

When attempting to assess energy risk in Russia today, traditional methods of risk analysis are no longer sufficient – they must be accompanied by a detailed political risk analysis, writes *Robert Amsterdam*

## Risking it in Russia



**Robert Amsterdam, founding partner at specialist law firm Amsterdam & Peroff**

★ There is no denying that Russia is one of the world's most important countries for global energy markets. According to the *Oil & Gas Journal*, it boasts the world's largest natural gas reserves (27%), the second largest coal deposits (173 billion short tons), and the eighth largest proven oil reserves (60 billion barrels). The country is well positioned to supply the European Union and the energy-hungry industrial sectors of China and India. It is no wonder, then, that Russia's energy industry attracts intense interest from the international financial community.

The country badly needs foreign capital in the energy sector to maximise production and alleviate the hangover effects of centralised Soviet planning. Yet despite all its potential, Russia remains a very difficult country for foreign energy investors, and one that should not be rushed into.

Ever since the Yukos debacle of 2004, political risk has been extremely high in Russia. There now exists a new reality in risk management for Russian energy investment. Russia poses huge opportunities for investors, but risk management needs to factor in recent political developments not as a series of unrelated events, but as a constant.

A high level of state involvement now exists not only in the energy sector but across a wide variety of business segments, including automotive and aviation industries as well as metals and mining. State intervention, which often uses tax and environment ministries as enforcement arms, has introduced what is effectively a tax on success. Risk managers need to factor this into their models. If a foreign company is seen to be performing well, the government will often seek a greater participation. A failure to account accurately for these kinds of political risk in Russia can

result in risk management myopia, and leave companies and corporations more exposed than they may realise.

The integral role of political risk in understanding and investing in Russian energy was most recently highlighted by two related events: the G8 summit and the initial public offering of Rosneft. When leaders gathered for the summit in St Petersburg last July, the energy agenda was focused on bridging the gap between security of supply for European Union members and security of demand for Russia. While some major commercial deals were sealed to allow Russian energy companies access to other markets, virtually no tangible progress was achieved in EU-Russian energy relations.

### Assertive

The fact is that Russia is feeling remarkably assertive in its relations with Europe, given the high energy prices, and has demonstrated its willingness to intervene in the oil and gas industry to reward and punish nations and corporations in response to political imperatives. The most heavy-handed instance of this was the cut-off of gas to Ukraine at the New Year, which left homes across the region without heat. Russia has attempted to paint the incident as a price dispute between state-owned Gazprom and the Ukrainian government, but it was widely viewed as an attempt to destabilise the pro-Western government of Viktor Yushchenko.

If the Kremlin has learned anything from the Ukraine fiasco, it is only that it needs to cover such tactics with better public relations – but nothing of substance has changed. Russia's pipelines to its former satellite states and eastern European members of the EU currently function as powerful political

levers, most recently demonstrated by the cut-off to Mazeikiu Nafta, a Polish-owned refinery in Lithuania. Russia claimed that 'an accident' on the Druzhba pipeline last July required them to divert their crude away from the largest refinery in the Baltic states – a move interpreted as punishment for having sold the former Yukos asset to Polish company PKN instead of LUKoil. (Poland has fallen out of the Kremlin's favour for its vocal opposition to the North European gas pipeline project.) On August 14th, international ratings agency Fitch issued a report on the Mazeikiu affair stating that "a mixture of political and economic reasons are behind the interruptions of Russian crude oil and gas supply to central Europe experienced in the past two years."

What risk managers must understand is that this is not simply another isolated event in the operations of this administration, but rather its standard operating procedure. These types of political intervention in the oil and gas sectors have become the norm in Russia, even up to and following the G8 summit. As part of its efforts to assume greater control of strategic energy assets, the Russian government has passed into law new rules limiting foreign participation in energy joint ventures to minority status – allowing them the convenience of not holding shareholder meetings. Without warning, the government announced this summer that it would 'review' the Sakhalin-2 joint ventures, putting companies such as Shell under extraordinary pressure to give up a larger stake to the Russian state or face crippling audits. Such events serve as poignant reminders that in Russia, no contract is final.

### **Rosneft**

The other event to illustrate the centrality of geopolitical risk in Russian energy was the initial public offering of state-owned oil company Rosneft on the London Stock Exchange. Along with many other observers at the time, I publicly identified the moral and legal problems posed by this IPO and its relationship to the assets of my client, the ex-Yukos CEO Mikhail Khodorkovsky. The Russian Federation's intentions with this float were twofold: to bring an image of legality and closure to the Yukos affair, and to test investor willingness to participate in Russia's

mineral wealth indirectly – by attracting foreign investors to invest in their national champions instead of in the multinationals.

What is significant about the IPO is that, due to the price, it can be deduced that the main buyers were subscribing not purely out of economic interest but out of political necessity for the sake of future business opportunities in Russia. Many felt the stocks were overpriced, and they have since slumped below the initial offer despite a war in the Middle East and rampant speculation on oil. More than half of the IPO was paid for by a group of large companies, including BP (\$1 billion), the Malaysian state-held Petronas (\$1.1 billion) and the China National Oil Company (\$500 million), in an effort to establish good relations with Moscow.

In the case of BP, some have commented that it was pressured into the purchase by the Kremlin in order to avoid any problems with joint venture extraction projects in eastern Siberia and Sakhalin Island.

### **Indelible change**

While the Yukos affair marked the pinnacle of geopolitical risk in relation to energy in Russia, what many analysts have failed to recognise is that these events have indelibly changed the overlapping of energy business and politics, making the Russia of today vastly different from the relative calm of 2003. Yukos was seized by the state primarily in response to a perceived political challenge from the company's founder. But following Rosneft's incorporation of Yuganskneftegaz, Yukos's main production arm, and Gazprom's purchase of Sibneft which gave it a total monopoly on pipeline distribution, the government discovered the strength and effectiveness of projecting its power through these national champions.

But Russia recognised that to project political influence through Rosneft and Gazprom it would have to break into new markets and diversify its customer base away from the EU. Thanks to the funds raised through the sales of minority shares, Russia's national champions have set out on an aggressive expansion campaign, acquiring downstream and distribution assets in a wide range of countries, especially in Germany where the country is rife with rumours of a major takeover possibility involving RWE.

Russia's national champions have also signed agreements with everyone from the Venezuelan and Iranian governments to the Algerian state-owned company Sonatrach. Gazprom has even opened an office in Houston for the future commercialisation of LNG.

The current international expansion of Rosneft and Gazprom raises the geopolitical risk to western investors in several ways. With a diversified customer base funded by foreign minority shareholders, the EU has less bargaining power, and Russia will be even less inclined to sign into agreements to protect European rights. For example, as Dr Shamil Midkhatovich Yenikayeff of the Oxford Institute for Energy Studies noted in the August 2006 issue of *Oxford Energy Comment*, Russia has not ratified the Washington Convention of 1965, which establishes legal mechanisms to resolve investor disputes, and has not offered adequate incentives to foreign companies to guarantee stable taxes for the duration of a project. Neither will the Russians ratify the Energy Charter, vital for security of supply and freedom from political pressures, when they can continue to negotiate bilaterally with individual EU members.

In summary, the IPO of Rosneft has fundamentally and significantly weakened the prospects for the development of international legal frameworks that protect investors and consumers of Russian energy, and increased the ability of Russia to use energy for political objectives.

### New risk calculus

To deal with the new risk surrounding Russian energy investment, some organisations are already using a new risk model that factors in politics as well as economics. Companies are starting to conclude that the quality of a political relationship with the local government and state-owned firms is just as important as the financial details of a potential deal.

Because of the flexible and discretionary approach to property rights and contract law in Russia and the ever-weakening rule of law, the risk manager is not likely to have an accurate degree of certainty of what the risk actually is. Pricing is no longer simply an economic issue but also a political issue,

which means there is far less transparency.

Some banks and finance groups are already adapting to this enlarged role of geopolitical risk, which goes far beyond simple elections to include a measurement of active cooperation in helping the government and national champions secure their objectives.

Look, for example, at the recent activities of banks involved in the Rosneft IPO. It was announced in August that ABN Amro, Dresdner Kleinwort Wasserstein, JPMorgan and Morgan Stanley would purchase \$232 million of Rosneft shares at the original offer price, above the current market value, making the IPO the fifth largest in the world.

Why would these banks exercise such an unusual over-allotment option, especially when the stock appears to be getting cool reception on the market? A banker interviewed by Joanna Chung of the *Financial Times* on August 14th, 2006, remarked: "I think they are doing things not on the basis of capital markets considerations but political considerations." To wit, it appears that ABN Amro will be involved in Gazprom's negotiations with Belarus, and Dresdner will handle the North European gas pipeline project and other energy initiatives.

The key lesson here is that traditional risk analysis is being distorted by the rising importance of political risk. Good business sense and market acumen are no longer sufficient in evaluating opportunities, and a comprehensive political evaluation by a professional experienced in the local market is becoming critical for investment success in Russian energy. Investors using financial and legal consultants who aren't thoroughly familiar with the political landscape face a big liability beyond what is quantitatively measurable. While some qualities of Russia's investment environment are systemic, there is still much that can be done to navigate through the correct channels to minimise both political and financial risk – they are, after all, inseparable. ■

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