

# Russia: A Complex Transition

## Increasing Transparency and Accountability in the Extractive Industries

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### Summary

Russia's distinct political and social context distinguish it from both developed and emerging economies. The cause of advancing transparency in the country's extractive industry depends on a keen understanding of the complex relationship between large corporations and the government.

Russia's transition from a command economy to a market-based society has been characterized by a strong link between political power and industry, while the influence of civil society remains limited.

This report argues that to enhance transparency, Russian firms should be encouraged to adopt practices of good industrial citizenship, such as taking a more active role in global industrial bodies. They should be reminded of the ways in which greater transparency will allow them to be more competitive domestically and to expand internationally.

Financial reporting standards should also be tightened. In particular, the new entity emerging from the tie-up of Russia's two big stock exchanges, RTS and Micex, should be encouraged to implement the best practices of the New York Stock Exchange or London Stock Exchange.

Issues related to transparency are being raised with increasing frequency by business and political elites. The growing power of independent oil and gas producers provides an impetus for enhanced transparency. Likewise, regional political and economic elites are increasingly concerned about the environment and the impact of extractive industries on local development. Russian overseas investments are also growing, implying a need for greater compliance with international transparency and accountability standards.

The lack of secure property rights creates an incentive for corporations to hoard information, since anything they disclose may later be used against them to expropriate their property. One of the most likely avenues for reform may be to encourage cross-the-board regulation of financial

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<sup>1</sup> Emerging economies are playing an increasing role in oil, gas and mining globally. This paper is one of a series commissioned by the Transparency and Accountability Initiative (T/AI) and the Revenue Watch Institute (RWI) to explore trends and promising strategies for dialogue at the national and international level. The series covers Brazil, China, India, Mexico, the Philippines, Russia and South Africa. The views expressed are those of the authors and are not necessarily those of T/AI and RWI.

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markets.

## ACRONYMS

IAS	Ministry of Environment and Natural Resources
CSR	corporate social responsibility
PRMS	Petroleum Resource Management System
RAS	Russian accounting standards
US GAAP	U.S. generally approved accounting practices

## Introduction

It is difficult to overestimate the impact of extractive industries on the global economy, including their effect on economic development, the environment and local populations. The concept of transparency posits that industry should be open about the negative externalities of development as well as the positive ones, and implies heightened attention to the mitigation of environmental pollution and adverse effects on local communities.

Russia ranks among the world's leading countries in the production, consumption and export of crude and refined hydrocarbon products, as well as raw minerals and metals. Russian extractive industries work primarily in remote regions where their activities have a direct impact on local populations and the regional environment. At the same time, Russia's resource-rich regions maintain strikingly high levels of social poverty, and even experience energy poverty despite Russia's status as an oil and gas superpower. Russia's turbulent and complex transition from a command economy to a market society, and the controversial privatization of extractive industries, gave rise to questions about the legitimacy of the industry as a whole.

The debate over transparency in extractive industries has been limited by the top-down, vertical power structure of Russia's energy market, and by the weak influence of civil society. Multi-stakeholder groups, such as those encouraged by the Extractive Industries Transparency Initiative (EITI), do not operate in Russia. Russia's strong vertical integration of political power reduces the space for any bottom-up transparency initiatives. Yet some top-down proposals for increasing transparency in the extractive industries have indeed appeared.

The initiative to make the extractive industry transparent should come from the industry itself, given its interest in enhancing both the domestic and international competitiveness of Russian companies. Moreover, greater involvement by local and regional governments in the debate over transparency should focus on imperatives for local development. Consequently, there is much potential for transparency reforms in Russia, although implementation remains difficult. Hence despite an underlying interest in transparency, there is a lack of focused debate at the policy level.

This report is divided in three parts, and addresses domestic and international aspects of the Russian extractive industry as well as the general public perception of transparency. It looks at existing barriers to, and interest in, greater transparency. It also gives special attention to the importance that concepts of legitimacy and competitiveness can play in developing support for enhanced transparency in Russia's extractive industry.

## Domestic issues

### Extractive Industries in Russian Economic and Political Structures

Oil, natural gas, mining and metals make up the core of the Russian economy. Hydrocarbons alone account for as much as 40 percent of gross domestic product (GDP) and more than 60 percent of budgetary revenues. Russia has channeled significant revenues from oil and gas sales into a so-called “Stabilization Fund,” overseen primarily by the Russian Ministry of Finance. The fund is designed to buttress the country’s entire financial system.

A mixture of government-owned and privately held Russian corporations dominates Russia’s minerals sector, while the role played by foreign extractive corporations is marginal. The country’s executive branch is closely linked to the extractive industry. In addition, the country’s weak civil society remains dominated by a strong, vertically integrated political party: United Russia. The lack of political opposition contributes to the opacity of the relationship between the extractive industry and political power. Alongside financial institutions, Russian extractive corporations dominate the list of the largest companies in the country and are among the biggest employers and taxpayers (although their share of total employment is considerably smaller than their share of total economic production). Unsurprisingly, they are also seen as having a dominant position in the policymaking landscape and in politics more broadly.

Russia’s extractive industry is characterized by its top-down design. The extractive sector is designated by law as “strategic,” making it off-limits to significant foreign investment without the express permission of the government. Moreover, regulations allow governmental agencies to revoke licenses even without a court decision.

Gazprom, the state-controlled natural gas monopoly, is by far the most important company in the country. As a result, it functions quite differently from the rest of the industry, playing roles that are unusual for a commercial enterprise. It provides fixed, regulated gas prices for retail and most wholesale customers on the domestic market and financially supports the government’s pet projects like the 2014 Olympic Games in Sochi. Gazprom provides rents of various kinds to the ruling bureaucracy and its patronage system, and it serves as a tool of foreign policy. The company also owns (and presumably subsidizes) one of the country’s three largest television networks, along with several major newspapers and radio stations. Unfortunately, there is no reliable estimate of the level of nontax transfers to the government.

As a result, the company is understood to suffer considerable losses both domestically, through the provision of subsidies and investments that will never be recouped, as well as internationally, through costly “gas wars” and politically motivated, long-term gas provision pricing. It is often difficult to discern where the Russian state bureaucracy ends and Gazprom begins.

Gazprom’s daughter company, MRG, has a monopoly on all gas transmission networks, whereas distribution to retail markets is operated by regional branches of the company. At the level of the wholesale market, there is marginal access to markets for non-Gazprom producers. Even the design of the market, including pipeline access, is mainly decided by MRG itself.

MRG is required by law to provide access to independent gas producers, including natural gas companies Novatek and Itera, as well as oil companies seeking to sell associated gas. But this

arrangement is highly opaque, resulting in severely limited opportunities for independent gas producers. (A more detailed discussion of this issue follows in Section IV.) The result is that the only two major successful independent gas producers, Novatek and Itera, have unusual relationships with the state. The former is controlled by Gennady Timchenko, owner of Gunvor, the largest trader of Russian oil on foreign markets, and reportedly a close personal friend of Prime Minister Vladimir Putin. The latter, meanwhile, has an opaque transnational shareholder structure that includes holdings based in the United States as well as a share accruing to Gazprom itself, and Gazprom is broadly assumed to control the company.

The oil sector is more diverse, although it too has seen politically motivated consolidation in recent years. Once split up into a significant number of privately owned companies, 90 percent of the country's oil extraction is now dominated by seven operators, two of which are state-controlled. The most significant private player is Lukoil, a horizontally and geographically diversified major controlled by its CEO, founder and largest shareholder, Vagit Alekperov. The second-largest private player is TNK-BP, a joint venture between TNK (a midsize Russian oil company owned by three so-called "oligarchs," Mikhail Fridman, Viktor Vekselberg and Len Blavatnik) and the multinational concern BP.

The state, in turn, is represented by Rosneft—which was a marginal company until 2004 when it absorbed the nationalized assets of the Yukos Oil Co., formerly owned by jailed oligarch Mikhail Khodorkovsky—and of Gazpromneft, an oil subsidiary of Gazprom. Gazpromneft's assets consisted primarily of the nationalized assets of Sibneft, a private company sold under pressure (though technically in a voluntary sale) to the state by oligarchs Roman Abramovich and Boris Berezovsky. (The terms of the Sibneft sale were the subject of the lawsuit *Berezovsky v. Abramovich*, High Court of Justice, Queen's Bench Division, Commercial Court Case No. 09-1080. The court rejected Berezovsky's claim that Abramovich forced him by illegal methods to sell a 50% stake in Sibneft at a lower price.)<sup>2</sup> Smaller Russian oil players include the privately held, secretive Surgutneftegaz, as well as companies owned by regional governments, most notably Tatneft (Tatarstan) and Bashneft (Bashkortostan). Another state-owned company, Zarubezhneft, focuses exclusively on overseas production, most prominently in Southeast Asia.

The metals and mining sector is more diverse still and predominantly privately held, although consolidation has led to the emergence of a number of sectoral "champions" and relatively little direct competition between them. The most significant state-owned players are Alrosa, the diamond mining company controlled by the federal government and the government of Yakutia, where most of the diamonds are mined; and VSMPO-Avisma, the titanium producer, owned by the state-run industrial holding Rostekhnlogia (Russian Technologies).

Steelmaking is far and away the most competitive sector of the industry, with five significant players, all privately held. The largest of these is Severstal, controlled by Alexey Mordashov and based in the northern city of Cherepovets. This is followed by Evraz, owned by Roman Abramovich, and the Magnitogorsk Iron & Steel Works, which is controlled by Viktor Rashnikov. Mechel Steel, Russia's fourth-largest steelmaker, is controlled by Igor Zyuzin, while the smallest of the big five,

<sup>2</sup> Abramovich Beats Berezovsky in Battle of the Oligarchs, Bloomberg News, August 31, 2012: <http://www.bloomberg.com/news/2012-08-31/abramovich-wins-berzovsky-s-u-k-lawsuit-over-stake-in-sibneft.html>.

NLMK, is controlled by Vladimir Lisin, by some estimates Russia's richest man. All of the steel-makers also have significant interests in iron ore and coal.

Russia's largest metals and mining company, however, is the towering aluminum giant Rusal, which, since taking over its competitor Sual and purchasing significant international assets from Glencore (based in Switzerland) and others, now accounts for some 12 percent of global aluminum production. The company has positioned itself alongside Rio Tinto, Alcan and Alcoa as a global major. Similarly, the giant Norilsk Nickel, controlled by Vladimir Potanin but with a significant state interest, is unrivalled in nickel, palladium, platinum and cobalt production in Russia.

#### **Market for Corporate Control**

Most of the largest extractive corporations, including those controlled by the state, have shares traded on Russian and international stock exchanges. Nonetheless, there is no true market for corporate control in the classical sense. The state retains more than 50 percent ownership of all of the companies that it controls, making a takeover impossible. And the chief executives of private companies, who are usually also the founders, control similar stakes either directly or indirectly. To further complicate matters for would-be suitors, shareholding structures are often murky, and they involve complex systems of on- and offshore shell companies.

The more fundamental issue, however, is the nature of property rights in Russia. The post-reform settlement brokered by Putin in the early 2000s was meant to shore up the state and relieve economic and political elites of the chaotic, zero-sum competition of the 1990s. The settlement rests on two interlocking rules. First, all resources within the economy belong to the system as a whole, rather than to individuals or corporations. They can thus be redistributed by the state in order to maintain balance within the system. Second, no player may seek to mobilize resources from outside the system (whether political or economic) to gain leverage or competitive advantage. Those who play by the rules know that they may be deprived of their assets, but maintain a high degree of certainty that they will be rewarded for their loyalty with other assets in return. Those who break the rules by resisting are removed from the game permanently. For examples of this phenomenon, consider the individual case histories of Khodorkovsky, self-exiled oligarchs Berezovsky and Vladimir Gusinsky, and former Moscow mayor Yuri Luzhkov.

The result is that for all but the smallest holders and entrepreneurs (and, in truth, for them as well), assets are not truly owned but are held in lease, allowing the "owner" to extract flows of cash and rents until such time as the system—represented by the arbiter, which has been Putin since 2000—sees fit to redistribute them. This creates a peculiar set of incentives. All players are encouraged to seek short-term profits at the expense of long-term investment. They are encouraged to invest in mechanisms to provide security against disenfranchisement—or at least to make disenfranchisement sufficiently costly to the system that adequate compensation may be expected. As will be described later on, this set of incentives shapes the ways that Russian extractive corporations pursue overseas expansion.

Therefore, an interest in transparency is not absent at either policy or corporate levels. "Competitiveness" clearly outweighs "legitimacy" as a priority for the extractive industry. Yet legitimacy is still a concern for a large part of public, which broadly considers the top-down market design of 1990s dubious, opaque and unfair.

**Interest in Transparency at the Political Level**

Both President Dmitry Medvedev and Prime Minister Putin have mentioned the need to enhance transparency. Russian officials have spoken about the need for transparency at various international forums. The issue was also put forward in the Russian Proposal on the Draft Convention on Energy Security. Last but not least, Russia is joining the World Trade Organization, which has the potential to help make transparency a higher priority.

**Transparency and Russia's Gas Markets**

Two areas in which the government has displayed an increased interest in transparency are the development of the domestic gas market and offshore oil trading.

Gazprom's domestic gas trading structure is complex. MRG operates the country's gas transmission network and regulates access to the network for other gas producers unrelated to Gazprom. A number of independent gas producers—most prominently Itera and Novatek—own and operate gas fields around the country. Oil companies, driven in part by regulation, are increasingly seeking to sell, rather than flare, associated gas. Forcing them to sell this gas to Gazprom, however, would make the latter the only seller and buyer of gas on the wholesale market.

To remedy this, the government in 1997 passed a series of laws and regulations requiring Gazprom to give independent gas producers access to its pipeline network on a contractual basis without prejudice, provided that three conditions are met. First, the network must have sufficient capacity. Second, the gas must be of sufficient quality to mix with Gazprom's gas. And third, the producer must provide pipelines from the field to the main line. The latter two of those conditions can be independently verified without too much difficulty. But verification of the first condition requires Gazprom's cooperation—and that cooperation has not been forthcoming.

Independent gas producers complained that Gazprom was misrepresenting capacity and violating its legal obligations. They supported the Federal Antimonopoly Service and Federal Tariff Service when it filed a lawsuit against Gazprom in 2004, which would have forced the company to make capacity information public. The courts ruled in favor of Gazprom, however, in what many observers believed was a politically motivated decision. Still the Federal Tax Service has prepared a standard capacity reporting system, as well as a series of normative acts requiring that Gazprom make capacity information publicly available. These have not been implemented, however. Gazprom does not release any direct capacity information, although it does release the annual amount of gas transported on behalf of independent producers. Gazprom's estimate, however, often differs from that of the independent producers themselves by a factor of 10 or more.

The debate took an unexpected turn in 2011, however, when Prime Minister Putin, together with Minister of Energy Sergei Shmatko and Deputy Prime Minister Igor Sechin, issued a declaration accusing Gazprom of "putting its interests before that of the development of the [gas] sector" by systematically under-investing in pipeline infrastructure. If, before that moment, Putin had generally been seen to be a steadfast ally of Gazprom—a company he controls closely through his deputies and which he believes is the backbone of the Russian economy—the statement created the perception of divided loyalties.

In particular, the oil lobby, led by Sechin (who, until recently, was also chair of the board of state-controlled oil producer Rosneft), began complaining that it had been left out in the cold by Gazprom for too long. The level of dissatisfaction among independent gas producers may have

recently become untenable. Putin's close ally, the oil trader Gennady Timchenko, recently entered the gas business by purchasing control of gas producer Novatek. Recently, oil producer Lukoil obtained an agreement with MRG to ship gas (without transferring ownership to Gazprom) in the Caspian-Volga region from 2012 to 2014. However, the tariff conditions of the agreement remain undisclosed. Lastly, Russia is coming under increasing pressure from both domestic and international gas industries to liberalize its gas export system and to allow more access. The Kremlin has so far resisted this pressure. But concessions may be forced in the future. The issue remains unresolved, but Gazprom's status may begin to shift.

### **Transparency and Offshore Oil Trading**

The Gazprom pipeline story intersects with the second issue, that of trading companies and transfer pricing. The issue is personified in Timchenko.

Gunvor emerged as a major player as oil prices picked up after 2000. By 2006, the company was the largest trader of shipborne oil from Rosneft and Gazpromneft. It added Surgutneftegaz to the list the next year. Given those companies' close ties to the Kremlin, as well as the close personal history between Putin and Timchenko, Gunvor became known in some circles as "Kremlin Oil." Virtually all observers assume that the company's success is built on political foundations. Gunvor currently trades some 40 percent of Russian oil, and in 2010 it began trading natural gas as well.

Gunvor, of course, is not the only company trading Russian oil, but it is the largest by far. It is followed distantly by Litasco, Glencore and a host of other smaller traders. In addition, state-owned oil pipeline operator Transneft and Russian Railways also own trading companies that handle oil flowing through their own export networks to Europe. The large private oil companies, including Lukoil and TNK-BP, also own their own trading companies. The vast majority of these traders are based in Switzerland. The Geneva Trade and Transport Association estimates that as much as 75 percent of Russian oil export transactions pass through that city.

The fact that many traders are privately held, offshore companies makes it is very difficult to determine the nature of the transactions. Virtually no trading contracts are made public, and prices are generally secret. Given the wealth that many traders have been able to generate, this has led observers to speculate that traders are purchasing commodities at artificially low prices and reselling them at market rates, leaving the resulting profits overseas. This practice, known as transfer pricing, was widely acknowledged to have been used by Russian extractive corporations in the 1990s, ostensibly as a reaction to punitive tax regimes. Now that taxes have been relaxed and the industries themselves have become more profitable, there is some debate over how much transfer pricing still occurs. But the lack of transparency in the trading industry leads many to assume that transfer pricing—which denies the government tax revenues, deprives the industry of investment, and reduces dividends for minority shareholders—remains a significant factor.

### **Corporate Interest in Transparency**

Because most major Russian extractive corporations have publicly traded shares, a basic modicum of transparency is provided by their mandatory reporting obligations (for a breakdown of reporting by company, see Table 1). Of the 21 companies reviewed for this report, 16 have equity listings in Moscow. Of those in Moscow, seven also have listings in London, Frankfurt or New York (and some have listed shares in more than one of those cities). All but one (Itera) released annual reports in 2010. The vast majority reported in both Russian and English (the exceptions were Zarubezhneft, which reported only in Russian, and Evraz, which reported only in English). All but

three release financial data according to either international accounting standards (IAS) or U.S. generally approved accounting practices (US GAAP); the remainder report according to Russian accounting standards (RAS), which are generally weaker in terms of operational detail and allow for a greater degree of consolidation.

Table 1

## Russian Extractive Industry Reporting Practices

Company	Latest annual report released, year (Russian)	Latest annual report released, year (English)	Equity listings	Reporting standard	PRMS reserve disclosure (hydro-carbon companies only)	Latest CSR sustainability report released, year	Latest environmental impact report released, year	Third-country operations reported separately
<b>Hydrocarbon Sector</b>								
Bashneft	2010	2010	RTS	IAS	Yes	2009	2009	No
Gazprom	2010	2010	RTS London Frankfurt	IAS	No	2010	2010	Yes
Gazprom-neft	2010	2010	RTS	IAS	No	2010	2010	No
Itera	None	None	None	IAS	No	None	None	No
Lukoil	2010	2010	RTS, Micex, London	IAS	No	2010	2010	Yes
Novatek	2010	2010	RTS	IAS	Yes	2009	2009	No
Rosneft	2010	2010	RTS, Micex, London	US GAAP	Yes	2010	2010	No
Surgut-neftegaz	2010	2010	RTS, Micex	IAS	No	None	2010	No
Tatneft	2010	2010	RTS, Micex, London	RAS US GAAP	No	2010	None	No
-BP	2010	2010	RTS, Micex	IAS	Yes	2010	None	Yes
Transneft	2010	2010	None	RAS	--	None	None	No
Zarubezhneft	2010	None	None	RAS	No	None	None	No
<b>Metals and Mining Sector</b>								
Alrosa	2010	2010	Micex	IAS	--	None	None	No
Evraz	None	2010	None	IAS	--	None	None	No
MMK	2010	2010	London Micex, RTS	IAS	--	2010	2010	No
Mechel	2010	2010	NYSE	IAS	--	None	None	Yes
Metallo-invest	2010	2010	None	RAS	--	None	None	Yes
NLMK	2010	2010	Micex, RTS London	US GAAP RAS	--	2009	None	No
Norilsk Nickel	2010	2010	Micex, RTS	IAS	--	2009	None	Yes
Rusal	2010	2010	Micex, RTS	IAS	--	2008	None	Yes
Severstal	2010	2010	Micex, RTS	IAS	--	None	None	Yes

Beyond those basic releases, however, the level of disclosure deteriorates. Only four of the 11 hydrocarbon producers reported reserves according to Petroleum Resource Management System (PRMS) standards. Only seven of them released 2010 corporate social responsibility (CSR), sustainability or environmental impact reports in any language. Not surprisingly, companies with listings in the European Union or United States were much more likely to have done so. Only eight broke out results for third-country operations, and these were generally the companies with more significant overseas operations.

The overview demonstrates that corporate transparency is strongly correlated with international competitiveness. Therefore, access to world markets represents the largest incentive for adopting contemporary transparency practices.

### Overseas investments

#### Overview

Russian interest in transparency may be motivated primarily from a need to protect overseas investments. Transparency is crucially important for companies that aim to develop internationally. In particular, firms may face significant difficulties in gaining access to foreign markets if their financial statements and information about their resources remain opaque.

An increasing debate surrounding corruption in project finance has also been forged by the well-known Russian anticorruption blogger Alexey Navalny. He has said that state-owned companies exaggerate spending compared with real costs, and let the difference be “consumed” in profits within opaque companies networks. Overseas investments can be convenient tools for such practices. Russia’s extractive corporations have a significant and growing overseas presence in a range of activities including extraction, transshipment, downstream sales, distribution, finance and processing. Subsidiaries of Russian extractive corporations are present in at least 66 countries around the world. A full listing is presented in Table 2.

Relatively few of these operations involve actual extraction. Among those that do, the most prominent are Rusal’s bauxite operations, particularly in Guinea, Jamaica and Guyana. Evraz also has significant mining operations in South Africa and minor stakes in mines in Australia, the United States and elsewhere. Aside from Lukoil’s oilfields in Azerbaijan and Kazakhstan, and Alrosa’s oil operations in Angola, there is very little hydrocarbon extraction by Russian companies outside Russia. Most overseas investments by Lukoil and Gazpromneft go to refining and distribution segments of the industry.

Metals and hydrocarbon processing are more significant, however. Rusal, Severstal and Evraz in particular have important metals plants around the world. Among the more significant are assets owned by Evraz and Severstal in the United States and the European Union. Gas giant Gazprom’s overseas holdings feature significant gas transportation networks in the European Union, Central Asia and the Caucasus. Several of the metals and mining companies also own sales and distribution units in Europe. Perhaps most crucial, however, are the holding companies and financial corporations that almost every major Russian extractive player has in the European Union and offshore locations such as the Cayman Islands—including state-controlled firms like Gazprom.

All of the companies in question use such firms to handle the operations of their production sub-

sidiaries and to channel cash flows generated overseas. In many cases, much of the cash actually remains overseas and is never comes to Russia. Moreover, for the fully private companies, shares are also held in overseas financial firms; Evraz, for example, is officially registered in Luxembourg and is not technically Russian at all.

Table 2  
Russian Extractive Industries'  
Presence in Third Countries

Company	Sector	Countries Present		
Alrosa	diamond mining	Angola	Belgium	
Evraz	metals and mining	Canada Czech Republic	Italy South Africa	United States
Gazprom	natural gas	Armenia Belarus Belgium Bulgaria Estonia Finland France Greece Hungary	India Italy Kazakhstan Kyrgyzstan Latvia Lithuania Moldova Poland Romania	Serbia Slovakia Switzerland Turkey Ukraine Uzbekistan Venezuela Vietnam
Gazprom-Europe	natural gas (trading only)	Germany		
Gazprom Operations and Trading Ltd.	natural gas (trading only)	United Kingdom		
Itera	natural gas	Armenia	Georgia	United States
Lukoil	oil	Algeria Azerbaijan Belgium Bulgaria Canada Colombia Cote d'Ivoire	Egypt Finland Ghana Hungary Iran Kazakhstan Lithuania	Romania Saudi Arabia Serbia Singapore Ukraine United States
Magnitogorsk Iron & Steel Works	metals and mining	Australia	Turkey	
Mechel Steel Group	metals and mining	Croatia Kazakhstan	Lithuania Romania	
Norilsk Nickel	metals and mining	Australia Belgium Botswana	Canada Finland South Africa	United Kingdom United States
NLMK	metals and mining	Belgium Denmark	France Italy	Ukraine United States
Rosneft	oil	Afghanistan Georgia	Mongolia Turkmenistan	Ukraine United Kingdom
Rusal	metals and mining	Armenia Australia China Guinea Guyana	Ireland Jamaica Montenegro Nigeria Romania	Serbia Sweden Ukraine
Severstal	metals and mining	Cyprus France Ireland	Italy Ukraine United Kingdom	United States
VSMPO-Avisma (Rostekhnologii)	metals and mining	Canada France Germany	Sweden Switzerland United Kingdom	United States
Zarubezhneft	oil and gas	Angola Bosnia	Iraq Kazakhstan	Vietnam Turkmenistan

Source: S. Greene, *The Global Atlas of the Russian Extractive Industries*, (Moscow: Carnegie Moscow Center, 2008).

**Strategy**

The scale, structure and strategic orientation of Russian extraction industry operations abroad vary widely from company to company. A general analysis, however, suggests that Russian extraction-based corporations invest overseas for one of two strategic purposes—either to support the generation and maintenance of cash flow, or to diversify the owner’s asset base and thus serve as insurance against political risks at home. These strategies broadly shape the structure of their holdings. The selection of an overseas expansion strategy, in turn, depends highly on the domestic ownership and control profile of the corporation and the associated political risks.

Thus, companies that are effectively state-owned or controlled (such as Gazprom or VSMPO-Avisma), as well as private companies with owners who are secure enough politically to protect their assets (such as Lukoil or Rusal), tend toward the former strategy. They develop their overseas holdings in order to generate income, mostly through the sale of resources extracted in Russia to customers in the West. That income is then returned directly to the parent company in Russia. This is necessitated both by the need to provide robust rent flows to political patrons and clients, as well as by a desire to increase profits sapped by the need to provide, in many cases, subsidized commodities to the domestic market.

For those companies whose ownership profile is less stable—and whose owners therefore face a greater risk of losing control—the second strategy is more attractive. Overseas operations are pursued for the purpose of asset diversification and political insurance. This is most prominent in the metals and mining sector, as exemplified by Evraz and Severstal. Such companies have expanded aggressively, in some cases to the point in which more than 50 percent of the holding’s total revenue is generated outside of Russia. However, their foreign subsidiaries are often not fully integrated into their business. Production processes of the subsidiaries are commonly held in offshore structures that can be easily separated from the parent. As a result, while the overseas holdings are not necessarily useful to the parent from a standard business perspective, they are supremely useful to the parent’s owners as an escape plan in the event they lose control of their Russian assets.

**Perceptions of transparency**

To better gauge the relative transparency and opacity of Russia’s extractive industries, 42 experts on the sector were approached for interviews. At the time this draft was written, however, fewer than half had been interviewed, with numerous refusals motivated either by the sensitivity of the topic or the perceived futility of addressing extractive-industry transparency in Russia. Of those interviewed at the time of this writing, three were representatives of NGOs, three were journalists, seven were academic researchers, and three were from the business community (predominantly analysts for investment banks analysts); eight were Russian specialists, and four were foreign specialists. All of them research the Russian extractive industries professionally on at least a monthly basis.

While not a representative survey, the results are indicative of broad trends and tendencies. More than 80 percent of respondents believed that the level of transparency in the industry was moderate or low. No one reported that it was high. More than 70 percent reported that the Russian extraction industry’s compliance with international transparency norms was moderate or low. While 85 percent of respondents periodically engaged in professional conversations about extractive industry transparency in Russia, only two said that such a conversation involved in-

ternational transparency norms, such as the EITI, or foreign legislation (such as the U.S. FCPA or Dodd-Frank). Fewer than 60 percent reported having professional conversations concerning the operations of Russian extractive corporations in third countries.

As shown in Table 3, the majority of respondents reported that the information they need on resource extraction by both Russian and foreign companies is available with some, but not inordinate, difficulty. Very few reported being able to access such information with ease. Respondents reported the most difficulty accessing information about Russian extractive industry operations in third countries, and the most ease accessing information about Russian government regulation of domestic operations.

Table 3  
Ease or Difficulty of Information Access

	How easy or difficult is it for you to access the information you need on...			
	Russian extractive corporations in Russia	Foreign extractive corporations in Russia	Russian extractive corporations in third countries	Government regulation of extractive industries in Russia
Easy	0.0 percent	8.3 percent	0.0 percent	33.3 percent
Somewhat difficult	58.3 percent	50.0 percent	16.7 percent	41.7 percent
Very difficult	16.7 percent	16.7 percent	58.3 percent	0.0 percent
Not relevant to my work	8.3 percent	8.3 percent	8.3 percent	8.3 percent

The level of difficulty involved in accessing information, however, does not seem to shape the degree to which researchers use Russian sources of information, as delineated in Table 4. Thus, despite the relative ease of using Russian government sources, fewer than half of respondents reported turning regularly to any government body other than the Ministry of Economic Development. Within the hydrocarbon sectors, several of the most opaque companies—including Tatneft, Rosneft and Bashneft—are among the most popular subjects of research. The metals and mining sector, on the other hand, is comparatively poorly addressed, at least by our survey’s admittedly unrepresentative sample.

Table 4  
Most Common Sources of Information

Russian Government	Hydrocarbon Sector	Metals and Mining Sector
Ministry of Economic Development (58.3 percent)	Gazprom (66.7 percent)	Norilsk Nickel (50 percent)
Ministry of Energy (41.7 percent)	Lukoil (58.3 percent)	Rusal (41.7 percent)
Ministry of Natural Resources (33.3 percent)	Tatneft (58.3 percent)	Severstal (41.7 percent)
Regional governments (33.3 percent)	TNK-BP (58.3 percent)	Evraz (16.7 percent)
Ministry of Finance (16.7 percent)	Rosneft (50.0 percent)	Magnitogorsk (16.7 percent)
	Bashneft (41.7 percent)	Mechel (16.7 percent)
	Gazpromneft (41.7 percent)	NLMK (16.7 percent)
	Novatek (41.7 percent)	VSMPO-Avisma (16.7 percent)
	Transneft (33.3 percent)	Alrosa (8.3 percent)
	Surgutneftgaz (25 percent)	Metalloinvest (8.3 percent)
	Itera (16.7 percent)	

Respondents to the small survey conducted for this report indicated that, for the most part, transparency measures implemented by Russian extractive industry corporations (and, indeed, by Russian corporations more broadly) are generally little more than “box-ticking” exercises. They are carried out primarily to satisfy the requirements of financial market regulators. This is particularly true for those listed on non-Russian markets, or those that have bonds trading overseas. In rare cases, Russian corporations may sign up to international initiatives, such as the Global Compact against Corruption, or the Carbon Disclosure Project (in the latter case, Novatek, the independent

natural gas company, is the only Russian participant to date).

These are, however, again seen as brand-building steps by corporate managers who are eager to make their companies more attractive to international investors. International transparency initiatives, which require more intense participation and are open-ended in their outcomes, such as the EITI, hold no attraction, either for Russian corporations or the government. No Russian corporate or government institution has ever attended any of the international EITI conferences. The Russian government, meanwhile, has not taken any steps to encourage participation or to set its own standards for the public transparency of corporate citizens. In fact, the government has at times opposed the release of what it has deemed “strategically sensitive information,” including reserves and, in the case of Gazprom’s gas pipeline company, MRG, available transmission capacity.

### Current Debates

It would be inappropriate to suggest that there is a true debate—in policy circles, the media, civil society or elsewhere—about transparency in Russia’s extractive industries today. There is, to be certain, a debate about corruption and about transparency writ large, particularly having to do with government contracting and procurement. This debate does involve the procurement practices of state-owned corporations, a particular focus of blogger Alexey Navalny. While Gazprom is a subject of this national dialogue, the focus is less on its extractive activities and more on the financial dealings of the company and its subsidiaries. There are, from time to time, accusations that the allocation of exploration and drilling rights in a given case was done in an opaque manner. And there is an underlying expectation that all such transactions involve a combination of politics and corruption.

The link with transparency is indirect and, curiously enough, rarely seen by the public. Likewise, official statements on corruption and transparency are often decoupled in the national discourse. NGOs remain limited in Russia. There is greater political influence among independent companies, regions and national universities than among NGOs.

An important aspect of the transparency debate focuses on environmental pollution stemming from extractive operations. Environmental organizations have difficulty accessing reliable information, both from companies and from the government, about the release of pollutants into the atmosphere or the water table. Such debates are often salient in localities where extraction is conducted, such as the Pacific coast island of Sakhalin, some of the industrial areas around Lake Baikal, or mining districts in the Urals or the Kuzbas. But they generally do not garner national attention. It is worth noting that this discussion is an entirely domestic one. The campaigns pursued by Greenpeace, the World Wildlife Fund and other environmental groups in Russia focus exclusively on the preservation of Russian habitats and wildlife, and do not discuss global issues like climate change.

Those within industry debate governance, regulatory and taxation issues. Respondents to the survey reported having observed frequent conversations about a perceived arbitrariness in the taxation regime. Those industry representatives generally see tax policy as discouraging oil investment and making life difficult for independent gas producers while providing comparatively large incentives for mining and metals. There is also significant concern that oil companies will not meet government-set targets to utilize 95 percent of associated gas by 2014 or to produce European-standard gasoline and diesel fuel for the domestic market. Energy firms also face the

need to install energy-intensive refining and power-generating equipment in order to process larger amounts of gas condensate. Those issues could become core elements of a transparency debate. Respondents, as well as some industry participants, worry that these governance issues will give rise to corruption as politically connected corporations reach informal agreements with the government to allow them to evade untenable (or simply uncomfortable) formal rules and regulations. Those concerns are most pervasive among small domestic players.

### Policy recommendations

#### Structural Challenges

Anyone seeking to engage Russian corporations and the state on issues of transparency will need to grapple with several interlocking structural challenges. Two are common to resource-export oriented countries. First is the lack of transparency in contract and license allocation, and second is the mismatched time horizons and incentive structures. Finally, companies often believe that secrecy provides a better economic efficiency than a transparency.

In addition to these challenges, relations between Russian corporations and the government present a number of problems related to issues of ownership and control. Those nominally in control of the assets of Russia's extractive industries are not, in reality, the owners of those assets. The government exerts a high level of control in spite of the private structure of ownership. Rather, the nominal owners enjoy tentative leasehold, which allows them to extract rents for as long as the state sees fit to allow them to hold the lease. This arrangement, however, imposes a particular set of incentives on both parties. The controller or leaseholder tacitly accepts the rules of the game under which he can be deprived of his assets at any time (generally in return for something, although the value of transaction cannot be assured). The leaseholder is therefore encouraged in this arrangement to reduce his vulnerability and increase his insurance.

Four important observations can be made about the status of the current transparency debate in Russia:

- By creating an environment based on uncertainty in which institutions are weak and rules are fluid, actors at all levels are encouraged to hoard information. Information communicated publicly can and often will be used to loosen one's grip on rent-producing assets. So traditional arguments that help Western-based corporations see the value of transparency face a higher hurdle in Russia. This logic applies to the state itself as well as corporations.
- When the controllers of Russian corporations expand internationally, it is often to create an insurance policy against expropriation. They often invest abroad in order to ensure themselves a soft landing in the event that they are deprived of their Russian businesses. Confidentiality and secrecy are crucial to maintaining the value of this insurance policy, as they make it easier for the overseas holdings to be kept separate from those in Russia.
- This system is held together by the extraction and redistribution of rents. Unable to ensure perpetual ownership, and interested in maximizing short-term benefits, corporations extract rents from the assets they "own" and redistribute rewards to political patrons and clients as compensation for the right to hold the assets. This arrangement is mutually beneficial to the corporate controllers and to the political leadership. Both would suffer if the extent of rent flows were made public.

- The relationship described in above makes corporate controllers highly risk-averse. Understanding the sensitivity with which the state views the extractive industries, no corporation is willing to be seen as leading the industry into meaningful increases in transparency. Global governance and civil society initiatives are broadly seen as suspect by the Russian government.

There are several crucial differences between Russian extractive corporations and their Western and emerging-markets counterparts, all of which flow back to issues of ownership and control. Many have to do with the time horizons perceived by corporate controllers. There are three factors of particular relevance here:

- Because of unsettled ownership structures, Russian corporations have difficulty engaging in long-term strategy and investment planning. Value is attached first and foremost to short-term rent maximization.
- While many Russian extractive corporations' presence in Russian and international financial markets is secondary to their presence within the Russian "political market," there can be no question of them being part of a global market for corporate control. The Russian government would not countenance a major Russian firm being bought out by a foreign suitor. If there were such a danger, or, indeed, if participation in international capital markets were otherwise to threaten the political position of a company (for example, by introducing too much transparency), the company in question would be likely to de-list.
- The role of minority shareholders in corporate governance remains insignificant. They are generally unable to lobby for even their most basic interests, such as dividends.

### Conclusion and Recommendations

The structural challenges described above are not insurmountable. We suggest five key recommendations for those interested in engaging Russia in a debate on transparency. They are listed hereafter in order of priorities to the Russian major players in the field (industry and political elites).

- *Recommendation 1:* Focus on industrial citizenship, which would reinforce a legitimacy incentive for both industry and government. In particular, the issue of legitimacy arose during the elections of December 2011. Several of the largest Russian extractive corporations have ambitions to be global leaders in their industries, and some already are. They should be encouraged to take a more active role in global industrial bodies. Even if these bodies are not seen by transparency advocates today to be on the "right" side of the issue, these bodies do engage in internal and external debates on an international level. Russian companies are broadly unaware of these debates, and they have no experience of participation. This would be a small step, but it would be in the right direction toward raising legitimacy of the extractive industry in public opinion. And when new transparency practices are mainstreamed, it will in many cases be through the mediation of industry groups; thus, the sooner Russian corporations learn to be comfortable with the recommendations coming from these groups, the more receptive they will be to transparency-related guidance. In addition, industrial citizenship cannot be built without the active participation of the regional authorities. Curiously enough, regional administrations could have a higher impact on federal government than any hypothetical civil society organization.
- *Recommendation 2:* Focus on financial markets. While individual companies may some-

times balk at one-off issues coming from investors or market regulators, the industry as a whole cannot buck across-the-board regulation. Strengthening international accounting standards, or requirements such as those placed in Dodd-Frank, is likely to be the most effective method. The recommendation here, however, is not to engage with Russian extractive corporations, which would be pure policymakers in this area. Rather, reformers should seek to engage Russian financial market players. In particular, the new entity emerging from the tie-up of Russia's two big stock exchanges, RTS and Micex, should be encouraged to take on the best practices of NYSE or LSE, particularly if it is serious about growing an international financial center in Moscow. Similar engagement can and should be pursued with Russia's investment banks, financial advisors and auditors.

- *Recommendation 3:* Focus on domestic competitiveness. Russian domestic companies need to understand that international majors have increased levels of transparency over time in order to enhance competitiveness. In particular, greater transparency allows companies to correctly assess assets (including investments, resources, social and environmental spending, etc.). In turn, creditworthiness of the companies increases. In addition, transparency in the allocation of gas transportation capacity would reinforce the competitiveness of the industry as a whole. For example, levels of gas losses would decline in the context of a transparent and market-oriented capacity allocation. For the government, a higher level of corporate transparency would also ease access to the international arena.
- *Recommendation 4:* Focus on international competitiveness. The process of EU market liberalization will require a higher level of transparency for the gas industry. In turn, restrictive measures will affect non-EU companies from countries that have not liberalized their gas markets. In such conditions, Gazprom should be increasingly interested in providing a better market design for domestic producers in order to attenuate restrictive reciprocity norms that could be used by the European regulators against the Russian gas major. Moreover, EU market design is expanding through the Energy Community Treaty to some former Soviet Union States—Ukraine in particular. This situation cannot leave Russian companies unaffected. For example, in 2010, a Hungarian regulator refused to let Russian oil producer Surgutneftegaz take control of Hungarian MOL's assets due to the nontransparency of the company. Similarly, requirements for greater transparency for traders—most of whom are based in the EU—will have to start and finish in Europe. If Europe is successful in such initiatives, it will create a learning curve for corporations around the world, Russia included, and after that a process of adaptation. But Russian corporations and government bodies will not get involved in this process until it becomes absolutely clear that Europe will follow through.
- *Recommendation 5:* Share knowledge and help foster joint action between civil and corporate representatives of countries oriented toward resource exports. Indeed, it is important to understand the best practices of other countries and to assess how transparency can positively contribute to the development of a competitive economy. Obviously, this will take time. In Russia specifically, there is great interest in learning about best practices at the regional level, whereas there is almost none at the federal one.



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