will not be able to obtain controlling stakes in a number of projects. According to Natural Resources Minister Trutnev's suggestion, 10 oil wells and 26 gas fields may be classified as "strategic."[68] Currently, even though Russia receives more FDI than in previous years, very little of it goes into long-term energy projects which require large sums and necessitate the protection of ownership rights by the government.[69]

Finally, some other recent developments that have caused concern among foreign investors have had to do with the threats of the Federal Nature Inspectorate (*Rosprirodnadzor)* to revoke licenses of foreign companies working in Russia, such as Royal Dutch/ Shell in the Sakhalin-2 project or TNK-BP in the development of the Kovykta field, on the grounds of alleged environmental violations. [70]

1.4. Conclusion

On the whole, as one may conclude, Russia experiences a genuine need in greater inflows of private investment, and FDI in particular. Moreover, given today's situation in the global energy market, major international energy companies are also interested in investing in Russia.

[67] "EU Blocked in Raid on Russian markets," *Morning Star,* November 25, 2006.
[68] "Russian Government Passes Draft Law to Restrict Foreign Ownership of Strategic Companies," *AFX International Focus,* January 31, 2007.
[69] Perovic and Orttung, "Russia's Energy Policy: Should Europe Worry?," 3.
[70] "Sud prekratil rassmotrenie iska TNK-BP po Kovykte" (The Court Ruled Negative in TNK-BP's Kovykta Suit") *RosBiznes Consulting,* May 28. 2007.

Despite these two facts, Russia's official policy toward FDI has been characterized by contradictory developments and a trend toward limiting foreign presence in the energy sector. It is this puzzle that the following two chapters will try to find explanations for, relying on the theoretical framework laid out in the introduction.

Chapter 2. Russia's Policy toward FDI in the Making: A Patchwork of Actors

The previous chapter discussed the apparent mismatch between the need for investment and the current policy on FDI in the energy sector. A popular explanation stresses Russia's "energy nationalism," picturing it as an example of biased and irrational thinking. When discussing the Russian energy policy, the Western media is likely to "present President Vladimir Putin as a gangster with a gasoline pump and a Soviet Commissar wielding Gazprom's massive pipeline network."[71] Even though the reasons for such an impression may be altogether quite understandable, the underlying message, however, misses the point, since it contains the assumption that the Russian government (and personally the Russian President) can single-handedly formulate and conduct the type of energy policy it desires to have. This is precisely the assumption I would like to refute in this part, using Segbers' concept of a patchwork of actors. As will be shown in this chapter, the reasons for Russia's shifting stance toward FDI in the energy sector lie in the fact that the evolution of the country's energy policy is the result of the ongoing conflict of interests of numerous actors and stakeholders, the influence of which may be different at different periods of time.

[71] Perovic and Orttung, "Russia's Energy Policy: Should Europe Worry?," 2.

2.1. Russian Government as a Divided Actor

2.1.1. Heterogeneity of Public Administration

In the words of Adam Landes, a London-based analyst at the Russian Renaissance Capital bank, "Russia unfortunately has an energy policy where everyone has a say, so no one knows who's in charge."[72] Rutland described such a policy paradigm as the "pluralist school," which lacks a pre-set pattern of policy-making; instead, it involves an "open-ended process in which rival groups compete to influence policies as they flow through the decision process."[73] Similarly to other governments, Moscow officials do not speak with one voice when it comes to the issue as important as energy is for Russia. A part of the Russian political establishment remains more open and outward-oriented, believing in the need to fully integrate Russia into the global economy and to promote cooperation with major oil and gas consumers, yet there are also groups that vehemently oppose giving more control to foreign investors.[74]

In his analysis of the business-state relationship in Russia, Yakovlev, too, argues that there exists a "heterogeneity of public administration and internal bureaucratic in the system of public governance in Russia."[75] In his view, private companies are involved in the struggle of interests between top-level government officials and middle-level bureaucrats. According to Yakovlev, the Russian "super-elite" has a different structure of preferences with a longer-term orientation and is actually interested in promoting long-term economic growth, considering foreign investment to be an important factor for economic modernization. In addition, federal

[72] Jason Bush and Michael S. Serrill, "What's Holding Back the Flood of Russian Oil?" *Business Week*, July 25, 2005.
[73] Peter Rutland, "Oil, Politics and Foreign Policy" in *The Political Economy of Russian Oil*, ed. David Lane (Lanham: Rowman and Littlefield, 1999), cited in Debra Johnson, "EU-Russian Energy Policy – Single or Multiple Policy Paradigms?" *Energy and Environment* 15, no. 3 (2004): 454.
[74] Gawdat Bahgat, "Russia's Oil Potential: Prospects and Implications," *OPEC Review* (June 2004): 136.
[75] Yakovlev, "The Evolution of Business-State Interaction in Russia: From State Capture to Business Capture?," 1048.

agencies are competing for resources and power, which may also translate into the differences in their attitudes toward foreign companies investing in the Russian energy sector. Finally, there is also a competition between federal and regional authorities, with the latter being more interested in having major foreign companies operate on their territory, improving the state of the local economy.[76]

A closer look at the economic situation in Russia in a dynamic perspective allows one to find a number of examples of bureaucratic divisions over important economic issues, including the policy on FDI. Discussing the proposed structural reform in the Russian electricity and gas industries, Tompson identifies numerous instances of bureaucratic infighting and the divisions within the executive branch with regard to the policy in the energy sector.[77] While many of these debates take place behind the scenes and thus are not visible to the general public, there have been a number of statements made by various Russian officials and businessmen that testify to the existence of controversy over private investment and FDI in the energy sector. In 2004, for example, both government and Transneft officials openly admitted to the existence of a "highly polarized debate" in the political couloirs concerning private investment in export pipelines. While the Ministry of Economic Development and Trade, which represents the liberal, market-oriented interests within the executive branch, insisted on the complete liberalization of the system, the conservative groups were resolved not to allow any non-state players access to the export infrastructure.[78] In October 2006 the Russian Economy Minister German Gref made a public statement to the effect that one of the main obstacles hindering the improvement of Russia's investment climate was the "pressure of excessive government regulation on the economy," adding that attracting more investment would also depend on the transparency in the

[76] Ibid, 1050-1051.
[77] Tompson, "Putin's Challenge," 936.
[78] Gorst, "Russian Pipeline Strategies," 11.

country's court and law enforcement systems.[79] It thus becomes apparent that the Ministry of Economic Development and especially its head Gref, informed by the liberal views on the market economy, are actors that are interested in attracting FDI to the Russian energy sector. The other key ministry in formulating energy policy, including policy toward FDI, is the Ministry of Industry and Energy headed by Viktor Khristenko. This federal ministry has been known for its "markedly conservative" views, as has been seen in a variety of cases, including the negotiations for WTO accession.[80]

2.1.2. Diverging Views on the Model of Economic Development

Speaking of the diversity of views and positions concerning the prospects and direction for Russia's economic development, it is important to note the contribution of Mau, who has been able to broadly categorize the different views on models of economic growth present within the government:

a) *Etatist* model;

b) *Model based on the dominance of major conglomerates, such as financial-industrials groups (FIGs);*

c) An approach featuring drastically decreased government participation in the economy, including a significant reduction of the government's budgets at all levels;

d) Model which stresses economic growth through encouraging enterprise activity and creating a favorable investment climate both for national and foreign companies. This option is contingent on the presence of adequately developed institutions.

[79] "Excessive Government Regulation Hinders Investment in Russia," *RosBusinessConsulting Database*, October 16, 2006.
[80] David A. Dyker, "Russian Accession to the WTO," *Post-Communist Economies* 16, no. 1 (March 2004): 15.

In Mau's opinion, the feasible overall strategy adopted by the Russian government will probably be a combination of the last three models.[81] These divisions are important to keep in mind as we proceed to analyze the existence of various factions within the executive branch of power, since some of the more important differences between them are ideological.

2.1.3. Factions within the Federal Executive Branch

In fact, while, on the one hand, there has been a marked tendency toward concentration of power in the executive branch at the federal level during Putin's presidency, this very same development implies that the internal divisions within the Kremlin become all the more important for determining policy. In his analysis of the factional struggles within the Russian federal executive, Bremmer identifies three main groups:

a) the market- and FDI-friendly "liberals," such as Economy Minister German Gref and Finance Minister Aleksei Kudrin (the weakest group in Bremmer's view).

b) The "technocrats," represented by First Deputy Prime Minister and Gazprom chairman Dmitrii Medvedev and Gazprom president Aleksei Miller, whose goal is to strengthen the position of this gas monopoly. The tensions between Gazprom and other factions, as well as the extent of the company's influence over certain regulatory bodies, became evident, for example, in 2004, the Federal Service for Anti-Monopoly Policy found that Gazprom used the aid from the Federal Energy Commission to abuse its position within the downstream sector, violating the anti-monopoly legislation.[82]

[81] Vladimir Mau, *From Crisis to Growth* (London: Centre for Research into Post-Communist Economies (CRCE), 2005), 214-215.
[82] Rudiger Ahrend and William Tompson, "Unnatural Monopoly: The Endless Wait for Gas Sector Reform in Russia," *Europe-Asia Studies* 57, no. 6 (2005): 802.

c) The "*siloviki*," probably the most powerful group of the three. For the most part, this group comprises officials coming from the military, as well as from law enforcement and intelligence agencies, such as the Federal Security Service (FSB), who are believed to be especially close to Putin and exercise significant influence over state policy. Some individuals in this group, however, do not fit the profile above: a noteworthy example is Sergei Bogdanchikov, the influential president of the state-owned oil company Rosneft. In what is also relevant for this research, the *siloviki* control the Federal Energy Agency (a substructure of the Ministry of Industry and Energy), which has a significant regulatory power in the energy sector. The *siloviki* have also infiltrated other groups, industries, and agencies: for instance, while Gazprom is controlled by the technocrats Miller and Medvedev and is generally believed to be hostile to the *siloviki*, four of Gazprom's vice presidents have links to the lead *siloviki* Ivanov, Sechin, and Patrushev. The *siloviki* are believed to be united by a set of views and positions on key issues in Russian politics, including a preference for state intervention into economics, economic nationalism and opposition to foreign investment and foreign ownership of natural resources, and a desire to reassert Russia's power and influence in the international arena and particularly in post-Soviet space.[83] The general tendency of Russian official state policy to reflect this set of views in the recent times bears witness to the extent of the *siloviki*'s influence. For instance, the widely discussed draft law on strategic sectors in the economy, which was ratified by the Russian government in January 2007 and aims to exclude foreign investors from holding controlling stakes in "strategic" Russian companies, especially in the energy sector, has been pushed through by the *siloviki* faction. The draft law contains a provision concerning a mechanism of issuing permissions to foreign investors, and the committee charged with this responsibility is expected

[83] Ian Bremmer and Samuel Charap, "The Siloviki in Putin's Russia: Who They Are and What They Want," *The Washington Quarterly* 30, no. 1 (Winter 2006-07): 83–86, 88, 89.

to consist of the representatives of the sector insiders and of the Federal Security Service (FSB).[84]

2.1.4. Ministry of Natural Resources: An Unclear Agenda?

For some government agencies, it is not so easy to determine whether they belong to any of these three groups. For instance, the Ministry of Natural Resources headed by Yuri Trutnev came to the attention of investors in October 2006 when it threatened to apply a full range of sanctions to Shell, including the withdrawal of the company's license, as a result of alleged environmental violations at its Sakhalin-2 project. This incident has been seen by many analysts as a pretext on the part of the Kremlin to continue its policy of pushing out foreign investors from the energy sector.[85] In addition, in my personal interview with a representative of ExxonMobil, the company developing the Sakhalin-2 project, it was also a subdivision of the Ministry (namely, the Federal Nature Inspectorate, or *Rosprirodnadzor*) that was named as an agency that is least supportive of foreign investment in the energy sector through applying "different levels of scrutiny to national and foreign companies."[86] Yet early this year (2007), it was Yuganskneftegaz, a subsidiary company of the state-owned Rosneft, that was accused by Rosprirodnadzor of numerous environmental violations and, like Shell, was threatened with a license revocation,[87] which makes the link between this federal agency and the *siloviki* in the federal executive somewhat more doubtful. Some analysts do believe that in the case of the Sakhalin-2 the Ministry of Natural Resources had legitimate reasons for its complaints. After all,

[84] "Russian Government Passes Draft Law to Restrict Foreign Ownership of Strategic Companies," *AFX News*, January 31, 2007.
[85] "Russian Energy Minister Puts New Pressure on Shell: Fix Environmental Problems or Face Sanctions," *The Calgary Herald*, October 16, 2006, D5.
[86] Author's interview with a representative of ExxonMobil in Sakhalin, Russian Federation (anonymous).
[87] Anna Gorshkova, "Mitvol' vzyalsya za Yuganskneftegaz," *Vremya Novostey*, January 21, 2007.

it is precisely because of the concerns with the environmental impact of the project that the EBRD had refused to issue a credit to "Sakhalin Energy," the consortium of foreign companies working on the project.[88] Natural Resources Minister Trutnev has also supported amendments to the Law of Natural Resources that, aimed at ensuring the long-term recoverability of the country's oil and gas resources, would enforce stricter observance of licenses and encourage producers to invest in the exploration of new fields rather than in draining the existing ones.[89]

Alternatively, however, the conflicts over potential revocation of licenses may be interpreted to be caused by the internal bureaucratic rivalry between the Ministry of Natural Resources and the Ministry of Industry and Energy, since both are involved in the process of issuing licenses for exploration and development of natural resources, yet the precise division of responsibilities between them remains unclear and contested.[90] Finally, yet another explanation of the actions of the Ministry of Natural Resources may emphasize the fact that at the end of the day, the Ministry's confrontation with Royal Dutch/ Shell over the company's environmental record benefited Gazprom, which had been negotiating to buy part of Shell's stake in the Sakhalin-2 project yet had been unpleasantly surprised when in July 2006 Shell unexpectedly announced a sudden rise in the implementation costs of the second stage of the project from 12 to 20 billion USD, which implied that the cost of the assets that Gazprom was planning to purchase also increased dramatically. Already a week later, Rosprirodnadzor pressed charges against Shell and its Japanese partners, citing environmental violations. The story ended well for Gazprom, which was finally able to obtain a controlling stake in the project in December 2006.[91]

[88] Mikhail Subbotin, "Sakhalin – eto vser'ez i nadolgo" ("Sakhalin is Something That Is Serious and Will Be There for A Long Time," *Mirovaya energetika* no. 4 (April 2007).
[89] Gorst, "Russian Pipeline Strategies: Business versus Politics," 12
[90] Locatelli, "The Russian Oil Industry between Public and Private Governance," 1079.
[91] Subbotin, "Sakhalin – eto vser'ez i nadolgo."

The case of the Sakhalin-2 project is also an illustration of the fact that the character of Russian legislation on product-sharing agreements is part of the reason why many groups within the government have felt the need to change the terms on which foreign investors operate in Russia. The law on PSA's was adopted in 1995, when Russia was undergoing an extremely complex economic transition and desperately needed foreign investment to develop its natural resources; it also happened at the time when world prices on hydrocarbons were low. Today, given the changed situation on the world energy market and Russia's much stronger economic and political position internationally, many regard legislation on PSA's as being outdated. These agreements specified that the Russian government would receive a share of the profits only the foreign company in charge the project would reimburse its operating costs. This, of course, created a potential incentive for the companies to inflate their operating costs and thus reduce Russian profits. As such, Shell's announcement of a major increase in the operating costs in the Sakhalin-2 project was negatively perceived not only by Gazprom, but also by a number of groups within the government, since it was seen as a conscious attempt on the part of the foreign companies to deprive the Russian side from the benefits it was supposed to receive. Another case in which the Rosprirodnadzor and Rosnedra brought the case against a foreign company took place in February 2007, when these federal agencies notified the subsidiary company of TNK-BP developing the Kovykta gas field in Eastern Siberia about a possible revocation of a license on the grounds of the violation of the license agreement, according to which the company was responsible for providing the Irkutsk Oblast with 9 billion cu. m of gas starting in 2006.[92]

[92] "Sud prekratil rassmotrenie iska TNK-BP po Kovykte" (The Court Ruled Negative in TNK's Suit on Kovykta), *RosBiznes Consulting,* May 28. 2007. http://top.rbc.ru/economics/28/05/2007/104243.shtml?print

2.1.5. Federal-Regional Conflict of Interests

Finally, yet another division that underlines the divided nature of the Russian government in the field of energy policy has to do with the tensions between the regions and the federal center. Despite Putin's policy of strengthening "the vertical of power" and of concentrating power in the federal center, a number of experts argue that the role of regional authorities remains important for the prospects of big businesses conducting their activities in Russia. Orttung finds that "most of the state-business interaction in Russia today takes place at the regional level."[93] In addition, in a number of resource-rich regions in Siberia, the top regional officials are closely affiliated with major businesses. For instance, in the Tyumen Oblast the position of the head of the board of the Tyumen Oil Company has been occupied by the region's governors. Similarly, in the Yamal-Nenets Autonomous Okrug, a major site of Gazprom's natural gas extraction, the governor Yuri Neelov has close ties with the gas monopoly.[94] As a rule, regional authorities have exhibited positive attitudes toward foreign investment in their regions. A case in point is Sakhalin, which is frequently described as a "foreign-influenced region." Due to the fact that the region is the location of the activities of the world's major oil and gas companies which are developing the island's oil and gas reserves, it received more foreign investment than any Russian region with the exception of Moscow and Moskovskaya Oblast.[95] In my personal interview with an ExxonMobil representative, the latter, too, noted that the regional administration had been supportive of foreign investment in the region and of working with foreign companies. A similar situation can be observed in the resource-rich and rather independent regions of Tatarstan and Bashkortostan, whose leaders have also been open to FDI in the area of energy.

[93] Robert W. Orttung, "Business and Politics in the Russian Regions," *Problems of Post-Communism* 51, no. 2 (March/April 2004): 51.
[94] Ibid, 50.
[95] Ibid, 55.

On the whole, as we can see, the shifts and turns in the Russian policy toward FDI in the energy sector can be explained by the heterogeneity of public administration, the factional divisions within the executive, the absence of consensus on the accepted model of economic development for Russia, as well as by the tensions between the federal center and regional authorities. The state and state agencies, however, are not the only actors and stakeholders when it comes to energy policy and attitudes toward FDI. The role of large corporations themselves, both Russian and foreign, should not be underestimated. In this regard, I will put emphasis on the role of Gazprom, the most influential business actor in Russia, which has extensive influence on the energy sector at large and on the policy outcomes in this sphere.

2.2. The Role of Large Corporations: Key Actors

2.2.1. Energy Lobby: The Impact on the PSA Legislation

Much can be concluded from the analysis of the changing business-state relationship in Russia. The Russian privatization in the 1990's benefited a narrow circle of insider companies, who, in the absence of competition from the side of foreign companies, were able to accumulate significant assets at very low cost. The insider-dominated mode of privatization seems to be an important factor determining the inflow of FDI into a country; with rare exceptions, transition countries adopted a reluctant policy toward FDI for reasons such as the desire to give a preference to national companies and in particular to the insiders such as managers, employers or public actors.[96]

The Russian case is a good illustration of this finding. At first, in the early 1990's, Russian companies were interested in such a form of FDI as joint ventures with foreign partners,

[96] Fabry, "The Role of Inward FDI in the Transition Countries in Europe," 4.

since JVs were seen as the only way to gain access to markets abroad and to Western technology. However, as the major Russian oil companies became vertically integrated and started commanding much greater resources, the interest in JV fell drastically, as FDI in the energy sector increasingly took the form of production-sharing agreements (PSAs).[97] Russian oil companies have been hesitant toward PSAs, perceiving them as giving a competitive advantage to the competing foreign firms (such as, for example, beneficial tax treatment). In addition, as the large national companies accumulated more and more financial resources and technological expertise, their interest in cooperation with foreign investors decreased. It was only after the oil price collapse that interest in PSAs was renewed and Russia made fast progress with amending the PSA law. Yet this attitude was reverted to the original suspicion already in 1999, following the increase in international oil prices, which resulted in the strengthened confidence of Russian companies. In 2003, the Russian oil lobby successfully pushed the Duma to adopt a law which introduced a number of limitations into the existing PSA regime.[98]

2.2.2. The case of Gazprom

2.2.2.1. Gazprom: State Capture or Business Capture?

When analyzing the business-state relationship in the energy sector, the most important player that requires close attention is, without doubt, Gazprom. On the one hand, the state controls the majority of the company's shares, and the membership of the board of directors of the company includes CEO Alexei Miller, appointed by Putin; Dmitrii Medvedev, the chairman of the board and simultaneously the First Deputy Prime Minister, as well as Minister of Natural

[97] Andreas Heinrich, Julia Kusznir, and Heiko Pleines, "Foreign Investment and National Interests in the Russian Oil and Gas Industry," *Post-Communist Economies* 14, no. 4 (2002): 498.
[98] Bahgat, "Russia's Oil Potential: Prospects and Implications," 139.

Resources Khristenko and Economy Minister Gref.[99] Yet, while it is common to present the company as being state-controlled and thus conducting the policy that represents the interests of the government, the reality is that the extent to which the state can manipulate Gazprom appears to be rather limited. According to Grigoryev, "[state] regulation of Gazprom is really but a concept," and "Gazprom is a quasi-ministry that is regulating itself,"[100] the point also found in Ahrend and Tompson's analysis, which states that "it can sometimes be difficult to identify where the state budget ends and Gazprom's begins."[101] For instance, the Federal Tariff Service is responsible for setting gas prices for the domestic markets, as well as gas transmission tariffs for non-Gazprom organizations. Yet this activity always takes place in consultation with Gazprom; the lack of transparency within the company also means that in many cases, Gazprom alone has the necessary information upon which the government bases its regulations.[102]

2.2.2.2. Gazprom: A Self-Interested Monopolist

Gazprom's behavior in the Russian and foreign energy markets bears witness to the company's ambitions to improve its international status and maintain its power domestically. Because of the company's sheer size, importance and its contributions to the state budget, Gazprom enjoys high leverage in Russia. For instance, the already mentioned row of the Ministry of Natural Resources with the foreign companies carrying out the Sakhalin-2 project happened exactly at the time when Gazprom was looking for ways to obtain a share in the project. In the end, as we know, Gazprom succeeded, and in April 2007 the company became the

[99] Gazprom Website, "Board of Directors," http://www.gazprom.com/eng/articles/article8823.shtml.
[100] Grigoryev, "Deregulating the Russian Gas Sector," 3041.
[101] Ahrend and Tompson, "The Endless Wait for Gas Sector Reform in Russia," 803.
[102] Grigoryev, "Deregulating the Russian Gas Sector," 3041.

owner of a controlling stake in the Sakhalin-2[103]. Over the past several years, Gazprom has relied on quite an aggressive strategy in the markets in Russia, expanding not only in the gas market, but also in other fields, such as oil production and power generation. Formally, Gazprom is not against having independent producers in the Russian gas market (who anyway account for only a very small share of Russia's total gas production), since the domestic market is not a priority activity for the company, which makes most of its profits from exports.[104] However, given Gazprom's activities in trying to obtain control over independents, as well as the informal support it receives from the government in its activities,[105] it makes sense to reassess this claim. Not only that, but Gazprom has also been actively buying assets in other sectors, such as, for example, the coal industry (The Siberian Coal Energy Company, or SUEK).[106] In the oil sector, notable examples include Gazprom's purchase of a 72.7% stake (13.1 billion USD) in Sibneft, Russia's fifth-biggest oil company;[107] as well as the takeover of the Yukos assets in April 2007.[108] In addition, this past year has seen Gazprom's penetration into the capital of power companies, which are being privatized as part of the reform of the electricity sector; such a move on the part of the monopoly undermines the very rationale of the reform, which is to create a competitive environment in the sector.[109] As for gas exports, their high profitability explains why Gazprom has been very reluctant to relinquish its informal control over the gas transit infrastructure. Gazprom's uncompromising position constitutes the main reason for Russia's refusal to sign the Energy Charter, since it would allow third parties access to the gas pipelines.

[103] "Sostoyalos' zasedanie koordinacionnogo komiteta po sakhalinskim proektam." *Gazprom.Ru,* May 24, 2007.
[104] Jake Benford, "EU Energy Policy: Internal Developments and External Challenges," *The Economic Intelligence Unit Limited, European Policy Analyst* (May 2006): 44.
[105] Vladimir Milov, "Problemy energeticheskoy politiki Rossii" (presentation), May 30, 2005, slide 33.
[106] Boris Rubashkin, "Ugolnyy Gazprom" ("Coal Gazprom), *NG Energiya*, April 10, 2007.
[107] "Oil's Well That Ends Well," *Economist*, Oct. 1, 2005.
[108] Andrew E. Kramer, "Gazprom to Gain Assets of Yukos after Auction," *The International Herald Tribune,* April 5, 2007.
[109] Milov, "Problemy energeticheskoy politiki Rossii," slide 33.

All in all, one may conclude that Gazprom is constantly trying to preserve and increase its influence in the sector.

2.2.2.3. Gazprom: Position toward Foreign Investment in the Energy Sector

Gazprom's position toward FDI, as far as one can tell, is not unequivocally positive or negative. Using Bremmer's classification of the company as belonging to the "technocratic" faction that has considerable impact on official state policy, Gazprom's position is informed more by utilitarian considerations rather than by a certain ideological stance. Moreover, like the Russian government, Gazprom is also not a completely unitary actor. Milov of the Institute for Energy Policy mentions the existence of a powerful "pipeline" lobby within the company, which is able to influence the firm's business strategy.[110] Gazprom's handling of the Shtokman field project is a case in point. The Shtokman field, located in the Barents Sea, contains very promising, yet extremely difficult to develop gas reserves. Aside from the need to invest exorbitantly large sums into the development of this field, a process which could take decades, the utter technological complexity of the project (particularly in the part related to LNG production, which is a completely new area of activity for the Russian gas sector) has led experts to justify the need for active foreign involvement in the project. In September 2005, Gazprom shortlisted several major international energy companies as candidates for the implementation of the first phase of the project, the building of an LNG production plant, promising to allow foreign investors to purchase up to 49% of the shares in the project. Yet already in October 2006 Gazprom's CEO Miller announced that Gazprom decided to take possession of 100% of the capital in the Shtokman project, and that the priority activity in the Shtokman project would be gas exports via pipelines (specifically, the Nord Stream gas pipelines that are currently being

[110] Vladimir Mirov, "Reforma energetiki poka ne prinesla rezul'tatov," *RBC Daily*, February 19, 2004.

built by Gazprom), rather than LNG production.[111] The latter, having been given a lower priority, will still necessitate the involvement of foreign companies, but only as subcontractors, rather than as strategic investors. This confirms Milov's observation concerning the influence of the pipeline lobby within the company, as well as the fact that Gazprom appears to be more interested in profiting from high revenues from its export activities and in taking advantage over its monopoly control over the pipelines, rather than in the long-term prospects of the gas sector development. Overall, it appears that Gazprom is interested in the technologies that foreign companies may bring, but it will only allow foreign investment on its own terms which would preclude any serious possibility for a foreign company to challenge the monopoly's position in the energy sector. As for the lack of financial resources, it is important to keep in mind that Gazprom is a financial-industrial group with powerful connections and as such is not limited by the budget constraints to the same extent as a smaller company would be, since it can obtain large sums through various arrangements, including informal ones.

2.3. Conclusion

Overall, the analysis of the key actors exercising influence on Russia's policy allows one to identify two most powerful constituencies: the *siloviki* faction within the federal government, and Gazprom as an extremely powerful national and global player. If the *siloviki* are characterized by a hostile stance toward foreign investment in Russia's natural resource industries, Gazprom's position seems to be less ideological, as the company is mostly concerned with preserving its monopoly position abroad and improving its status internationally. Therefore,

[111] "Gaz so Shtokmanovskogo mestorozhdeniya budet postavlyatsya truboprovodnym transportom na evropeyskiy rynok" ("Gas from the Shtokman Field Will Be Delivered to the European Market through The System of Pipelines"), *Gazprom.Ru*, October 9, 2006.

while the *siloviki* try to institutionalize restrictions on foreign investment in the energy sector through the adoption of respective legislation, Gazprom cooperates with a few select “strategic” foreign partners and uses its informal connections to curb the power of other foreign investors (such as, for example, Shell), if they happen to interfere with the monopoly’s sphere of interests.

CHAPTER 3. THE RUSSIAN ENERGY SECTOR: BETWEEN SOVIET LEGACIES AND GLOBALIZATION PRESSURES

As has been mentioned in the introduction, the energy sector is uniquely positioned, reflecting the impact two groups of factors: Soviet institutions and structures, on the one hand, and the pressures of globalization, on the other. As Segbers points out, "actors and institutions respond differently to the legacies of the past and the stimuli of the present, in local and global contexts."[112] The complex interplay of these two factors contributes to the difficulty of reaching a consensus on what the role of FDI should be in this sector, and therefore, translates into various inconsistencies in Russia's policy on FDI.

3.1. The Soviet Legacies in the Energy Sector

3.1.1. Poor allocation of investment resources

In many ways, the Russian energy sector is still affected by its Soviet legacies, many of which have implications for the state policy toward FDI in this sector. One of the most important features inherited from the period of the centrally planned economy is poor investment planning and as a result, poor allocation of investment resources. With regard to this issue, Csaba argues that one of the continuities from the Soviet past lies in the mechanism of resource allocation remains an "arbitrary, bureaucratic bargaining process without any market control."[113] The weaknesses of resource allocation, as has been shown in the previous parts, remain a problem in the oil and gas industry, where investment in short-term projects promising fast returns is often given preference over investment in more challenging long-term projects which, however, would

[112] Klaus Segbers, "Institutional Change in Russia: A Research Design," in *Explaining Post-Soviet Patchworks.* Vol. 2, *Pathways from the Past to the Global,* ed. Klaus Segbers (Aldershot, UK: Ashgate Publishing Ltd., 2001), 1.
[113] László Csaba, *The New Political Economy of Emerging Europe*, 2nd ed (Budapest: Akademiai Kiado, 2007), 127.

be critical for the future development of the sector (such as investment in the LNG production) and would incidentally also require significant amounts of FDI. The second important continuity from the Soviet period is an insufficient understanding of technology transfers.[114] As one can see, the combination of these factors may result in reluctance toward FDI inflows, even though the latter may be actually instrumental in bringing the much-needed investment and technologies into the industry.

3.1.2. High Energy Intensity of the Economy

Secondly, an enduring and well-attested characteristic of the entire Russian economy is extremely high levels of energy intensity. For instance, according to the Carnegie Research Center, in 2005 Russian economy consumed on average over 500 grams of the oil equivalent for each dollar of the GDP in purchasing power parity terms, or about 1.5 kg oil equivalent for each dollar in the GDP. In most developed and even developing economies this indicator is only a fraction of the Russian one and is likely to be within the range of 0.1-0.2 kg oil equivalent per GDP dollar.[115] That such high rates of energy intensity indeed reflect the Soviet legacies is proven by the fact that Ukraine and Kazakhastan, although located in different geographical and climatic zones, have similar indicators. The reasons include the Soviet industrial infrastructure, such as the energy-intensive industrial production, poorly insulated buildings and facilities, energy intensive appliances, automobiles, and so forth.[116] This high energy intensity is exacerbated by the constantly growing domestic energy demand, which puts in question Russia's ability to supply its own market and at the same time fulfill its export commitments. This factor

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[114] David A. Dyker, "Foreign Direct Investment in Transition Countries: A Global Perspective," in *Foreign Direct Investment and Technology Transfer in the Former Soviet Union,* ed. David A. Dyker (Cheltenham, UK: Edward Elgar, 1999): 10.
[115] Carnegie Research Center, "Problemy energeticheskoy politiki Rossii," (Moscow: Carnegie Center, 2005), 5.
[116] Ibid, 7.

is significant in that it reduces the competitiveness of the Russian economy at large. In addition, another negative legacy from the centrally planned economy in the energy sector has to do with the extent of the environmental damage – after all, Russia inherited one of the most polluting energy sectors in the world from the Soviet times.[117] Introducing energy-saving and environmentally-friendly technologies and infrastructure would raise the economy's competitiveness in the long run yet would require extensive investment, including FDI, into upgrading the infrastructure and improving corporate governance and thus are often shunned by Russian companies. However, as long as subsidized domestic energy prices (a leftover from the Soviet past in themselves) remain below the market price, there is little incentive for consumers to seriously consider optimizing their energy consumption.[118]

3.1.3. Soviet-Type Approach to Energy Policy

Russia's energy policy as described in the *Energy Strategy to 2020*, adopted in 2003, also features an outdated approach to policy-making. Similarly to the socialist five-year plans, the Strategy lists planned targets of energy production volumes, rather than clearly defining the rules of the game in the sector, the role of the markets, of competition, the state, and domestic and foreign energy companies. Nor does the Strategy define the means by which the stated goals are to be reached. Overall, the Energy Strategy does not present a well-developed vision of the development of the Russia and the government's expected role in it, which may explain the strong element of uncertainty and mutability present in Russia's policy today, including the policy on the politically sensitive subject of FDI.[119] In addition, the Strategy proposes an increase

[117] Diana Ürge-Vorsatz, Gergana Miladinova, and László Paizsc, "Energy in Transition: From the Iron Curtain to the European Union," *Energy Policy* 34 (2006): 2279.
[118] Ibid, 2283.
[119] Carnegie, "Problemy energeticheskoy politiki Rossii," 4.

in coal consumption as a way to decrease the economy's reliance on natural gas.[120] Given the high levels of pollution associated with coal consumption, one may conclude that environmental concerns currently do not constitute a top priority for Russian policy-makers, just as they were not a priority during the Soviet times.

The legacies from the Soviet past are also very present in Russia's gas sector. The centralized model of the sector raises doubts as to its ability to promptly adapt to the changing market conditions and the new challenges. In addition, according to Nesterenko, Gazprom's position as a monopoly on the gas market, as well as its organizational form as a vertically integrated financial-industrial group is an example of the influences of the Soviet past, manifest in the "persistence of links and networks, poor specification of property rights and poor enforcement of contracts."[121] West describes Gazprom as a "huge, Soviet-style bureaucracy that is unresponsive to senior management and has special-interest fiefdoms."[122] Eager to preserve its monopoly status, Gazprom is not welcoming toward foreign investors who could potentially challenge its position in the Russian energy sector.

3.1.4. Importance of Informal Institutions

When explaining the changing character of Russia's policy with regard to FDI in the energy sector, one more Soviet legacy appears to be critical, and that is the role of the informal institutions. Present already during the Soviet times, their influence increased even further as the institutional vacuum was created during the demise of the Soviet system. As Douglass North

[120] Government of the Russian Federation, "Energeticheskaya strategiya Rossii na period do 2020 goda," August 28, 2003.
[121] Andrei N. Nesterenko, "Markets between Soviet Legacy and Globalization: Neoinstitutionalist Perspectives on Transformation," in *Explaining Post-Soviet Patchworks.* Vol. 2, *Pathways from the Past to the Global*, ed. Klaus Segbers (Aldershot, UK: Ashgate Publishing Ltd., 2001), 83, 89.
[122] West, "The Future of Russian Energy," 126.

argues, “the collapse of formal institutions inevitably invites the emergence of informal institutions to fill the vacuum.”[123] Informal institutions permeate the Russian economy and politics, creating a system that has little transparency and benefits the insiders rather than the new entrants. In the absence of developed, well-functioning institutions, personal ties, informal connections, and an ad-hoc approach to policy-making become all the more important. This may explain why, in Bremmer’s analysis, a “well-placed individual within the right agency or body can become crucial in exercising influence on state policy.”[124] In general, the predominance of informalism hinders the development of clear rules of the game that would allow foreign investors to develop long-term prospects for working in the Russian market. It also allows powerful individuals to influence the government’s policy in accordance with their interests. The findings concerning the prevalence of informal rules rather than developed, transparent institutions are numerous. When analyzing the business-state relationships in Russia, Frye observes that successful lobbyists (which, of course, include the representatives of the energy sector) rely on various means to influence legislation, and an important one is personal consultations with state officials. This can be interpreted as evidence of such an element of the Soviet legacy as a continued reliance on personal ties rather than formal organizations.[125]

Also, the empirical evidence about Gazprom being its own regulator fits well with Olson’s argument that monopolists find it easier to succeed in state capture, since it is easier for them to overcome collective action problems.[126] Frye proposes his own take on this relationship, preferring to describe it as “elite exchange,” that is, a relationship in which “successful lobbyists

[123] North, *Institutions, Institutional Change and Economic Performance*, 36.
[124] Bremmer and Charap, “The Siloviki in Putin’s Russia,” 88.
[125] Timothy Frye, “Capture or Exchange? Business Lobbying in Russia,” *Europe-Asia Studies* 54, no. 7 (2002): 1018-1019.
[126] Ibid.

gain influence by providing benefits to state officials."[127] This can be evident, for instance, in the fact that the government's relationship with Gazprom has not always been smooth. At the end of the 1990's, the government tried to end Gazprom's monopoly status by creating competition in some parts of the natural sector, with little success. Additionally, in 1997 and 1998, as well as in 2000, the state tried to force the company to pay all its outstanding taxes.[128] It may be argued that Gazprom has been able to keep its monopoly position by allowing the state to benefit from its market strength (for instance, in conducting a certain type of policy with regard to "less-friendly" CIS states such as Georgia or Ukraine or selling gas at the domestic market at prices that arguably do not even cover production costs).

The legal basis for foreign investment in the energy sector also bears traces of predominance of the orientation toward informal rules. The body of legal regulations in this sphere has been criticized by many analysts as unclear, complicated, and constantly changing. However, such a situation may correspond to the overall bureaucratic interest of state agencies, for whom a clear, sound regulatory framework would imply the loss of opportunities to extract benefits for themselves while negotiating with foreign investors. Even the draft law on foreign investment in strategic sectors, which, while not particularly friendly toward foreign investors, could at least set clear and predictable rules of the game,[129] contains many characteristics that would give the Russian government much room for discretion. When the law was drafted, the Federal Security Service proposed inserting an unlimited list of reasons for refusing a foreign company entry into a "strategic sector," while the Ministry of Economic Development and Trade

[127] Ibid, 1021.
[128] Andreas Heinrich, "Large Corporations: The Case of Gazprom," in *Explaining Post-Soviet Patchworks.* Vol. 1, *Actors and Sectors in Russian between Accommodation and Resistance to Globalization*, ed. Klaus Segbers (Aldershot, UK: Ashgate Publishing Ltd., 2001), 102-103.
[129] Aleksandr Yurov, "Novym pravilam igry dlya inostrannyh investorov byt'" ("New Rules of the Game for Foreign Investors"), *RIA Novosti*, February 1, 2007.

criticized the law for creating grounds for corruption. The draft law that was ratified by the Russian government in January 2007 has been described as a compromise between the liberals and the conservatives, such as Ministry of Industry and Energy.[130] In its current form, the draft law still contains a provision according to which all foreign investment in strategic sectors, no matter how small, has to receive the direct permission of the President and the Government. According to Polukhin, such a system gives too much discretion to the latter and allows vested interests in the government to influence the decisions, since it does not clearly specify the grounds for refusal. Also, it does not provide for sufficient transparency and publicity.[131]

Some other features of activity in the energy sector also point to the existence of informal rules and institutions. For instance, the fact that the exact information on the available energy reserves in Russia is a matter of state secret makes international experts rely on estimates which can vary widely.[132] Another example is Gazprom's dual-pricing policy. The prices for the domestic market are regulated by the government and are negotiated between the monopoly and government on an annual basis, as part of a very opaque procedure. The consumer quotas awarded are also subject to change and may be adjusted several times a year, all of which leaves plenty of room for informal negotiations and bargaining. [133]

Finally, informal institutions provide a very valuable argument for why the Russian government seems to restrict foreign direct investment in the energy sector and why, at the same time, there are some successful deals in this field. After all, contrary to the fears raised after the Yukos affair concerning the potential renationalization of the oil sector, this has not been the

[130] "Russian Government Passes Draft Law to Restrict Foreign Ownership of Strategic Companies," *AFX News*, January 31, 2007.
[131] Aleksei Polukhin, "Akcii Putina podnimutsya," *Novaya Gazeta,* no. 16, March 6, 2006.
[132] Sadek Boussena and Catherine Locatelli, "Towards a More Coherent Oil Policy in Russia?" *OPEC Review* (Jun. 2005): 88, 91.
[133] Aldo Spanjer, "Russian Gas Price Reform and the EU–Russia Gas Relationship: Incentives, Consequences and European Security of Supply," *Energy Policy,* no. 35 (2007): 2892.

case. It seems more likely that the future developments in this area would rather focus on setting new – informal – rules of the game between the state and the business, in which the state will increase its influence not so much through purchasing or renationalizing energy companies, but rather through relying on a variety of legal, regulatory, and informal instruments of influence.[134]

3.1.5. Russia as a "Predatory" State

All in all, the Soviet legacies, including the importance of informal institutions and networks, have turned Russia into a type of the so-called "predatory state." In such a state, the elites take advantage of informal networks to enrich themselves and to increase their power. As Stavrakis insightfully notes, in such a state the boundaries between key societal sectors and institutions become unclear and fluid. For this reason, the legal regulatory framework in the area of FDI remains complex and opaque, since making it otherwise would significant curtail the influence and discretion of the elites.[135] Currently, for example, some analysts argue that the FDI in the energy sector is subject to an informal system of permission-issuing by the Kremlin. The examples given by the Carnegie center include the Russian government's permission for ConocoPhillips to purchase 7.6% of Lukoil's stock and for Total to purchase 25% of the shares in the Novatek gas company. At the same time, it is believed that the government blocked the sale of a significant amount of Sibneft shares to Total.[136] Another example of the poorly delineated boundaries between institutions include the fact that, for instance, some of the major decisions affecting the operation of foreign investors in the energy sector (for example, the decision on the dispute with Shell concerning possible license revocation on the ground of

[134] Carnegie Research Center, "
[135] Peter J. Stavrakis, "Russia's Evolution As a Predatory State," in *Russia's Uncertain Economic Future*, ed. John P. Hardt (New York: M.E. Sharpe, 2003),
[136] Carnegie, p. 25.

environmental violations) have been taken with direct participation of the Federal Security Service, a body that is officially charged with quite a different set of responsibilities.

3.2. The Impact of Globalization on the Russian Energy Sector

3.2.1. Regional Level

On the other hand, the Russian energy sector, as well as the actors responsible for policy-making toward FDI, is affected by a variety by pressures originating in the nature of the globalizing world economy. First of all, some Russian regions are naturally deeper impacted by global processes and as such are much more open to FDI. Sakhalin, for example, is one of the most open regions in Russa, since its prospects for future development and growth are contingent on the global oil and gas market situation. More specifically, much promise for Sakhalin has been associated with its ability to gain access to export markets in Northeast Asia.[137] As such, Sakhalin's regional authorities are known for their positive attitude toward FDI.

3.2.2. Federal Level

At the federal level Stavrakis's argument holds particularly true: according to him, since few predatory states could afford being purposefully isolated from the processes of economic globalization, which, however, demand the state's institutions to maintain at least a degree of legality and transparency, the strategy that predatory states use to solve this dilemma is that of "presentability." This concept implies the formal acceptance of market principles and norms and other demands associated with integration into global economy and the simultaneous reliance on

[137] Michael Bradshaw, "Foreign Investment in the Russian Oil and Gas Industry: Lessons from Sakhalin," 8.

informal rules and practices from the previous era to conduct business.[138] When analyzing Russian official discourses with regard to FDI in the energy sector, much of the dissonance between statements of intent and declarations, on the one hand, and the reality of operating in Russia that foreign investors are faced with, on the other, may be attributed precisely to the "presentability" strategy of the Russian government (to the degree it can conduct it, of course, given its nature as a divided actor). As such, Russian political leaders may make promising statements at the US-Russia energy dialogue, or at the World Economic Forum in Davos, like Dmitrii Medvedev, but this does not necessarily mean that the actual policy toward FDI has become benevolent.

3.2.3. Internationalization of Russia's Energy Companies: The Post-Soviet Space

Moreover, Russia's main companies within the sector, which exercise influence on policy-making in the area of energy, are becoming increasingly integrated into the global economy, and for the most part with the consent and support from the state. In Russia, the processes of globalization have been largely viewed in terms of the nation's geopolitical interests and activities in post-Soviet space.[139] For this reason, the first dimension of internationalization takes place in the post-Soviet place and is closely linked to Russia's foreign policy in the former Soviet republics. When discussing Russia FDI abroad, Kuznetsov makes a distinction between Russian FDI in post-Soviet countries and elsewhere (mostly in the EU). The former category of investment, as he claims, is motivated by a different set of factors, such as taking leadership of potential markets (often characterized by lower competition) at the first state of their business internationalization process; reconstructing the previous economic links and relations, also in

[138] Stavrakis, "Russia's Evolution as a Predatory State," 359.
[139] Seliger, "The Impact of Globalization," 7.

order to decrease labor and transportation costs, and finally, participation in political processes in the FSU, in order to ensure these republic's economic orientation toward Russia.[140] Heinrich, too, finds that Gazprom's strategy in the FSU is markedly more aggressive than its business activities in Europe.[141] Since an influential position in post-Soviet affairs has been a general line of several Russian governments, it is hardly surprising that the state has been increasingly active in protecting Russian business interests in the CIS,[142] where Russia arguably possesses a greater degree of influence. For instance, Lukoil's joint project with a Kazakhstan gas company to develop Khvalynskoe gas field in the Caspian Sea, had to be agreed not only between the companies, but also at the intergovernmental level.[143]

3.2.4. Internationalization of Russia's Energy Companies: Beyond the Post-Soviet Space

The second dimension of the internationalization of the Russian economy takes place outside the post-Soviet space and for the most part in the EU. While at first Russian government viewed Russian FDI abroad mostly as a latent form of capital flight (which a substantial portion of the investment most likely was), with Gazprom and Lukoil gaining an accepted place as important energy companies, the attitude has become much more favorable. Gazprom, for instance, has been aided by the government in its strategy to become a multinational energy company (with capitalization exceeding 300 billion USD, Gazprom has become the world's third biggest company, following ExxonMobil and General Electric).[144] Gazprom has also been the leader in the amount and transparency of its FDI in Europe,[145] forming strategic partnerships

[140] Kuznetsov, "Dva vektora ekspansii rossiiskih TNK," 98.
[141] Heinrich, "Large Corporations: The Case of Gazprom," 114.
[142] Bezuglova, "Razvitie rynka kapitala v energetike," 576-577.
[143] Ibid.
[144] Grigoryev, "Deregulating the Russian Gas Sector," 3042.
[145] Kuznetsov, "Dva vektora ekspansii rossiiskih TNK," 99.

with leading Western energy companies in order to gain access to new markets and to strengthen its reputation as a global player. Some of Gazprom's key strategic partners include Germany's Ruhrgas and BASF/ Wintershall and Italy's Eni.[146] Lukoil, too, has actively invested abroad, in particular in oil refineries in Romania, Bulgaria, and Ukraine.[147]

3.2.5. Implications of the Internationalization Process for Russia's Policy toward FDI in the Energy Sector

The implications of Russian companies' intensified activities abroad and their becoming "normal" international companies playing by accepted rules for the Russian policy toward FDI are evident. In the era of increased global competition, mobility, and transnational capital flows, full integration into the global economy, with all the benefits that are to be derived from that, is "greater transparency and predictability in the legal and economic environment."[148] A wary attitude toward FDI in the energy sector is not an exclusively Russian characteristic; the new EU Member States, who are particularly dependent on Russia for their energy supplies, have been especially suspicious toward FDI by Russian energy companies, perceiving it as an intention to manipulate their dependency on Russian energy supplies; Lithuania and Poland are two good examples of such an attitude.[149] Given the fact that the Russian government does not have effective foreign policy instruments to protect Russian business interests in the EU, the only feasible strategy becomes that of reciprocity, that is, having both sides agree to be open toward foreign investors, which may serve as an incentive for the Russian government and vested interests to relax their stance on foreign investment in the energy sector. For instance, when

[146] Heinrich, "Large Corporations: The Case of Gazprom," 110.
[147] Kuznetsov, "Dva vektora ekspansii rossiiskih TNK," 99.
[148] Stavrakis, "Russia's Evolution As a Predatory State," 362.
[149] Heiko Pleines, "Russian Business Interests and the Enlarged European Union," *Post-Communist Economies* 17, no. 3 (Sept. 2005):

inviting foreign investors to invest in the Russian electricity sector, RAO UES CEO Chubais made it a point that "Russian energy should be a two-way street. So that Russian companies can buy energy assets abroad and foreigners can buy assets in Russia."[150] In view of the plans of RAO UES to actively expand in the Central and Eastern European markets (in 2003, the company announced its intention to purchase power companies in Latvia, Lithuania, and Slovakia),[151] Chubais' emphasis on reciprocity becomes very understandable.

3.3. The Interplay between Soviet Legacies and Global Pressures: Implications for FDI in the Russian Energy Sector

In the end, however, given the elites' reluctance to establish transparent rules of the game and effective institutions, it is likely that the boundaries between "public and private, legal and illegal, formal and informal" will remain blurred.[152] In such a situation, foreign investors will have to closely observe the political situation in the country and rely on a variety of indirect means (such as personal relationships, rather than institutional guarantees) to reassert their position in Russia.[153] This can be done in several ways. For instance, British Petroleum, having purchased a 50% stake in TNK, has realized that being a Russian company (as opposed to the previously foreign-owned projects like the Sakhalin-2) would help it be closer to the circle of insiders and to conduct its business activities more successfully, as long as it does not become involved in conflicts with the government.[154] Even if a foreign company is not able to conclude

[150] "UES Head Chubais Invites Foreign Investors into Russian Energy Sector," *AFX News International,* December 5, 2006.
[151] Pleines, "Russian Business Interests and the EU," 277.
[152] Stavrakis, "Russia's Evolution As a Predatory State," 363.
[153] Ibid.
[154] Bradshaw, "Foreign Investment in the Russian Oil and Gas Industry: Lesson from Sakhalin," 8.

such a large deal as the BP's purchase of 50% of TNK, acquiring minority interests in key projects by making a commitment to contribute technical expertise and financing still remains a strategy of choice for investors interested in the lucrative Russian market.[155] Finally, by establishing good contacts with the key actors in the Russian energy policy – that is, first and foremost Gazprom, foreign investors can hope for certain privileges. For instance, Italian company Enel which plans to participate in auctions to purchase stakes in the Russian power generating companies, is likely to have an advantage over other foreign candidates, since earlier this year (2007), together with ENI, it purchased a significant share of YUKOS assets only to hand it over to Gazprom, which could not participate in the auction due to possible legal implications.[156] Having been a strategic partner of Gazprom for several years and having helped the gas monopoly to get a hold of YUKOS assets, Eni can expect preferential treatment on the part of Gazprom, which is the main bidder in the process of the privatization of Russian power generating companies.[157] The recently established joint venture between another one of Gazprom's strategic partners, E.ON Ruhrgas, and a Russian energy company STS Energy with plans to purchase a stake in one of the generating companies, is another example of the fact that Russia's policy toward foreign investors is dependent on the latter's informal ties with the key actors in the sector.

[155] Author's personal interview with a representative of ExxonMobil in Sakhalin.
[156] Andrew E. Kramer, "Gazprom to Gain Assets of Yukos after Auction," *The International Herald Tribune*, April 5, 2007.
[157] Nikolai Makeev, "Svetit, no ne greet: mezhdu kem podelyat rossiiskuyu energetiku" ("It Shines but Doesn't Give Heat: Who Will Get a Share of the Russian Energy Sector"). *Kompaniya,* no. 460, April 23, 2007.

3.4. Conclusion

The analysis provided above leads one to the conclusion that due to such path dependencies from the Soviet past as the persistence of informal relations and institutions, the absence of coherent formal policy on FDI in the energy sector does not necessarily mean that foreign investors are altogether excluded: after all, prohibitive formal policy toward foreign investment can go hand in hand with “informal guarantees that circumvent all obstacles.”[158] Furthermore, Russian bureaucrats may actually be interested in intentionally preserving the opacity of the rules, since it provides them with greater discretion in policy interpreting the policy and thus allows to extract benefits for themselves.

[158] Stavrakis, “Russia’s Evolution As a Predatory State,” 363.

CONCLUSION

The goal of this research was to explain the fragmented and unpredictable nature of Russia's policy toward FDI in the energy sector, given the well-attested objective need for such investment for the sector's long-term development. The theoretical approaches chosen for the research framework have proven their ability to furnish useful insights into the complex nature of policy-making in the energy sector. Segbers' concept of the "patchwork of actors" allowed me to view the policy on FDI as the outcome of a complex struggle of interests among various actors and stakeholders, each possessing a different extent of influence on the policy-making process. North's neoinstitutionalism, in turn, was crucial in exploring the intricacies of policy-making in a sector as strongly affected by Soviet path dependencies and the pressures of globalization as the Russian energy sector is, and helped me to distinguish between the role of formal and informal institutions.

Guided by the theoretical insights mentioned above, I have been able to draw the following conclusions from the research and analysis undertaken. First, Russia's policy on FDI is indeed shaped by the conflicting interests of various actors, and in this regard, two groups – the *siloviki* faction in the Russian executive and Gazprom – appear to be particularly influential. While the *siloviki* are generally opposed to foreign investment in the energy sector, both on economic and ideological grounds, and are channeling this attitude in law-making activities, Gazprom is rather motivated by technocratic and business considerations and seems to be more interested in maintaining its monopoly position in the domestic market. The influence of these two actors thus has been translated into a trend toward increasingly restrictive legislation toward

FDI in the energy sector, as well as into various complications for the foreign companies already operating in Russia that have interfered with Gazprom's business interests.

Secondly, the inconsistent and less-than-welcoming character of Russia's policy toward FDI is also the result of Russia's overall struggle in finding adequate responses to the challenges of globalization. Importantly, policy-making in Russia is shaped by the continuities from the Soviet era, such as the persistence of informal relationships and institutions. The policy-makers may actually be interested in preserving the opacity of the policy since allows them to extract benefits from their discretion in policy implementation. The latter also explains why the shape of the formal policy toward FDI alone cannot give a full picture of the actual position of foreign investors in the Russian energy sector. Even if the official policy becomes more restrictive, foreign investors can still try to rely on informal connections and institutions to pursue their interests in the Russian market.

It seems fitting to conclude this work with a general discussion of the implications of the research findings for Russia's development path and its future prospects. The fact that from a rather advanced industrial nation Russia has turned into a petro-state is in itself interesting. The factors that have influenced such transformation include Russia's desire to regain its former great power status, for which purposes energy has been seen as the only remaining instrument of geopolitical influence at the nation's disposal.[159] In addition, Russia has been somewhat isolated in the Western community and has not had an external anchor such as the potential EU or NATO membership, which proved to be of crucial importance to the political and economic development of Central and Eastern European countries. Russian industry, previously concentrated in the high-tech military sector, found it extremely difficult to become competitive

[159] Yuri Godin, "Geopoliticheskaya rol' vneshney torgovli energoresursami dlya Rossii" ("The Geopolitical Importance of the External Trade in Energy Resources for Russia"), *Mirovaya Ekonomika i Mezhdunarodnye Otnosheniya*, no. 2 (2006): 108.

in the post-Soviet period, and Russia's protectionist policies only exacerbated this situation. Finally, the unexpected windfall in the form of high world energy prices may have improved the general well-being of the population, but it has also reduced incentives to pursue the long-term foundations of economic growth through the restructuring of the economy and raising Russia's competitiveness, which leaves the country dangerously dependent on its energy exports.

Generally, the implications of the research findings on Russia's policy toward FDI in the energy sector are hardly reassuring. The increasing influence of the *siloviki* faction in the government weakens the state capacity to enforce impartial rules and policies. The absence of clear rules and the weakness of formal institutions, while not strong enough to completely deter foreign investors from doing business in the lucrative energy sector, will, however, have a detrimental impact on private investment in other sectors of the economy where the expected profits are not that high as in the energy sector. In the long-run, this creates a dangerous situation of underinvestment and reduced competitiveness of all sectors of the Russian economy, which could seriously compromise Russia's long-term economic development prospects.

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