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June 2008

Text presented at Atlantik Brücke's Young Leaders Conference in Ukraine.

Russia as competitor and energy provider for the European Union

Europe has grown more dependent of energy supply from Russia. Russia's shares of Europe's use of oil and gas are 25 percent, respectively, and the shares are increasing. At the same time, Europe increasingly is concerned of its commercial dependence of Russia. In the last five years, Russia has become assertive and bullied its commercial partners. There is no commercial rule of law to speak of, at least not for foreign investors. Trade and investments policies are uncertain and are often amended, sometimes without advanced notification for affected parties. Power increasingly has been centralized around the (former) President, politics have slided towards authoritarianism, and there has been a surprising convergence of interest between Kremlin and Russian oligopolies.

Russian commercial assertiveness applies across the entire economy, but is especially pronounced in the energy sectors: oil and hydrocarbon. The Yukos affair, where the owners of Russia's biggest hydrocarbons company was systematically stripped of their assets in 2004, was a true shock to Russia's and the international business community. Re-nationalization of hydrocarbons asset has been detrimental to foreign investors, such as was the case in the Sakhalin-II oil field, or in the Kovytka site in Siberia. In 2007, Russneft, a smaller oil company operating independently of the Kremlin, was forced to merge into a holding headed by a major Kremlin connected tycoon, which sent jitters to European investors as well.

These are only a few examples in a long series of violations of basic commercial principles. They have created considerable problems, commercial and political, to Europe. Russia is too important as a supplier of energy for Europe to take strong legal or political action. Russia is also too appealing as an investment destination for troubled firms to take action. Investors have often discounted some costs for "Russian unpredictability", but legal action might provoke strong reactions from Russia.

There are only a handful of cases when Bilateral Investment Treaties (BITs) signed by Russia have been invoked in legal proceedings. The EU's Partnership and Co-operation Agreement with Russia, establishing some procedures for commercial disputes, has hitherto not been used. Russia's membership of the Energy Charter Conference, arguably a membership with obligations, has not been invoked in many disputes.

European actors are wary of using legal methods to address commercial concerns. However, European governments are also well aware of the fact that Europe's increasing energy demand from Russia puts Kremlin in a position where they don't have to heed the calls for change, especially when other countries, China in particular, increasingly competes over access to Russian energy. In fact, Europe's rising demand of Russian energy – and its inability to press ahead with investments in other energy supply (notably the Nabucco pipeline) – enables Russia to behave unpredictably and underpins its assertiveness on the global political stage as well as in commercial affairs. Approximately 40 percent of Russia's foreign currency earnings, and a similar share of the federal budget, is based on its raw-material export to the EU. Nor is this situation likely to improve. Regardless the tenant of Kremlin, he or she will be hostage to greater economic forces and economic powers. In fact, the situation is likely to become ever more troubling in near-to-mid term future.

The decade-long boom in Russia has largely been driven by its export. Domestic consumption, outside Moscow and the circle of people close to the energy companies, remains weak and the value growth from export trumps by far increases in domestic demand. Oil and gas represent more than two thirds of Russia total export. The real-exchange rate effect of the energy boom – or the Dutch disease properties of Russia's economy – has increased prices of Russia's industrial produce to the degree that it is not internationally competitive. The share of energy in total export has also increased due to increased export *volumes*. Since the collapse of Russia in the mid-1990s, crude oil output has three-folded. According to the IEA, it will continue to rise till 10,5 bbl/day in 2011, which represents an increase of 1,1 barrels a day between 2006 and 2011. Growth in gas output, however, has been slower and averaged at 2 percent a year between 2002 and 2006.

At current world-market prices, the increase will yield significant revenues to Russia. It has already filled its coffers from the energy boom, and increasing prices combined with increasing output will push up revenues further. As with all other resource-rich countries, economic and income growth in Russia will largely remain an issue of ownership of energy sources and the distribution of the windfall gains.

In the case of Russia, this is not good news. The ownership of Russia's energy sources are increasingly in the hands of the government or firms controlled by the government. Gazprom, for example, which until recently had Dmitry Medvedev as its Chairman, has been on a buying spree (Northgaz, Purgaz, Zapolyarne gas field) in the last years and today represents almost 85 percent of Russian output. Concentration has also increased in the oil sector. Renationalization has been considerable also in the oil sector. More than two thirds of crude production in 2006 was controlled by state-controlled companies. However, growth in output was in 2002-2004 ten times bigger in the private oil majors than in the Kremlin controlled companies. Foreign investors share of Russia's energy sources have declined somewhat in recent years, and trails far below ten percent of total ownership. Foreign investors in the energy sector also find it increasingly difficult to do business in Russia.

Yet the trend of re-nationalization and increasing government ownership is highly predictable considering Russia's economic profile and the sources of its economic growth. The trend is also likely to increase. Ownership is the chief determinant of the distribution of the windfall gains, and Russia will not accept money being transferred into the pockets of foreigners. The Russian government also prefers to be in control of the ownership, partly to stymie political competition. As ownership is nationalized, Russia will also become more unpredictable as a partner. Commercial relations increasingly become subject to political relations and the whims of political leaders. Fragmented ownership provides for greater stability; concentration moves in the opposite direction.

Evidence firmly demonstrates that re-nationalization leads to less investment in the supply of energy. Windfall gains is used for consumption and government savings rather than for investment in the energy sectors – investments in increasing output that could result in a greater social value of the energy boom. Nationalized, state-owned energy majors in Russia also belong to the least productive energy firms in the world. The return on total asset (ROTA) of Gazprom, for example, was only 25 percent of the ROTA of Yukos before it was nationalized. Despite this distressing record of performance in government controlled firms, Kremlin is likely to increase its control over private oil firms. Potential revenues are too big to let them slip away. Equally important, as energy sources will diminish, partly due to low investments, increasing ownership is the only way to a continued growth of windfall revenues.

Europe is responding to Russia's increasing assertiveness with new calls for closer economic co-operation and deeper agreements (re-negotiated PCA, FTA and, ultimately, a CES). Yet the diplomatic route of "regulating" Russia's behavior clearly has diminishing returns. Previous agreements have not succeeded on that account; Russia continues to violate its commercial obligations without serious reactions, neither from European firms nor from European governments. As Russia grows more independent of European investments, there is less likely to be market-driven compliance or induction of good corporate citizenship. As Europe grows more dependent of Russian energy supply, its power to utilize economic tools to sanction Russia will be further depressed.