

Part 2.

**ECONOMIC SITUATION.  
“RUSSIAN ROLLERCOASTER” – FROM VIGOROUS  
GROWTH TO SHARP DECLINE OF PRODUCTION.**

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## 2.1 Government's anti-crisis measures

During the first half of 2008, the situation on the raw materials market was favourable for Russian economy. GNP was rapidly growing, rouble was strengthening, and stock exchange indices reached their historical maximums. The situation radically changed in the second half of August 2008, when crisis processes accelerated in RF.

***Russia's problems started from the banking sector, as in the majority of other countries.*** Then, the crash of stock market happened, followed by the crisis in the industrial sector. The sectors, which suffered the most severe damage, were: export-oriented sectors (fuel and energy complex, metallurgy), markets dependent from the long-term investing (construction, retail) and from consuming activity of population (automobile production). Gradually the financial crisis developed into systemic economic crisis, which required from the RF government quick and energetic actions to limit its consequences.

***RF government followed a three-stage process to support the economy, with each stage having its specific purpose.***

The first package of state financing was allotted to banks. During that period the main purpose of the authorities was to support the financial system.

Financial organizations received direct financing through the banking system. And in fact only the biggest state-owned banks got liquidity.

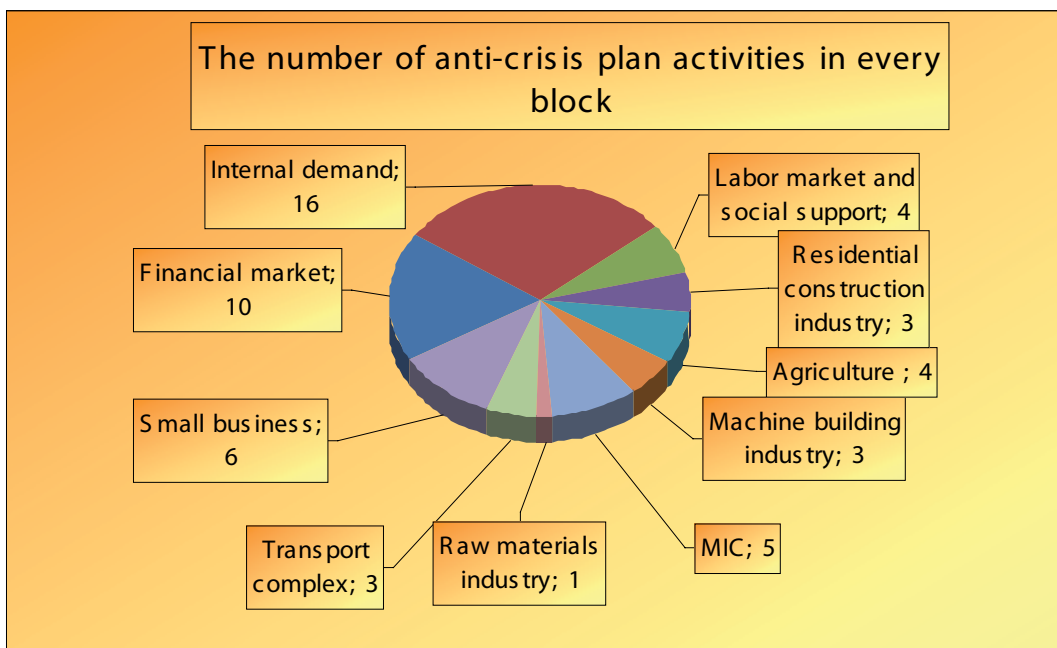
***Meanwhile several draft laws were prepared with the purpose to support the financial system.*** The most important among them was the amendment for the Article 46 of the Federal law "On the Central Bank of Russian Federation (Bank of Russia)", which significantly strengthened the Central Bank's position. The document granted to the Central Bank the right to allot uncollateralized credits to Russian credit organizations for the period up to six months. Earlier, the Central Bank granted credits only provided that there was some collateral: securities, guarantees, or loan portfolios. Now, the Central Bank was allowed much higher risks, because the credits, which the Bank granted, were non-collateral. The only safety measure was the decision to grant these credits not to all banks, but only to the banks with high ratings, the rating threshold being determined by the Central Bank's Board of Directors.

***With the purpose to stimulate transactions at the interbank market the Central Bank of RF was also authorized to sign contracts with credit organizations,*** which provided for the partial compensation of their losses incurred by the credits to those banks, whose licenses were revoked.

Eventually the first package of anti-crisis measures helped to avoid mass bankruptcies of big banks, but the allocated money did not get to real economy.

**The second package of financing was directly designated to various sectors of economy.** It had four components: refinancing of the foreign liabilities (through VEB), the expansion of the government purchases (in automobile production, construction), the protection from foreign competitors (tariffs' increases, the priority for Russian goods for the government purchases and tax reductions (profit tax, amortization deductions, custom duty on oil). All the initiatives of the second package were included in the so-called Anti-crisis Plan of the RF Government, approved on November 7, 2008.

There were 55 different tasks in the document aggregated into ten blocks intended for the support of the different sectors of economy.



***In the framework of the anti-crisis plan corporations supported by the leading special interest groups in the RF government got more preferences than others.***

The first block of measures (“The development of the financial and banking system”) made it possible to strengthen significantly VEB (Vnesheconombank) and Deposit Insurance Agency (DIA) positions, when this two organizations started reorganization of problematic banks. Then, it became easier for state corporations to reorganize financial organizations, which they bought out. It

essentially provided an opportunity to tighten state corporations' external control over banks. The Bank of Russia also got extra opportunity to tighten its control over financial organizations, because it has got the right to delegate its special representatives into banks' management structures. This is stipulated in the second block of the Anti-crisis Plan.

Thus, the role of the key controller of the banking sector reorganization was assigned to VEB (concerning big banks), to DIA (medium and small banks) and the Bank of Russia (general management of the reorganization process).

Besides, in the first block the provision was included for refinancing of foreign liabilities. It allows the simplified procedure for recovering and selling of the pledged property and assets. This measure was also actively lobbied by VEB. The case is that refinancing of foreign liabilities is usually executed with their securities pledged as collateral. After a year, state-owned corporation can use simplified (out-of-court) procedure to exempt debtor's assets, if the debtor fails to repay a credit.

One more measure proposed in the first block provides extra liquidity for VEB. The state corporation finances large scale infrastructure projects from its own resources. With the purpose of attracting additional investment VEB suggested an alternative scheme: the issue of infrastructural obligations with state guarantees. Specifically, it was proposed to invest into these securities pension savings of citizens. For a long time, the Ministry of Finance opposed this proposal, nevertheless because VEB experienced the problem with liquidity, the proposal was included into government's anti-crisis plan.

***The second block of the Anti-crisis Plan ("Internal demand support") grants significant preferences to domestic producers concerning export contracts and the system of government orders.*** According to this document, the resident providers of Russian goods will get price preferences (from 5% to 25%) for government orders. This decision was applied to several industries. Although, automobile producers ("KAMAZ", "Sollers", "GAZ" and some others) will receive the highest preferences.

The second block also provides the opportunity to correct investment programmes of natural monopolies and state-owned corporations. This provision has already influenced power and energy industry, railroads etc. As the practice of the last months showed, the investment programmes were reduced.

***The most important provision of the second block of the Anti-crisis Plan was the mechanism of state guarantees.*** The third package of the anti-crisis measures of the RF government, which will be introduced in the first quarter of 2009, was related exactly to this provision.

The special measure of the second block was the correction of the custom duties. Some of them were reduced (for export), and some – increased (for import). Oil custom duties were also corrected and this was lobbied by the biggest oil companies, including “Rosneft”. Agricultural sector and automobile producers also benefited from the increased custom duties for imported products.

***The third block of the Anti-crisis Plan (“Support for the labour market and social support”) was supervised by the Ministry of Health and Social Affairs.*** The measures in this block are rather “vague” in character. The most concrete provision is the increase of the maximal size of unemployment compensation.

***The forth block (“Housing construction”) was entirely lobbied by construction firms.*** It described the measures for the purchasing of the already built housing and housing under construction in the framework of the operating federal special-purpose programmes (FSPP). Buying apartments, the RF government intend to saturate the construction market with liquidity, which currently lacks proper financing. The key issue for these measures is the cost of one square meter. A differentiated approach was adopted for various regions. The Moscow government demonstrated maximal activity lobbying the interests of construction companies.

***The fifth block (“Agriculture”) has significantly strengthened the positions of Russian agrarians.*** According to the document’s text, agricultural producers have retained the important preferences, granted to them in by the FSPP “APC Development”. First of all, it is subsidized interest rates for some kinds of investment and short-term credits.

Besides, the Anti-crisis Plan stipulated the necessary amount of crediting for the realization of The State Programme for Agriculture Development for the years 2008-2012. VEB has become the main channel for the financing provided by the state. For this purpose it is intended to change the memorandum on the financing policy of a state-owned corporation. It should be pointed that earlier the state financing of agriculture was conducted through “Rosselkhozbank”, which was controlled by the Ministry of Agriculture, which positions after VEB has entered this market will be significantly weakened.

***The sixth (“Automobile production and agricultural engineering”) and the seventh (“Defence industry”) blocks of the Anti-crisis Plan of the government were apparently lobbied by “Rostekhnologii”.*** This conclusion could be made taking into account that this state corporation owns “AvtoVAZ” and the biggest assets in the Defence Industry Complex (DIC).

The key provision of the sixth block was the correction of the custom duties for automobile import, although the change in the customs policy was already declared in the second block of the Anti-crisis Plan.

The provisions of the seventh block significantly strengthened the positions of the Oboronprom, a company affiliated to “Rostekhnologii”.

The key provision pertained to the subsidies from federal budget for DIC enterprises, which partially compensated their spending on interests on credits, received in 2008-2009, including replenishment of current assets.

***The eighth block (“Raw materials sector”) was lobbied by Igor Setshin.*** The first vice-premier proposed only one initiative, although it was crucial for Russian fuel-energy complex (FEC). It was related to the reduction of the period for monitoring and the period of operation of export custom duties on oil and oil products, and also to the possibility of revisions of these duties. The main opponent of this decision was the Ministry of Finance, although in the situation of decreasing prices for energy resources Aleksey Kudrin had to make concessions on this matter.

***The ninth block (“Transport complex”) is intended to help air carriers.*** Earlier, the interests of the industry were lobbied predominantly by “Aeroflot”, yet aforementioned provisions of the Anti-crisis plan were proposed by “Rostekhnologii” corporation, not by Valeriy Okulov’s company. With the interests of this structure in mind, Sergey Chemezov lobbied for the inclusion of the provision for the non-discriminatory access to the infrastructure of fuel-and-refilling complexes in airports for all air carriers in the Anti-crisis plan. Furthermore, the document stipulated the provision for delay of custom duties payments up to 6 months for imported foreign aircrafts and components. This measure will help to update the aircraft fleet.

***The last tenth block (“Small business”) is formulated in most general terms.*** The only real measure was the delay for 2 years of the item 2.2 of the Article 346.26 of the Tax Code concerning pharmaceutical institutions. The other initiatives of this block were not realized.

***The second package of measures grants preferences to different sectors,*** although real business structures have not got any state support. Yet, these companies needed “live money” to realize their investment projects. The third package of the anti-crisis measures was intended to resolve this problem.

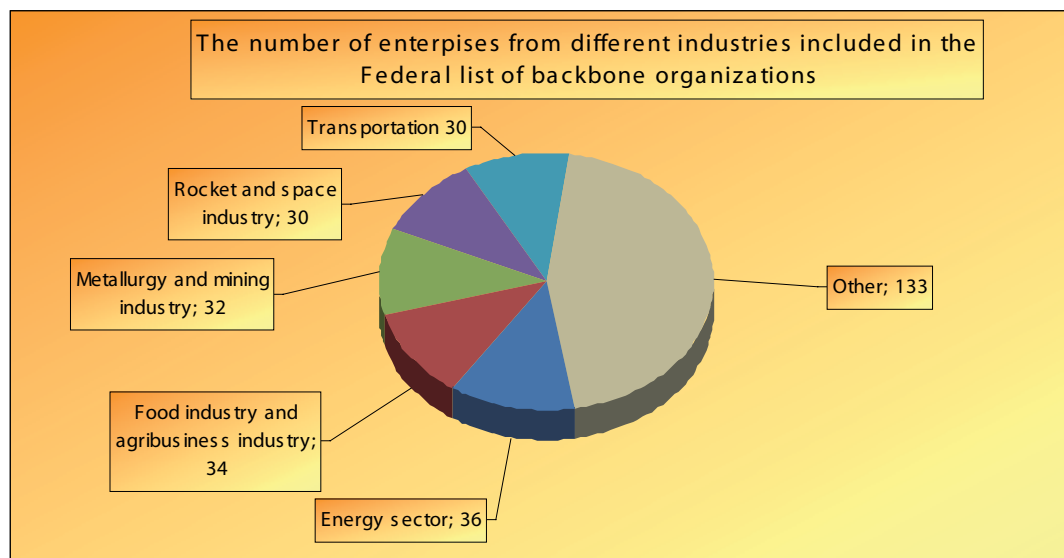
***The third package of financing was intended for specific companies.*** This was meant to be state guarantees for credits. Necessary amounts should be reserved in the 2009 budget. The State Commission for the Sustainable

Development of Russian Economy chaired by Igor Shuvalov should prepare the list of the companies which will get guarantees. In March 295 organizations were included in the list. In addition about 1000 companies were proposed by regions.

Performance and social indicators were used as formal criteria: the number of employees no less than 5000 and annual turnover no less than 15 billion roubles.

*The Prime Minister Vladimir Putin ordered the government to compose the list of “backbone” enterprises on December 15, 2008*, and in a week the commission chaired by Igor Shuvalov has approved the list of 250 companies. Later the Ministry for Economic Development added 45 more business structures. The final variant, including 295 companies, was announced at the end of December.

In the majority of cases, the size of a company was used as the main criterion for the inclusion into “Shuvalov’s list”. Those included in the list were predominantly the leaders of their industries. The majority of the places in the “support list” were received by the enterprises in the fuel and energy sector (FES), agricultural sector (APS), metallurgy, rocket and space industry and transport.



*The most significant is the support for two industries: transport and metallurgy.*

*In transport industry, the leading “players” strengthened their positions.*

Among the railroad companies, the joint stock company “Russian Railways” (RZhD) was the only one included in the list of strategic enterprises. It managed



to “push aside” from state financing independent railroad operators, which having failed to receive state guarantees, will have to reduce their presence in regions.

The inclusion in the “list” of “Aeroflot” with its base airport “Sheremetyevo” was lobbied by the head of the Ministry of Transport Igor Levitin, who have strong connection to the company. The other candidates for state guarantees were the biggest airports. Among air carriers, STC “Rossia”, which would be soon integrated into the new joint air carrier “Russian Airlines”, was not included in the list. The latter was represented in the list by its legal entity – LLC “Aviacompania”

***In metallurgy and mining industry all major companies saved their positions.***

These companies suffered the main impact of the crisis. Contrary to financial or construction business-structures, “metallurgists” in the case of trouble will have to fire their employees. Taking into account that the majority of their “profile” enterprises are the enterprises forming “company towns”, and the problems with their financing could negatively influence socio-political situation in the regions and to provoke in some of them protests and radical actions.

Nevertheless, ***after the “backbone” companies were included in the list, the struggle for the state financing has not finished.*** Not every company will succeed in receiving state guarantees for the credits. Thus, just 295 business structures, which were already approved, will require up to 3.2 trillion roubles to compensate the deficit of credit resources and this amount does not include state guarantees for another 1000 companies from the regional quota.

The government reserved in the 2009 budget for the support of backbone enterprises only 625 billion roubles: 300 billion roubles for state credit guarantees and 325 for the direct state financing.

Thus, the struggle for budget funds will continue in the second quarter of 2009.

***The distribution of financing will depend in many respects from the opinions of vice-premiers,*** who managed to strengthen significantly their status after the crisis started. In contrast, the apparatus weight of ministers has significantly decreased. Igor Shuvalov was the main beneficiary, because until December he was the official coordinator of the RF government anti-crisis programmes.

The impromptu anti-crisis staff was created under Igor Shuvalov’s leadership in September 2008, when the Russian economy experienced the first negative consequences of the global financial crisis. It included all the “profile” members



of the RF government. Three agencies played the key role in the stabilization of the situation: FFMS (Federal Financial Markets Service) headed by Vladimir Milovidov, the Ministry of Finance headed by Alexei Kudrin's and the Central Bank headed by Sergey Ignatiev.

FFMS was assigned to execute operative control over stock exchanges and to stop speculators activity. In general, Milovidov's agency has fulfilled its tasks. It was exactly FFMS, which acting decisively stopped trading at stock markets. With the purpose to "squeeze" out speculators FFMS prohibited margin trading and short selling at the stock markets.

The RF Ministry of Finance was commissioned to support stock market, to level the negative effect of "cheap raw materials" and to attract liquidity to the financial sector. Alexei Kudrin's agency was also efficient.

The Central Bank was instructed to "expand" financial market liquidity. There were some difficulties, but some positive results too.

***Before fall 2008 Shuvalov was mainly responsible for the RF strategic projects.*** The first vice-premier supervised the organization of the APEC summit in Vladivostok and was responsible for Russia's accession to WTO. The majority of the commissions under his supervision either encountered serious problems (for example, the Commission for Housing Construction Development or the Commission for Intellectual Property and Copyright Infringements Prevention) or were "of little importance" (the Commission for Ensuring Traffic Safety or the Commission for Ensuring Russia's Presence at the Spitsbergen Archipelago). Among relatively "resource-intensive" commissions, supervised by Shuvalov, two could be mentioned: the Commission for Technical Regulation and the Commission for the Development of Small and Medium Business.

***In addition, Igor Shuvalov's functions included supervision over a number of sectors.*** This became a crucial factor in fall 2008. In the very beginning of the crisis the first vice-premier has conducted several very important discussions with the representatives of various sectors and exactly during these discussions the important decisions about the main measures for the support of Russian economy were made.

***In December 2008, the "informal" status of Igor Shuvalov was officially confirmed:*** he was appointed as the Head of the Commission for Ensuring Sustainable Development of Russian Economy. Furthermore, the first vice-premier there were another 16 members of the commission.

It is worth noting that after the aforementioned appointment the number of the commissions of the Cabinet of Ministers controlled by Igor Shuvalov amounted to ten. He became an indisputable leader among other vice-premiers in

that respect: Sobyenin controls only 5 commissions and councils, Ivanov – 6, Zubkov – 4, Setshin – 2, Zhukov – 2, Kozak – 1.

Moreover, *his new commission proved to be one of the most important among the commissions affiliated with the Government*. For example, this commission in question prepared the list of 295 companies entitled for obtaining state guarantees.

Yet, Shuvalov still failed to get control over all leading sectors. Igor Setshin retained his control over FES sector and industry, Victor Zubkov – over agriculture, Sergey Ivanov – over Defence Industry, Dmitri Kozak – over Olympic project.

Yet, according to some data it is Igor Shuvalov, who is considered as the most probable candidate for the post of the Russian Prime Minister in the case of possible “apparatus changes” in 2009.

## 2.2 State corporations strengthening their position

*In 2008, the state expanded its presence in the economy.* State-controlled companies and corporations, which were organized in previous years, intensified their activity. The majority of business-structures have finished the consolidation of the assets, which they obtained, have created management structures and regulatory and legal framework. In total there are 7 “pure” state corporations in Russian Federation. They are: the “Deposit Insurance Agency” (DIA), “Vnesheconombank” (VEB), Rosatom, “Rosnano”, “Rostekhnologii” (Russian Technologies), “Olympstroy” (Olympic Construction), the “Fund for the assistance for housing and communal services reform”.

State-controlled companies in the form of OJSC similar to the state corporations are: United Aircraft Building Company (UAC) and United Ship Building Company (USC). One more state-controlled company – “Avtodor” (Russian Automobile Roads) will be created: the draft law concerning it was already submitted to the State Duma.

Aforementioned companies differ significantly according to their size, capitalization and “apparatus resource”. The most powerful business structures are presented in the influence rating.

*The role of the state-controlled residents has significantly increased in the situation of economic crisis.* That was exactly state-controlled corporations and

companies, which were assigned functions dealing with the state support for various sectors financial organizations restructuring, control over import and monitoring of the key infrastructure projects.

***Rostekhnologii has begun providing the state support for different sectors. This state corporation has got supervision over automobile industry and Defence industry.*** It was Rostekhnologii initiative to raise custom duties for the imported automobile components and then – for the second-hand foreign cars. Rostekhnologii has also got access to the key raw materials projects (including Udokan deposit in Mongolia). This state corporation will distribute a sizable share of the government orders for the military equipment in 2009.

***Another state-controlled corporation, which has actively started supporting its profile sectors, was “Rosatom”.*** Sergey Kirienko’s business structure consolidated dispersed assets and received a government order for nuclear reactors construction.

UAC and USC also received a cart blanche for the support of their industries. UAC agreed with the Government about opportunity to control import of the aircrafts manufactured abroad.

VEB and DIA (Deposit Insurance Agency) received exclusive rights for the reorganization of financial organizations. They have already bought out several banks. VEB predominant specialization is big financial assets – DIA deals with medium and small regional banks. VEB also received a right to refinance foreign credits of residents, usually with securities pledge. In a year, if the owners will be unable to pay the loan, the state corporation will get their assets.

***“Rosnano” has become the main operator for the distribution of state financing in the sphere of nanotechnologies.*** The state corporation processes all applications for the state support for research in this sphere.

***Some projects are supervised by the “Fund for the assistance of housing and communal services reform” and “Olympstroy”.*** The former state corporation is responsible for the capital repairs of apartment buildings. Because of this resource the business structure managed to establish itself in the constituent entities of RF and to get significant preferences from regional elites. The latter state corporation controls the project “Sochi 2014”. The Olympic project has a strategic significance for RF. Considering serious problems at the construction markets “Olympstroy” can initiate the growth of construction industry. Moreover, the Olympic project can support labour markets in the South of Russia during recession.

***The business-structures have received large amounts of budget financing and off-budget funds:*** the state-controlled companies are the major recipients of

the federal special-purpose programmes (FSPP), they have access to the preferential credit lines or they operate large federal funds (pension savings, gold and currency reserves, budget assets).

***Nearly every state corporation and state company has its “own” FSPP.*** UAC is financed in the framework of the programme “The Development of Civil Aviation Technology in Russia”. USC participates in FSPP “The Development of Civil Marine Engineering in Russia”. “Rosnano” controls FSPP “The Development of Nanoindustry Infrastructure”. “Olympstroy” is financed from FSPP “The Development of Sochi as the Mountain Climate Health Resort for the period up to 2014”.

***“Rosatom” receives the largest amount of financing from FSPPs.*** This business-structure is participating in at least three special purpose programmes: The development of nuclear power industry complex in Russia”, “The development of the nuclear weapon complex”, “The ensuring of nuclear and radiation safety”.

***There is only one state manufacturing corporation, which does not have its own FSPP.*** This is Rostekhnologii, although “as compensation” this state corporation has already received a number of preferences in the automobile industry (compensations for transport costs). Besides, Rostekhnologii receive lax credits from some state banks (Bank for Foreign Trade etc.).

Three state corporations in fact perform financial operations. These are VEB, the “Fund for the assistance for housing and communal services reform” and DIA. The first two get financing by increasing their authorized capital. VEB also has a direct access to the state finances and to the pension savings of “the silent ones” (those who did not make any decisions about their savings). DIA is financing its operations from banks’ contributions.

All manufacturing state corporations and state companies were included in the list of 295 backbone companies, prepared by Igor Shuvalov. As a result these business-structures got access to the state guarantees of their credits.

***Thus, exactly state corporations and state companies became the main channels for the state financing distribution in the situation of economic crisis.*** Moreover, the government delegated them some functions to support the liquidity of the economy.

Along with the increasing significance of the role of the state corporations and companies and the increase of their financing the struggle for control over them has intensified. During the year 2008 the leading elite groups were competing for the control over strategic assets. This struggle was unfolding at the

various levels of the government and provoked a number of “apparatus” conflicts. Some of them leaked into mass media.

***There were two main dimensions of this struggle: for the control over a Board of Directors (supervisory board) and for the control over company’s management.*** The most influential “apparatus players” struggled for the control over a Board of Directors (supervisory board). Usually (except of “Rostekhnologii”) these conflicts were over in the first half of 2008. The main struggle unfolded for the positions in the management and audit commissions in the state corporations and companies.

All corporations have both opportunities and risks related to development. They could be conditionally classified into two groups: economic and political.

***Rostekhnologii is the most powerful state corporation according to its political influence and economic potential.*** Among its political assets the strong lobbying resource should be mentioned. It has its representatives at the all three levels of the Government “pyramid”: among vice-premiers, in the Ministry for Economic Development and Trade and in the Ministry of Finance. The “Chemezov’s team” also controls the “profile” committee of the State Duma. Besides, Rostekhnologii are widely represented in the “profile” organizations. Specifically, Sergey Chemezov chairs the Union of Machine Builders of Russia. Among economic resources of Rostekhnologii are the opportunities to attract the significant amount of financing. The company has the strong positions in VEB and Bank for Foreign Trade (VTB). The political risks of Rostekhnologii are related to the numerous opponents of this state corporation. Among the key opponents of Sergey Chemezov is the president of RZhD Vladimir Yakunin, vice-premier Sergey Ivanov, the head of the Defence Ministry Anatoly Serdyukov. The economic risks of Rostekhnologii are related to its significant debts. The insufficient integration of the companies united in the state corporation should also be mentioned: there are redundant production facilities and consolidation will take a long time.

***VEB is the main channel for public funds distribution in RF.*** This state corporation was entitled to refinance the foreign liabilities of the residents and to reorganize banks. Its political opportunities include the direct access to appropriate agencies (the Ministry of Finance and the Ministry for Economic Development) and also its participation in the government’s commissions. Among economic opportunities is the access to state financing, pension savings and manufacturing assets. The political risks are related to the government functions (pension savings, debt management), rigid control over VEB and the fact that it

reports to several officials. VEB manages pension savings, which entails certain responsibilities. In addition, VEB is the only state corporation where the Chairman of the Control Committee is Vladimir Putin. Initially VEB as a state corporation was proposed by the Ministry for Economic Development, but later the Ministry of Finance, the Central Bank and the Ministry of Health and Social Development have started active interference into its operation. Among economic risks of VEB are the problems with its balance. Buying bad assets (banks, stock packages) the state corporation significantly deteriorates its financial standing.

***Among Olymstroy political assets is the support of the project at the level of vice-premiers.*** Only this corporation has its profile vice-premier, which is Dmitri Kozak. This official has a strong apparatus resource. The state corporation also has necessary regulatory and legal framework for the realization of the project. It is worth mentioning that there are federal special-purpose programmes targeted at operation of Olympic facilities after their completion. The main political risk is international control over the state corporation (by International Olympic Committee), the problems with needed land plots and regional protests. The main economic risk is the recession at the construction market, project budget's overdraft and the problem of the additional external financing.

***The first three 2009 quarters in Russian economy will be at the declining wave of the economic crisis.*** This will allow state corporations as the main channels of state financing and key bases for the industry integration to expand their activity. These corporations will start active expansion at the domestic RF market. Besides, they will speed up their takeover of the related sectors. Rostekhnologii will concentrate at raw materials. USC and UAC will intensify their activities related to leasing and import. "Rosnano" will participate in educational projects. VEB and DIA will deal with real economy. In the situation of decreasing resources the apparatus struggle for key assets, such as state-controlled corporations and companies will continue, and pressure groups will start forming strategic alliances.

***As global experience demonstrated, the state corporations could be either efficient "drivers" for the dynamic development of the whole sectors of economy or could become a burden and "hand brakes" for the economy.*** In many respects, the role of this business structures will depend on the position of the government. If the RF government manages to create the efficient control mechanism over state corporation's operations and to limit and to balance the activity of the key pressure groups, then it will be possible to build the network of innovative development on the foundation of their strategic assets. If the



economic and political conjuncture do not allow creating such efficient control mechanism, and single special interest group will gain control over key management structure, such business structures will act as brakes for economic development. Their debts will be growing, and state financial support will not reach manufacturing companies.

## 2.3 Private sector is consolidating its assets

*If in 2008 there was an active growth of the state sector, the private companies encountered with all negative consequences of the crisis.* They have started to consolidate to ensure their survival. “The first robin” was metallurgy.

So, in the beginning of 2009 Igor Setshin conducted a meeting with the major shareholders of “Nornickel” – Vladimir Potanin, Oleg Deripaska and Alisher Usmanov.

*They discussed several proposals for the creation of united mining and smelting company, based on “Nornickel”.*

It is worth remembering that this strategic asset was being contested for over a year, but the main events happened in summer 2008. Three special interest groups participated in the struggle.

*The first group was Vladimir Potanin’s “Interros”. He was also supported by Alisher Usmanov’s “Metalloinvest”.*

Usmanov during the last year was actively purchasing “Nornickel” shares and managed to consolidate about 5% of its stock. The partners negotiated possible merger of “Nornickel” and “Metalloinvest” assets. According to some data, “Rostekhnologii” State Corporation was also interested in this merger. The more so, because Sergey Chemezov’s state corporation already has some joint projects with Usmanov (Udokan – deposits in Mongolia).

*The key opponent for possible “Nornickel” and “Metalloinvest” merger was the major shareholder of “Rusal” Oleg Deripaska.*

This entrepreneur has already demonstrated his interest in “Nornickel” in 2007, when he initiated negotiations with Potanin’s partner Mikhail Prokhorov. Prokhorov agreed to sell to Deripaska blocking shareholding package of “Nornickel” stock. Immediately after the transaction was announced Deripaska proposed to merge “Nornickel” with his aluminium company. His junior partners in “Rusal” – Victor Vekselberg and Glencore supported this initiative.



As a protection from a hostile takeover Vladimir Potanin managed to appoint in August 2008 Vladimir Strzhalkovski the general director of “Nornickel”. This top manager, who was a head of “Rosturism” before, is assumed to be quite close (especially, because of his former affiliation to secret services) to some top-level officials of the RF government.

***During the last six months the new general director of “Nornickel” Strzhalkovski has significantly strengthened his position in the company.*** This top manager has managed to block Vladimir Potanin’s control over strategic operations of “Nornickel”. The latter’s representative Sergey Batekhin monitors only manufacturing process and social issues, although “Nornickel” budget and export contracts are controlled by Strzhalkovski’s “man” – Oleg Pivovarchuk.

***While weakening positions of Potanin’s representatives, the general director of “Nornickel” was actively negotiating with Igor Setshin and Sergey Chemezov.***

General Director’s positions have significantly strengthened in fall 2008. At that time VEB has provided to “Rusal”, because of this company’s complicated financial situation, \$4.5 billion loan pledged not only by “Nornickel”, but also by “Rusal” shares as a collateral to VEB. Besides, VEB’s representative Alexander Voloshin became the chairman of the Board of Directors of “Nornickel”. That was when the first rumours about pending consolidation in the metallurgy have appeared. In January major shareholders of “Nornickel” discussed the perspectives of “Nornickel” merger with “Metalloinvest” and “Rusal” with Dmitri Medvedev and later – with Igor Setshin.

***In principle this large-scale merger is beneficial for Vladimir Strzhalkovski,*** because it will dilute the major shareholders’ assets. In that case top management and the chairman of the Board of Directors will play a crucial role in “Nornickel”. The latter will be appointed by the government.

In contrast Oleg Deripaska and Vladimir Potanin in case of the merger will lose: because of their share of “Nornickel” stock dilution they risk to lose blocking and controlling packages of shares. That is why the entrepreneurs have prepared to defend their assets.

***Oleg Deripaska was the first one, who has started building several echelons of Defence.*** The entrepreneur has become again the Chief Executive Officer of “Rusal”. His predecessor Alexander Bulygin will become the chairman of the Board of Directors of En+ Group, which is the major shareholder of the aluminium company. At his new post Bulygin will supervise the issues of integration of mining and smelting assets in Russia.

***Oleg Deripaska was already the chief executive of “Rusal” for three years after the creation of the company in 2000.*** His return to this post was intended to strengthen the control of the main shareholder over this business structure.

At the same time Oleg Deripaska has prepared his suggestions on the debt payments to VEB and for the merger with “Nornickel”. The entrepreneur proposed to convert “Rusal” debts to state banks into privileged shares instead of voting shares. As a result Deripaska might retain operational control over his strategic asset.

Besides, he declared that he was against the merger of his aluminium company with “Metalloinvest” and “Nornickel”.

Vladimir Potanin also acted. The owner of “Interros” was actively buying back “Nornickel” shares. On January 14, 2009 “Nornickel” bought back approximately 8 million ordinary shares worth in total 48 billion roubles.

The Board of Directors of “Nornickel” has already approved the buyback of its shares issued on August 22, 2008. Then Deripaska has managed to stop this buyback activity: the owner of “Rusal” obtained the ruling of the Krasnoyarsk arbitration court on this matter. However, on 10<sup>th</sup> December 2008 court’s decision was revoked and in two days starting from 12<sup>th</sup> December “Nornickel” Board of Directors decided to resume buyback of its shares.

If bought shares will be cancelled, the Vladimir Potanin’s share in “Nornickel” capital will grow to 35%. Considering that Alisher Usmanov is also buying “Nornickel” stock in Potanin’s interests, the latter’s share of “Nornickel” could become even higher. In total the owner of “Metalloinvest” hopes to consolidate 5% of “Nornickel”. This will guarantee for Potanin the control over the Board of Directors and Usmanov will get an opportunity to intensify negotiations about “Nornickel” and “Metalloinvest” merger.

Potanin was not the only one who decided to buy back his company’s stock. ***In 2008 several big players in Russia decided to buy back their company’s shares.*** They decided to use dropping securities prices to increase the ownership of the major shareholders. Besides “Nornickel” two issuers were especially active – LUKOIL and Severstal.

So, LUKOIL management has already decided in the beginning of September 2008 to buy back company’s share issued to the market so that to support the company in the situation of financial crisis.

***It is worth remembering that JSC LUKOIL is the second in the world company according to its drilled proved reserves of hydrocarbons.*** Its core business is finding and producing oil and natural gas, and also production and

sales of petroleum products. LUKOIL is also at the sixth place in the world among the biggest private oil companies according to its volume of hydrocarbons production. The share of LUKOIL in global oil reserves is about 1.3%, and in global oil production – 2.3%. The company plays a key role in Russian energy sector: its share of oil production is 18.6%, and in oil processing – 18.1%. LUKOIL owns big oil refineries both in Russia and abroad. The net profit of LUKOIL group in the first quarter of 2008 was \$3.163 billion, which was for \$1.864 billion more or by 143,5% more compared to the same period in 2007. Its EBITDA (earnings before interest, taxes, depreciation and amortization) increased by 99.3% and amounted to \$4.846 billion.

***The president of LUKOIL Vagit Alekperov said that the top managers of his company have been actively buying shares.*** Alekperov himself bought 200 thousand shares worth 305 107 556 roubles in two tranches: on September 15 he bought 100 thousand shares for 162 373 742 roubles and on September 16 – another 100 thousand shares for 142 733 814 roubles. As a result, Alekperov increased his ownership from 20.58% to 20.6%. In total the organizations affiliated to LUKOIL group recently have bought 1.4 millions of ordinary shares, which amounts to 0,165% of the company's authorized capital.

It should be articulated that during the last several years Alekperov has been purposefully buying his company's stock. So, in June 2007 the entrepreneur has bought a big package (16149 thousand shares worth \$1.23 billion) from his partner Nikolai Tsvetkov. Alekperov's intention was to consolidate LUKOIL blocking shareholding.

***Alexei Mordashov has also decided to support his company.*** So, on September 16 "Severstal" has announced about starting a buyback programme worth \$400 million, which is approximately 2.8% from the capital of the company (estimation based on the \$14.04 price for a global depositary receipt /GDR/). The buyback programme will continue for 6 – 10 months depending on a current share price, "Severstal" GDR price and the situation at securities market.

***JSC "Severstal" is an international mining and smelting company, which shares are traded in Russian Trading System (RTS) and at London Stock Exchange (LSE).*** It went public in 1993 and it specializes at high value added products and unique "niche" products. The company has a successful experience of buying and integrating assets in North America and Europe. "Severstal" also owns mining enterprises in Russia, providing raw materials for its plants. In 2007 "Severstal" produced 17.5 million ton of steel and its revenue was \$15.2 billion. Company's EBITDA in 2007 was \$3.7 billion, and cash earnings per share was

\$1.92. The net profit of the company during the first six months of 2008 according to IAS increase by 69% compared to the same period of the previous year and amounted to \$1.94 billion. The revenue for the same period was \$10.547 billion (+36.3%), the profit from operating activities – \$2.254 billion (+34.3%), EBITDA – \$2.784 billion (+34.4%).

*In 2008, Mordashev's company announced that it already bought 156040 global depositary receipts (GDR) for the price, which was lower than the price calculated a month before (\$13.65 for one GDR). The transaction worth \$2.13 million was conducted by "Severstal" subsidiary "Severstal Overseas Limited". As in the case with "Nornickel" the securities will be probably owned by Alexei Mordashov.*

## 2.4. Restrictions for foreign companies' entrance into Russian market

*While Russian market was consolidating, tougher conditions for the entrance of foreign companies to Russia were introduced.* So, in 2008 the regulatory framework was significantly changed. As a result the operational environment for non-residents in Russian market has become much tougher and the access to the state corporations and companies has become very complicated.

Relevant legislative initiatives were submitted to the State Duma in 2008. That was the notorious draft legislation "On the procedure of foreign investments into commercial organizations which have strategic significance for the national security of Russian Federation".

*The draft law listed 39 kinds of activities, in which non-residents could be not allowed to invest.* Tentatively they could be grouped into 5 blocks: special equipment manufacturing (Rostekhnologii); arms and military equipment production (Rostekhnologii), aircraft construction (UAC), space industry, nuclear industry (Rosatom). Besides, the activities of natural monopolies were also included into the "proscription list".

The authority to support or to reject applications was entrusted to the government's commission chaired by the Prime Minister.

The foreign investors' application could be rejected on the grounds of several criteria. Among them are following: the organization in question has the right to use data, which are considered to be a state secret, it has the right to import to RF

or to export from RF military equipment, it has the right to perform foreign-economic activities with goods or technologies controlled by the state, it has fulfilled government's Defence orders during the last five years before the application was submitted, it has an exclusive copyright for the results of intellectual activity in the sphere of the crucial for the national security technologies etc. In case if no aforementioned criteria are applicable to the organization in question, transaction should be approved unconditionally and the permission for a foreign investor should be granted.

Besides, if a commercial organization fits with one or several of the aforementioned criteria, the permission still could be granted, if foreign investor would assume the obligations, which are provided in the draft legislation, for a example, will agree to form the management of the company fully or partially from the Russian citizens, who are authorized to conduct the activities for the realization of the state Defence orders etc., and if appropriate federal executive agency has no objections related to the security issues.

***The draft act stipulates also a provision prohibiting investors from buying or controlling strategic organizations*** if the investor is a foreign state or a legal entity controlled by a foreign state and the purchase of a majority of votes by such an investor in a strategic organization should be approved by the state.

Nevertheless, ***the foreign companies still have many opportunities to overcome these legislative obstacles***. The easiest way for non-resident to do it is to buy a share in UAC or USC, which legal status is not a state corporation, but JSC.

There are already some precedents. Thus, in the middle of January ex-president Vladimir Putin with the purpose of Russian-Italian collaboration in the project of construction of Russian middle range aircraft SuperJet-100 allowed the company Alenia Aeronautica (Italy) to acquire a blocking share holding (25% plus one share) in CJCS "Sukhoi Civil Aircraft" (GSS). This business-structure is a subsidiary of "Sukhoi" holding, which is included into UAC. The president's permission was necessary, because GSS belongs to strategic companies with limited access for non-residents.

***This decision was lobbied by "Irkutsk clan", controlling UAC.*** Italian company's participation is vital for the realization of Sukhoi Superjet-100 project and GSS is the main coordinator of this programme. Sukhoi Superjet-100 was solemnly demonstrated on September 26, 2007 in Komsomolsk-on-Amur. It is planned that the first customer – the biggest Russian air carrier "Aeroflot" will get new airplanes in the end of 2009, and the further promotion of the aircraft without the alliance with non-resident could be questionable.

***SuperJet-100 is a flagship project for the “United Aircraft building Corporation”.*** The preparation for the project continued for two years, starting in 2007. The key event was the air show in Le Bourget. That was when the contract between Italian company ItAli and Russian GSS for the purchase of 10 Russian airplanes Superjet-100 was signed. According to the contract the joint venture of Italian and Russian company will promote Sukhoi Superjet-100 in the markets in Western Europe and in the USA. That was a decisive argument in favour of granting access to non-resident to UAC subsidiary.

***In contrast to UAC and USC the access to the “classical” state corporation is more complicated.*** Still, if non-resident has support of Russian company, he can resolve this problem.

***The classical example is Rostekhnologii.*** The head of this business structure presented a number of IPO of his “subsidiary” structures in August 2007. It was planned that these IPOs will happen until 2012. In the next two years IPO is planned for AvtoVAZ, VSMPO-AVISMA and Oboronprom.

Sergey Chemezov, the general director of “Rostekhnologii” has already announced the plans for IPO for this corporation in 2006. Despite the differences of these companies belonging to different sectors and oriented to different markets the reasons for their intention to conduct IPO are similar. Tentatively it is possible to classify them into three groups.

***The first reason is the desire to attract strategic investor.*** VSMPO-AVISMA corporation was the first one who announced about its intention to share risks with a foreign partner. The reason was that this biggest producer of titan was initially oriented on the big aircraft building companies. There are two such companies on the market – Boeing и Airbus. Yet during the last year the choice of a partner was rather a political issue. “AvtoVAZ” also announced the advent of the strategic investor in the autumn 2006. In the end of 2007, it was announced that it was Renault. This non-resident corporation plans to assemble cars in Tolyatti. Concerning “Oboronprom” case it was rather the desire to attract big finance organizations, which could provide access to the “long and cheap” money.

***The second reason was the lack of funds for the realization o Sergey Chemezov’s strategic plans for the creation of big holdings in the Defence industry.*** It is worth mentioning that the debts of Defence industry enterprises are among the biggest.

The first public offer of the shares of companies, which are subsidiaries of the state corporations is legal, and exactly these companies (not the state corporations) will attract foreign investors.



*Yet, despite the serious obstacles, some major corporations still announced about their “entrance” into RF.* So, De Beers confirmed its intention to create a joint venture with “LUKOIL” for the development of “Verkhotinskoye” deposit. Until 2008 the partners could not agree about joint development of this strategic asset. Their conflict started in 1998, when the Canadian company Archangel Diamond Corp has requested from arbitration court to exact from Arkhangelskgeoldobycha (AGD) (100% of the stock of this company is owned by “LUKOIL”) \$4.8 billion. The problem was that Archangel Diamond Corp (owned by De Beers) created with AGD the joint company “Almaznyi Bereg” as early as in 1994. That company has won the tender for “Verkhotinskoye” deposit, but because of the rigid Russian legislation, the mining license until 2018 was given to AGD. The agreement between the partners stipulated that “Almaznyi Bereg” would get a license if non-resident would invest into geological exploration.

In few years in “Verkhotinskoye” region the Grib diamond pipe was discovered containing an estimated 67 million recoverable carats of gem diamonds, which estimated cost was 5.5 billion dollars.

*De Beers announced that the company has fulfilled all its investment commitments,* and that consequently it had the right to get a license for mining “Verkhotinskoye” deposit. In its turn, Vagit Alekperov’s company insisted that the contract was not fulfilled. Then the litigation started, which continued for fifteen years.

*It had important consequences, especially for LUKOIL.* Vagit Alekperov’s company was preparing to enter USA market and any negative information in American press (the legal proceedings took place in Colorado) could inflict a serious damage to the image of the company.

Yet, in April 2008 De Beers and LUKOIL signed an agreement about joint exploitation of “Verkhotinskoye” diamond deposit in Arkhangelsk Region.

*The companies are still deciding either to use open-cut mining or underground mining for deposit exploitation.* It is planned that after engineering design would be prepared, the deposit would be exploited for 20-25 years. The engineering design is not ready yet. The pipe was discovered in 1996. The diamond resources were proved in 2005. The deposit is located in 130 km from Arkhangelsk to the North-East, in Mezen region in 30 km from Lomonosov’s deposit. The environment is typical, but the deposit is fairly complex in regards to its geomining and hydro-geological conditions. It is planned to drill several boreholes up to 450 meters in depth. The license provides for 400 cubic kilometres, that is why the exploration works are conducted with the purpose to



find new diamond deposits. The exploration license was prolonged to 2009 and extra investment into exploration was planned.

Both companies had to compromise. LUKOIL sold a share in AGD to a non-resident and De Beers agreed to the package, which is less than controlling interest (49.99%). Now the companies can create a joint venture.

***The reason for the active promotion of the “Verkhotinskoye” deposit project was adverse conjuncture.*** So, in 2008 pursuant to the request of the European Commission, the trading agreement on raw diamonds purchasing in Russia between De Beers and ALROSA will be terminated. As a result non-resident might lose access to Russian diamonds. Its joint venture with LUKOIL can resolve this problem of potential shortage of raw diamonds. Yet De Beers expansion into Russian market could become an unpleasant surprise for ALROSA company, which is controlled by Alexei Kudrin.

***Nonetheless, the Minister of Finance has one efficient tool to protect the interests of the Russian company at the federal level.*** This is the aforesaid law on the restrictions on foreign investments.

According to this document, it is required to get approval from federal authorities for those contracts, which deal with the purchase of 5% of voting shares of the companies, which operate in the sectors of geological exploration and mining in the geological regions, which have federal significance. Diamonds deposits belong to this category according to the law “On mineral resources”.

***The decisions about allowing non-residents access to strategic deposits of mineral resources is a responsibility of the “Governmental commission for the control over foreign investments in RF”.*** It was created according to Prime Minister order on June 6, last year. Despite the fact that Alexei Kudrin was not included in the commission, the chairman of the commission Vladimir Putin will attend to the minister’s of finance opinion on this matter.

## 2.5. The “Energy superpower” project

***Despite adverse economic conjuncture, RF has continued realization of the project “Energy superpower”.*** The main event in this sphere was the active discussion of so-called “gas OPEC”. Remember that during their planned meeting in Moscow ***Iran, Russia and Qatar agreed on the coordination of their activities related to gas export.*** Consequently Iran’s the minister of oil Gholam-Hossein

Nozari even declared that the agreement on “gas OPEC” has been already signed.

***The idea to create gas cartel belongs to Iran.*** This middle-eastern country initiated in 2001 the first Gas Exporting Countries Forum in Teheran. The participants were: Iran, Russian, Turkmenistan, Qatar, Oman, Algeria, Nigeria, Brunei, Indonesia and Malaysia.

Later in November 2006, the experts on economics from NATO countries published a confidential report, in which they expressed their concerns about the possibility that Russia would create “gas OPEC”, uniting many supporters of this idea.

In general Iran’s and Qatar’s participation in the project is not surprising. The last few years “Gazprom” was actively collaborating with Teheran and Doha.

***The strategy of the Russian gas monopoly concerning Iran is mainly determined by the intention to minimize Iran’s participation in the Nabucco project, which could become the alternative to South Stream.*** Exactly Iran should become the main source of gas for the new gas pipeline. Yet Alexei Miller in 2006 prepared a draft contract with the Islamic Republic of Iran for the creation of the joint trans-continental pipeline Iran-Pakistan-India 2.7 thousand km long and costing \$4.1. Besides the access to the markets in the South-East Asia, this pipeline would allow to “pull away” all produced gas from Nabucco. Iran offered Russia in 2007 to create joint gas company with the purpose to support this project. At the sessions of the intergovernmental commission for collaboration in 2008 Teheran’s representative several times reminded about this project.

***Qatar has attracted Gazprom’s attention for the same reason.*** It is the well-known fact that Qatar has the second volume of proved gas reserves in the region (25 trillion cubic meters). In contrast to Iran it does not participate in European projects for pipelines construction, yet it is one of the leaders in compressed natural gas (CNG) production. CNG can be exported to EU by water that was the reasons for some concerns in the European Union about the Russian president’s visit to Qatar. Despite the fact that no binding agreement was signed, the potential threat of coordinated actions of Qatar and Russia in gas export sphere became a master card for “Gazprom”.

In fact the idea of “gas OPEC” was initiated mainly as a bargaining chip, which will strengthen positions of RF, Qatar and Iran in dealing with their external economic partners. As a result RF has got stronger positions on European market, and Qatar and Iran – on American.

It is revealing that Algeria and Libya has refused to join “gas OPEC”: the companies from these countries are potential “Gazprom” competitors in Southern

Europe, despite the fact that Russian gas monopoly has joint projects in these countries.

***“Miller’s company” enjoyed maximal success in two of them – Libya and Algeria.*** These two countries are traditional suppliers of gas to EU. Yet they do not compete directly with “Gazprom”. Although following the completion of “South Stream”, which gas-distributing centre will be located in Italy, the situation will change radically. So that to avoid unnecessary competition, the gas monopoly signed framework agreement with Algeria concerning coordinated actions on the European energy market.

***The proved reserves of natural gas in Algeria are 4.55 trillion cubic meters (the second place in Africa after Nigeria’s 5 trillion cubic meters).*** The major part of natural gas deposits is located in the central and eastern parts of the country. Algeria exports natural gas by pipelines to Italy, Spain, Portugal, Tunisia, Slovenia, and compressed natural gas (CNG) to France, Spain, USA, Turkey, Belgium, Italy, Greece and South Korea. The proved oil deposits in the country are 1.5 billions ton (the third place in Africa after Libya and Nigeria). Shell, Chevron and Exxon Mobil already operate in the region and the annual production is about 28 billion cubic meters.

“Gazprom” has managed to get access to gas fields in Libya. It got three blocks in the Gadames region in the south of Libya with total area almost 4 thousand squared meters. Its competitors for this perimeter were “Gas de France”, Japanese “Inpex” and “Polish oil and gas company”.

***“Gazprom” expansion to the North of Africa provoked emotional reaction in the EU, especially in France.*** In response, Nicolas Sarkozy intensified negotiations with Algeria and the Russian company was in fact “squeezed out” from gas fields in that country. The French President tried the same strategy with Libya, but Tripoli appeared to be less responsive to his attempts. However, exactly because the efforts of France, (with the US support) Algeria and Libya distanced themselves from the “gas OPEC” project.

***In 2008 the construction of oil pipelines continued.*** Besides East Siberia-Pacific Ocean oil pipeline (ESPO), Russia has intensified contraction of Baltic Pipeline System – 2 (BPS – 2).

Remember that the first segment of the Baltic Pipeline System (BPS) for transporting oil from Timan-Pechora and Western-Siberian oil and gas provinces and from Kazakhstan with capacity 12 million ton a year was placed into commission in December 2001. Currently the capacity of this pipeline is 75 million tons. BPS-2 construction project surfaced during oil conflict between

Russia and Belarus in the beginning of January 2007. At that time RF for four days could not transport oil to Europe through oil pipeline “Druzhba”, because Belarus refused to transit oil unless Russia will start paying transit duty. Oil pipeline BPS-2, which is 1016 km long and has the capacity of 50 million ton of oil a year will run from Unecha to Ust-Luga with a branch to “Surgutneftegas” refinery in Kirishi.

***Two stages of construction project are planned.*** At the first stage the construction of the first start-up complex with the capacity up to 30 million ton is planned. It will start operating in the third quarter of 2012. At the next stage the second start-up complex will be built and following its completion the capacity of the pipeline will increase to 50 million ton a year. The Ministry of Energy with the Ministry for Economic Development, Federal Tariffs Service, JSC “Federal Grid Company” and JSC “Holding MRSK” were ordered to include into their investment programmes the construction of power industry objects, which are needed for power supplying of BPS-2 objects. The estimated cost of this construction is 80 billions of roubles according to “Transneft” calculations.

***This project will strengthen positions of Gennady Timchenko and “Surgutneftegas”,*** which during the last years boosted the development of the pipeline system. Yet, despite all their joint efforts, before 2007 there were no any significant results.

***The intensification of the project is related to the appointment of the new head of “Transneft” Nikolai Tokarev.*** The resignation of his predecessor – Semen Vaynshtok was lobbied by “Rosneft”, which was dissatisfied with slow pace of pipeline “Eastern Siberia – Pacific Ocean” (ESPO) construction.

***ESPO is constructed with the purpose to deliver oil to the perspective market of the Asian-Pacific region.*** It is planned to realize the project in two stages. At the first stage the segment of the oil pipeline from Taishet (Irkutsk region) to Skovorodino (2400 km) and oil terminal at the Pacific Ocean with the capacity 30 million ton of oil in year will be constructed. According to the plan oil at this stage will be transported from Skovorodino to the Pacific Ocean by railroad. At the second stage it is planned to construct the segment of oil pipeline Skovorodino – Pacific Ocean and to increase the capacity of the sea terminal. If the pipeline to China will be constructed – 30 millions ton of oil a year will be transported to China and 50 million ton of oil along the route Skovorodino – Pacific Ocean.

Yet, ***Nikolai Tokarev decided not to rush the oil pipeline construction.*** Instead the new president of “Transneft” decided to act in the opposite direction. He intensified BPS-2 construction.

*But “Rosneft” did not want to surrender. The problem was the possible shortage of oil if both pipelines – ESPO and BPS-2 would operate.* As a result, “Rosneft” initiated a number of proposals. First of all, it suggested forming a working group for the calculation of the transit rate. Its idea was that the “black gold” transit rate in the Eastern direction should be subsidized at the expense of the higher rate for the transit to the West.

“Transneft” response was a request to Russia’s industry and energy Ministry to prolong the construction period for ESPO.

“Rosneft” received surprising support in its struggle with Tokarev from the long-time opponent of the company – Dmitri Medvedev. In February 2008, then still vice-premier demanded finishing the construction of the first segment of ESPO pipeline by the end of the year. He gave appropriate directives to the Head of the Industry and Energy Ministry and to the “Transneft” President. Victor Khristenko and Nikolai Tokarev have to prepare reports about all necessary arrangements.

Sergey Shmatko volunteered to support Tokarev. With this aim in mind, the new Minister of Energy started strengthening his positions in the ministry, transferring staff to the ministry from his previous job place. For example, Vladimir Azbukin was appointed deputy minister (previously he used to be a vice-president of “Atomstroyexport”). Later some other Azbukin former colleagues were appointed to strategic posts.

*Yet, even “special forces” from “Atomstroyexport” and active support of Nikolai Tokarev could not help to intensify the construction of the pipeline until December of 2008.* The reason to boost the construction of BPS-2 was Belarus position on the key economic and political issues. Despite his alleged support for the idea of the Union State, Alexander Lukashenko has “torpedoed” all Moscow’s initiatives in this direction in the recent years. Due to Minsk’s position, the issues about single currency and the creation of the unified finance infrastructure has disappeared from the agenda. The last drop was “blocking” of Moscow’s proposal on the Constitution for the Union State and contradictions in foreign policy.

In November 2008, Minsk organized Belarus investment forum in London. At this forum, the Prime Minister of RB Sergey Sidorski held negotiations with western investors about possible privatization of certain assets. Earlier Lukashenko has offered the same strategic companies to Moscow.

*Despite its obviously unfriendly actions, Minsk was at the same time receiving financial aid from RF.* So, in 2008, Russia transferred to Belarus half of the promised stabilization credit worth \$2 billion.

Minsk stance forced Moscow to speed up BPS-2 construction. *Yet, the realization of the project is still questionable.* In the economic crisis situation the most vulnerable aspect of the BPS-2 project is financing. Earlier “Transneft” used for the projects its own credits. *Currently state company does not have access to long and cheap money any longer.* So that to resolve this problem profile agencies (the ministries of energy, economic development, regional development, finance and federal tariffs service) and VEB should develop in 3 months after they receive finance and economic validation of the project of BPS-2 construction the mechanism for financing this project and also for financing renovation of operating main oil pipelines by means of the issue by “Transneft” long-dated bonds nominated in roubles and their private placement among financial organizations with the preferences for the state. Most probably, bonds will be guaranteed by the government.

*Initially it was supposed that BPS-2 would be partially financed through “Investfond”,* this initiative was actively lobbied by the Ministry for Energy and “Transneft”, and opposed by the Ministry for Regional Development and by the Ministry of Finance. Yet, after the budget was sequestered in 2009, the opportunity of financing through “Investfond” has disappeared.

## 2.6 The change of the external economic course

*In 2008 collaboration of Russia and China became more active.* Moscow and Beijing signed several economic agreements.

“Transneft” and “Chinese national oil and gas corporation” (CNPC) signed the agreement on the principles of construction and operation of the oil pipeline Skovorodino – Chinese border. The document was signed by the “Transneft” President Nikolai Tokarev and by the CNPC President Jiang Jiemin.

*As it was pointed earlier, the main initiator of the oil pipeline Skovorodino – Chinese border is “Rosneft”.* The state company is boosting its collaboration with Chinese partners concerning export of energy resources.

The last few years were marked by active cooperation of the “Bogdanchikov’s company” with the business structures of this Asian country. So, “Rosneft” has acquired the option from Sinopec for the purchase of 51% of the JSC “Udmurtneft”. And later the other Chinese state-owned company CNPC has participated in the IPO of “Rosneft” and purchased the shares of the company



worth \$500 million. Moreover, after “Rosneft” acquired “YUKOS” assets, it became the key provider of oil for China.

To intensify the cooperation with China in the energy sector, “Rosneft” speeded up the construction of oil pipeline “Eastern Siberia – Pacific Ocean” (ESPO). The treaties signed with Beijing in 2008 will allow partially compensate RF expenses for the construction of the branch of the pipeline to the Chinese border and to resolve some problems with the project’s financing.

***Also in the last year Russian-Chinese agreements in the financial sphere were announced.*** So, “Gazprom” and Chinese Export-Import Bank has signed and an agreement providing for the Russian side credit line for \$300 millions.

***It is worth remembering that “Gazprombank” has investment ratings by the leading international agencies, which are quite high.*** Moody’s assigned to “Gazprom bank” long-term foreign currency deposit ratings rating Baa1, and its foreign currency debt rating is among the highest in Russia – A3. Standard & Poor’s agency has granted high rating BBB both for the short-term and long-term credits and debts of this bank. “Gazprombank” has a quite sizable regional network consisting of 36 branches and also five subsidiary and affiliated Russian banks. “Gazprom bank” has also its share in the capital of two foreign banks: BelGazprom bank (Belarus) and Areksimbank (Armenia).

The credits will be provided for both medium-term and long-term financing for deliveries to Russia of Chinese equipment and related services ensured by Chinese corporation specializing on export credits insurance SINOSURE.

Currently Chinese side is already considering the possibility of the provision to “Gazprombank” the long-term credit amounting to over \$110 million for the deliveries to Russia of Chinese drilling rigs. These ***financial initiatives of Beijing will weaken the positions of the domestic engineering companies at the internal market.*** Subsidized deliveries of the Chinese drilling rigs will create serious competition for the domestic companies.

In 2008, the state corporation “Rosatom” signed the agreement with Chinese nuclear industry state corporation on the collaboration for the construction in PRC of two new blocks for the Tianwan NPP and demonstration fast-fission neutron reactor for the commercial purposes.

***It is worth reminding that the intergovernmental treaty on construction in PRC of the nuclear power station and the credit provided by Russian state to PRC was signed on December 18, 1992.*** For the realization of this treaty on December 29, 1997 the general contract was signed with Chinese company JNPC providing for the construction of Lyanyungan NPP (later renamed into Tianwan NPP) with



two VVER-1000 reactors 1000 megawatt each. Besides “Atomstroyexport” (the general contractor) in the construction of Tianwan NPP several other organizations participated: St. Petersburg Institute “Atomenergoproekt” – the general designer, Experimental Design Office “Gidropress” – the reactor designer, RNC “Kurchatov Institute” – the academic advisor for the project, and also the company “Izhorskie Zavody”, the concern “Sylovye Mashiny” and some other plants manufacturing equipment for NPP. In total, more than 150 Russian plants and organizations participated in the project.

***The treaties signed will significantly strengthen Kovalchuk brothers' positions.*** Two companies directly affiliated with the entrepreneurs actively participated in the construction of Tianwan NPP. They were “Kurchatov Insitute” headed by Mikhail Kovalchuk and “Atomstroyexport”, which is controlled by Yuri Kovalchuk’s bank “Rossia”.

***Besides, there was one more agreement signed with China, this time in the interests of “RZhD” and Vladimir Yakunin.*** It was the agreement between Russian and Chinese governments providing for joint construction, operation, maintaining and servicing the railroad bridge across Amur river. It should be constructed at the Russian-Chinese border near the settlement Nizhneleninskoye in the Jewish Autonomous Region.

This project will help to increase significantly the traffic with China, because it will expand trans-European transport corridor. Just until the year 2010 “RZhD” is planning to invest into the development of the railroad station at the borderline regions neighbouring China and North Korea 1.4 billion roubles.