



# **INVESTMENT CLIMATE OF THE RUSSIAN FEDERATION AND ITS PETROLEUM INDUSTRY**

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## **ABSTRACT**

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The image of the Russian Federation has been changing in the past years, making it difficult for people to understand what Russia is and where it is heading. The uncertainty makes investors avoid projects in Russia. At the same time the Russian Federation is one of the major powers in Europe, engaging in heavy trade and economic relationships with many European countries. For some Russia is major trade partner, for others it is an important and reliable supplier of natural resources. The differences between Russia and European countries are harmful for all the Europe and Russia's deeper integration in Europe will benefit all the economies of the region in the long run.

The objective of this thesis is to make a comprehensive analysis of the investment climate of modern day Russia and its economically most viable petroleum industry. It will give an answer to why investors are avoiding Russian economy. After finding problems, it is important to show how the situation is changing and, based on that, to form predictions that will be useful for people looking to invest in Russia. In the end, this thesis will help people understand Russian economy and make an investment decision.

In order to give a full picture, the thesis deals with the general investment climate and that of the petroleum industry separately. The general analyses includes economic, legal, business and political environment in Russia and the second part deals with industry specific factors.

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Key words: russia, investment climate, oil, gas, petroleum industry, economy

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# **1 INTRODUCTION**

## **1.1 Purpose and objective**

After the collapse of the Soviet Union Russia became an open market for international businesses. Now it is the 8<sup>th</sup> largest economy, with more than 140 million people, huge trade potential, vast mineral and intellectual resources. Even in the difficult business environment Russian businessmen were able to innovate and create new opportunities. However, Russia has plenty of problems and sometimes it seems to be not willing to deal with them. Russian economy is famous for huge levels of corruption, illegal schemes, little to no government support and large politicization of the economy. Moreover, Russia is experiencing a lot of pressure from the Western countries and some analytics even state that we are facing the Cold War 2. Those problems have a negative impact on the image of modern day Russia and lead to a shortages in highly needed investments. They also isolate the Russian Federation, not allowing it to unite with Europe and create close economic relationships that would benefit all the parties.

The purpose of this thesis is to make analysis of Russian investment climate and find out if the problems that Russia is known to have are real; what action it takes to improve. After showing the results, I will discuss the factors that are causing the situation and will try to make predictions on where the economy is heading. My objective is to give potential investors a complete picture of benefits and risks of investing in Russia and its petroleum industry.

## **1.2 Structure**

The thesis is divided in two main parts. The first part deals with the general investment climate in the Russian Federation. It begins with an overview of Russian economy, where I analyze main economic factors and indexes, like GDP, levels of foreign investments, inflation, unemployment, credit rating, etc. Also, I make a prediction about the future of the economy, based on the historical data and other factors. Next goes legal environment that deals with the legal system in Russia that has direct influence on how secure the investors and their investments are. The third sub-part is concerned with easiness of doing business in Russia and there I talk about main obstacles that small and medium businesses face in the realities of Russian market. The last is political environment. It has become even more important after the recent events in the Ukraine and imposition of the sanctions. In my

opinion, these are the parts that potential investors are most interested in, as they cover the most factors that may affect the investments and their profitability.

The second part of the work deals with the investment climate of the petroleum industry of Russia that includes oil and gas extraction, geological exploration and oil refining. The main object of the research is the oil industry though. It explains the structure of the industry and features of the business. Then I analyze the data from the previous year to show how the industry is doing and to make a basis for predictions. In this part I also research the main problems of the industry and their solutions. Moreover, there is a brief overview of main future projects.

### **1.3 Methodology**

For this thesis I will use a large amount of books, researches and articles, as such a large topic requires huge amount of information. For the quantitative information, on which my analysis will be based, I will use data provided by the official governmental statistic agencies and ministries. For industry specifics I will use books and works of specialists from the industries and for the analysis of the current situation I will use publications of large news agencies with good reputation.

## **2 THEORETICAL FRAMEWORK**

### **2.1 Investment**

There a large amount of definitions of investment in the economic literature. The most general one is the definition given in the Internet Encyclopedia of Economics – “Investment is the production of goods that will be used to produce other goods.” (Hassett 2014) Accordingly, cash and other capital invested in the implementation of any projects in order to obtain future income are called investments. Legal entity or individual engaged in investment activities are called investors. The main economic motive behind investment activities is to earn profit. In other words, investment is the action of investing capital in pursue of a profit. Therefore, consumers’ acquisitions of home appliances, cars and other similar products for personal use do not count as investments. Investments can be made not only in tangible assets, but also in intangible ones. They include investments in acquisition of licenses, patents on new technologies, know-how, etc. (Bodie, Kane, Marcus 2009)

In Russian Federation, investments are regulated by the Federal Law #39-FZ “About investing activities in the Russian Federation performed in the form of capital investments” of 25 February 1999. It states that investments are “money, securities, other property, including property rights, other rights having the money value, put in objects entrepreneurial and (or) other activities for the purpose of profit earning and (or) achievements of other useful effect”. This document also takes into account the concept of capital investment, which is considered as a form of investment in fixed assets, including the cost of new construction, maintenance of existing enterprises, purchase of machinery, equipment, tools, furniture, and several other costs.

Basically, investment can be defined as a process during which resources are transformed in expenses with an aim of receiving profits. (Igonina 2007)

Table 1. Types of investments

Classification	Form of Investment	Description
By objects of investment	Real Investment	Investment in land, property, machinery, patents, etc.
	Financial Investment	Investment in stocks, bonds, funds, etc.
By duration of investment	Short-term Investment	Investment for a period of less than 1 year
	Mid-term Investment	Investment for a period from 1 to 3 years
	Long-term Investment	Investment for a period longer than 3 years
By investment's target	Direct Investment	"The purchase or acquisition of a controlling interest in a foreign business by means other than the outright purchase of shares."
	Indirect Investment	Invest in financial assets with a purpose of gaining financial profit or diversification of risks
By investing entity	Private Investment	Investment made by a private person (citizens and non-government organizations)
	Governmental Investment	Investments made by the government or governmentally owned organizations
	Foreign Investment	Investments made by foreign citizens, organizations, governments
	Mixed Investment	Investments made by foreign and domestic organizations together
By risks	Aggressive Investment	High risk, high profit, low liquidity investment
	Moderate Investment	Moderate risk, profit and liquidity investment
	Conservative Investment	Low risk, high liquidity and safety investment

## 2.2 Investment climate

Investment climate is the environment in which the investment processes occur. It is influenced by the complex of interrelated legal, organizational, economic, socio-political and other factors that determine the conditions of investment activity in the individual country, region, or city. It should be noted that there is a wide range of definitions of investment climate, as well as methods of its measurement.

The term "investment climate" is applicable primarily to a market economy, where economic environment is not directly controlled. It is the most common criteria for the investment. Investment climate is composed of a set of economic, social, political, legal and even cultural conditions, making an area of the economy, specific industry, city, region or a country attractive for the investments. Basic estimation of the investment climate usually varies from favorable to unfavorable. Favorable is the one which is conducive to high investment activity and stimulating capital inflows. Unfavorable, on the other hand, increases risks for investors, leading to decreasing investment activity.

Factors that influence the investment climate are divided by ability of the society to influence them:

- Objective factors (environment conditions, mineral resources available, geographic position, demographic situation, etc.)
- Subjective factors (related to management of human activities)

Investment climate is closely linked with the investment policies. Investment climate is the object investment policy actions are aimed at. On one hand, it defines the initial conditions for the development of investment policy, and on the other - is its result. Efficiency of the investment policy is measured by the degree to which the investment climate is improved. And the better investment climate leads to improvement of investment policy.

To understand how effective the investment policy is we should look at the degree to which the investment climate changes. Better investment climate, in turn, affects the investment policy, helping it to develop further.



There are various methods of measuring the investment climate. Most of them are based on different economic, political and financial indexes, summing which a city, region or a country gets its investment rating.

The rating is an important factors for the investors, as most of them are not able to conduct their own detailed analyses of the markets they are going to invest in, especially if it is another country.

Investment activity is always connected with risks. The main risk is losing a part or the full sum of the investment. So, the process of risk reduction and creation of a stable predictable situation in the market is a primary goal of the officials. If the risk situation inside of a country is not balanced, some industries get more investments, while others get none, the government may intervene in the industry and boost its investment attractiveness without any large changes.

### **2.3 Capital outflow**

It is a term used for the capital flowing out of an economy. It happens due to a large amount of economic, political or other kind of reasons. Capital outflow is considered a bad thing for an economy, since it signals that people do not want to invest in that particular economy and bringing their money somewhere else. Therefore, countries try to lower the amount of outflowing capital in order to boost the economy.

A more serious case of capital outflow is called Capital Flight, which a spontaneous uncontrollable outflow of capital by individual and corporations from the country due to severe economic, political or other reasons. The ones taking capital out of the country do it with a goal of finding better investment projects, avoid taxation or inflation, or hide their income. (Mishkin 2012)

## **3 INVESTMENT CLIMATE OF THE RUSSIAN FEDERATION**

To give a full picture of the investment climate in the Russian Federation, I decided to concentrate on the 4 main factors affecting the investment environment:

- Economic – shows the growth of economy and its condition, letting investors to predict the possible returns from investments in the country.
- Legal – helps investors to analyze how safe their investments are in the country and what are the ways to defend your interests.
- Easiness of doing business – represents the ability of businesses to operate efficiently, innovate and generate profits. Is important because investors are interested in new fast developing business ideas.
- Political – gives investors an idea of how stable the country is and therefore is an indicator of safety of the long-term investments.

In my opinion, these 4 factors help to create a general picture of the investment climate without the division into regions or industries.

### 3.1 Economic

#### 3.1.1 Gross Domestic Product

Table 2. GDP of Russia in billion rubles, in 2008 prices

1996	1997	1998	1999	2000	2001	2002	2003	2004
22081,8	22386,8	21190,2	22536,0	24799,9	26062,5	27312,3	29304,9	31407,8
2005	2006	2007	2008	2009	2010	2011	2012	2013
33410,5	36134,6	39218,7	41276,8	38048,6	39762,2	41457,8	42882,1	43447,6

Table 3. GDP growth in Russia in % to previous year

1996	1997	1998	1999	2000	2001	2002	2003	2004
96,4	101,4	94,7	106,4	110,0	105,1	104,7	107,3	107,2
2005	2006	2007	2008	2009	2010	2011	2012	2013
106,4	108,2	108,5	105,2	92,2	104,5	104,3	103,4	101,3

After a decade of high GDP growth Russia, as well as the rest of the world, faced the financial crisis. Although it hit Russia harder than most countries, we can see a good growth afterwards. 3 years of stagnation led Russian economy to a large fall, which occurred in 2013. Mostly, Russia followed the global trend as the world's economic growth was slowing down after the crisis, making a large amount of arguments on whether the world is facing a new

economic crisis or a long-term stagnation. Economic growth of developing countries fell from 7.5% in 2010 to 4.5 in 2013, Latin American countries – from 6% to 2.7%, Asian countries – from 9.7% to 6.3%. World superpowers’ economic growth slowed and the EU’s economy continued to stagnate. (Rosstat 2014)

### 3.1.2 GDP analyses

The slowdown of the GDP growth from the production point of view in 2013 was mainly caused by the dynamic of industrial production, retail and wholesale trade, construction and taxation on the products. The growth of added value of industrial production fell from 2% in 2012 to 0.6% in 2013 mostly due to slow in manufacturing industries. Growth in wholesale and retail trade slowed from 3.8% to 1.1%, mainly due to a decrease of the dynamics of wholesale trade. Reduction in the dynamic of construction from 2.4% in 2012 to -1.5% in 2013 occurred due to falling investment demand. The decrease in net taxes is the result of low volume imports and exports of production of the energy industry. Negative trends in industrial production had an impact on the dynamics of the transport and communications - a slowdown from 3.8% in 2012 to 0.9% in 2013.

On the other hand, agriculture had a positive impact on economic growth. It increased 3.2% against poor result of -2.9% a year earlier. Financial activities demonstrate a double-digit growth for a second year in a row. Its contribution to the GDP almost stayed on the 2012 year level (0.5% in 2013 compared to 0.7% in 2012). Also, stable growth took place in Education, Medicine and Governmental Management. (Rosstat 2014)

#### Dynamics of GDP by economic activity

Table 4. Dynamics of GDP by economic activity in % compared to the previous year

	2012	2013
Gross Domestic Product	103,4	101,3
Agriculture, hunting and forestry	97,1	103,2
Mineral extraction	101,6	100,9
Manufacturing	102,7	100,8
Production and distribution of electricity, gas and water	100,2	98,4
Construction	102,5	97,6
Wholesale and retail trade	103,8	101,1
Hotels and restaurants	103,8	101,9
Transportation and communication	103,8	100,9
Financial activities	119,6	112

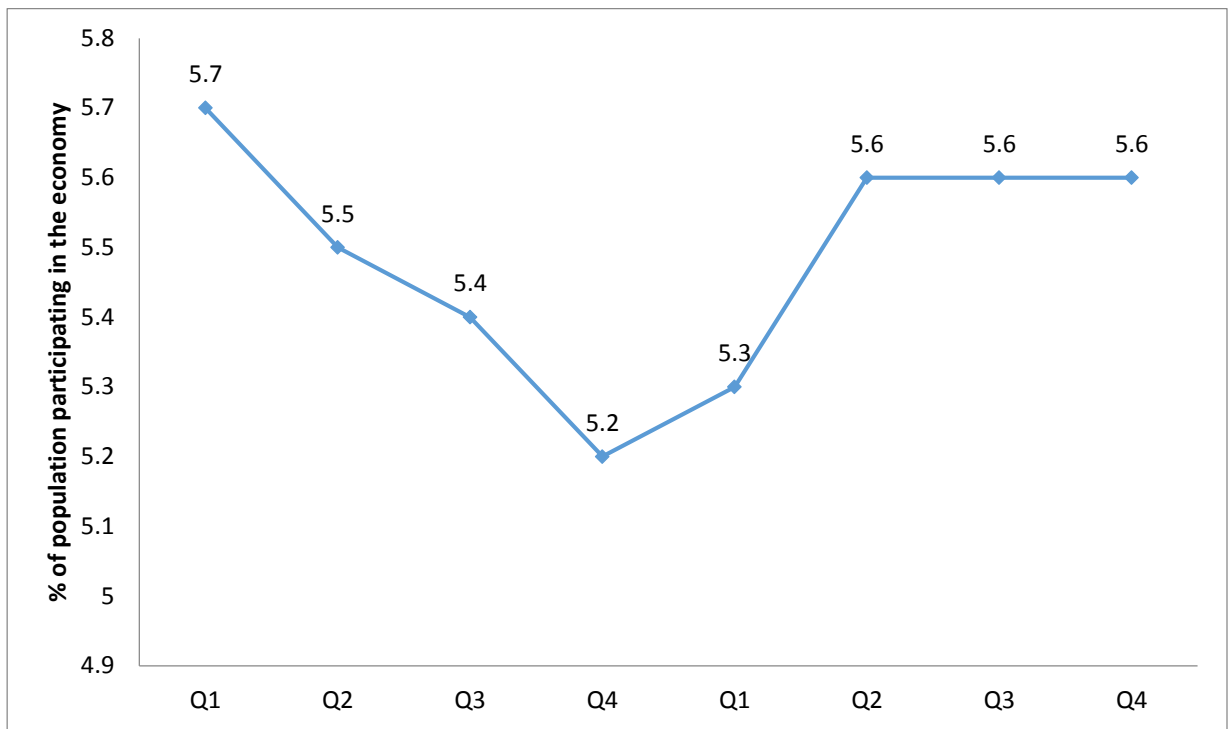
Real estate, rent and provision of housing services	106,4	101,6
Public administration and defense, compulsory social security	100,8	101,1
Education	100,3	100
Health and social services	103	103,1
Provision of community, social and personal services	96,6	99,1
Provision of services to households	114,3	101,4
Tax on imports	106,8	101,6
Tax on products	103	101,1
Net taxes on products and imports	103,4	101,2

### 3.1.3 Unemployment

The average amount of people participating in the economy in 2013 was 75.5 million people, out of which 4.1 million were unemployed. In the first half of 2013, the unemployment level was rising but later it stabilized at the level of 5.6% and the average for the 2013 was 5.5%.

Unemployment levels vary for different regions, for example, only 3.4% people are unemployed in the Central Federal District while in the North Caucasian Federal District unemployment is 12.4%. Highest unemployment rates are in Ingushetia (39.5%) and Chechnya (25.7%). (Rosstat 2014) They reflect the problems southern regions of Russia experience now.

These numbers are very low compared to the European economies, many of which struggle with high unemployment rate, especially between the young. On 24 January 2014, Russian Prime-Minister Dmitri Medvedev said that unemployment level of Russia is one of the lowest among European and Asian countries. However, he also stated that during the switch to an innovative economy companies sometimes have to let people go. (Interfax 2014)



Graph 1. Unemployment rate for 2012-2013

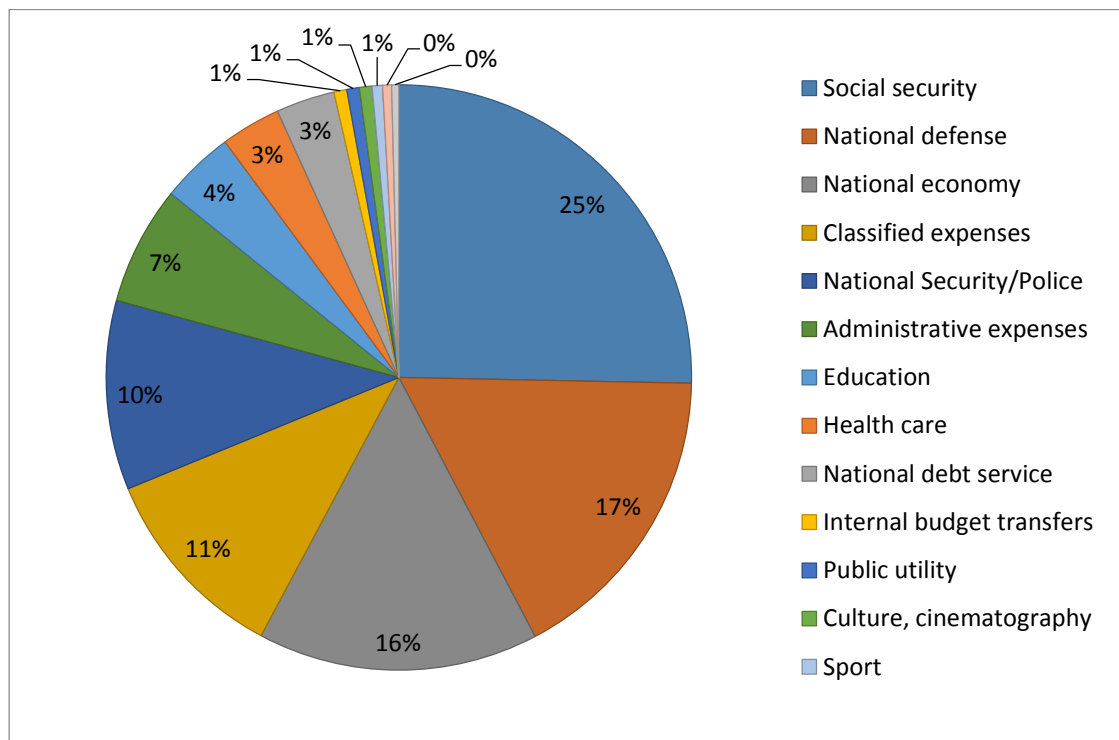
### 3.1.4 Budget

The 2013 budget was planned with an idea of decreasing revenues, especially from the oil and gas exports. By the end of the 2013 the revenues of the budget were counted to be 19.5% of the GDP, which is 1.3% lower than in 2012, although 0.1% better than predicted. It happened due to the market price of oil in 2013 being \$11.3 higher than predicted by the budget. With falling revenues the budget was also cutting the expenses and as a result the expenses for 2013 were 20% of GDP, 0.9% lower than the expenses for the 2012. With revenues falling more than expenses the federal budget deficit resulted to be 0.5%, compared with 0.1% in 2012. It worth mentioning that non-oil deficit grew to 10.1%, although it was planned to be 9.5%. So, we can see that the stagnation of Russian economy didn't lead to any serious troubles in executing the federal budget in 2013. Surprisingly, it was the result of the primitive nature of Russian economy – high dependence on oil and gas revenues. Although, the recession did have large effect on regional budgets – regional budgets deficit grew more than 2.5 times.

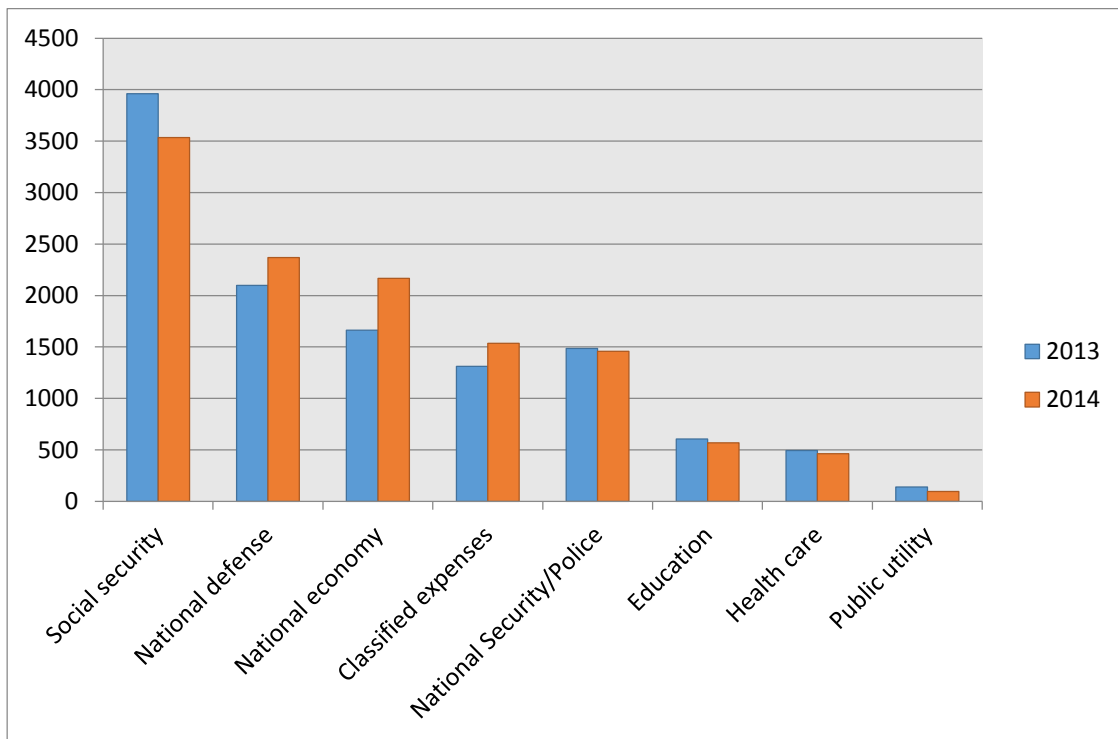
In 2013 the government proposed a new budget plan for the years 2014-2016. In 2014 budget revenues are expected to fall to 18.5% of GDP and later to 18.3% in 2016, which is first of

all linked to shrinking oil and gas revenues. 90% of all expenses in it are aimed at executing government national programs. For a realization of 39 national programs the budget allocates 11.6 trillion Rubles in 2014, 12 trillion Rubles in 2015, and 12.33 trillion Rubles in 2016. For the federal programs – 0.94 trillion, 1 trillion and 0.93 trillion accordingly.

The 3 years budget was made based on predicted yearly average price of oil: \$93 for a barrel in 2014 and \$95 in 2015-2016. It is lower than the prediction of oil price made by Russian Ministry of Economic Development. However, to better understand the Federal Budget's exposure to oil prices, it should be stated that oil revenues are predicted to be approximately 50% of the total budget revenues in 2014. Also, the budget predicted the exchange rate of Dollar to be 33.4 Rubles for a Dollar in 2014, which is already wrong as the Ruble has fell to 35.5 for a Dollar at the moment. The budget will have deficit in all 3 years, and the deficit is expected to grow. For the coverage of the deficit government plans to borrow money abroad. (Ministry of Economic Development of the Russian Federation 2014)



Graph 2. 2014 Federal budget predicted expenses by branches



Graph 3. 2013 and 2014 Federal budget expenses by branches

As we can see from the charts above the 2014 Federal budget is decreasing the expenses on social security, education, healthcare and public utility, while increasing national defense budget. The cuts made in the budget are understandable, as Russia is facing long-term stagnation but relocation of money from social branches to military is one of the problems of Russian economy. The quality of healthcare in Russia is falling with every year and public utility is officially stated to be one of the main problems of Russia today. Still, the expenses for the national defense are growing with every year. Basically, National Defense expenses might be somewhere about 28% of total expenses in 2014, as the “Classified expenses” branch is also related to military. This represents ongoing rearming of Russian army according to the “Federal Program of Rearming the Military” until the 2020. The program is concerned with modernizing the whole Russian military and navy. By the 2020 the government plans to have 70% of the military modernized. (VVP 2011)

Government’s obsession with the military spending are linked to the increasing tensions in the East with Japanese and Chinese, and rising amount of NATO bases at its borders. According to Deputy Prime Minister Sergey Rogozin, Russia, as the largest country in the world, requires an army of approximately 5 million people to be able to effectively defend

its territory from all external threats. However, the army has only 750000 people in it today. So, the answer to that problem is modernization of the military to the state when every soldier becomes an “operator of hi-tech equipment” and is able to operate without any threat to his life.

Also, military industry is considered to be one of the most important in Russia, as it constantly develops new technologies, which can later be used for economic purposes. Anyway, although understandable, high military spending are threatening grow of Russian economy, as the state is able to spend less and less money on other important branches with every year.

### **3.1.5 Inflation**

Inflation in 2013 in Russia was 6.5%, which is on the level of 2012, although the inflation was expected to be in the 5-6% range. Consumer goods had the largest impact on the inflation in 2013. Prices for vegetables rose dramatically due to bad weather conditions. Milk, cheese and eggs prices also increased dramatically, still following the drought in 2012. Inflation peaked at the end of the year with 7.3% in December. It also worth mentioning that medicine prices rose 9%, children’s products 9.9% and public utility services 9.8%. Although their prices rose well above the general inflation, the government reduces expenses on those areas in the 2014. That, in my opinion, is a dangerous condition, as the quality of life in Russia is falling.

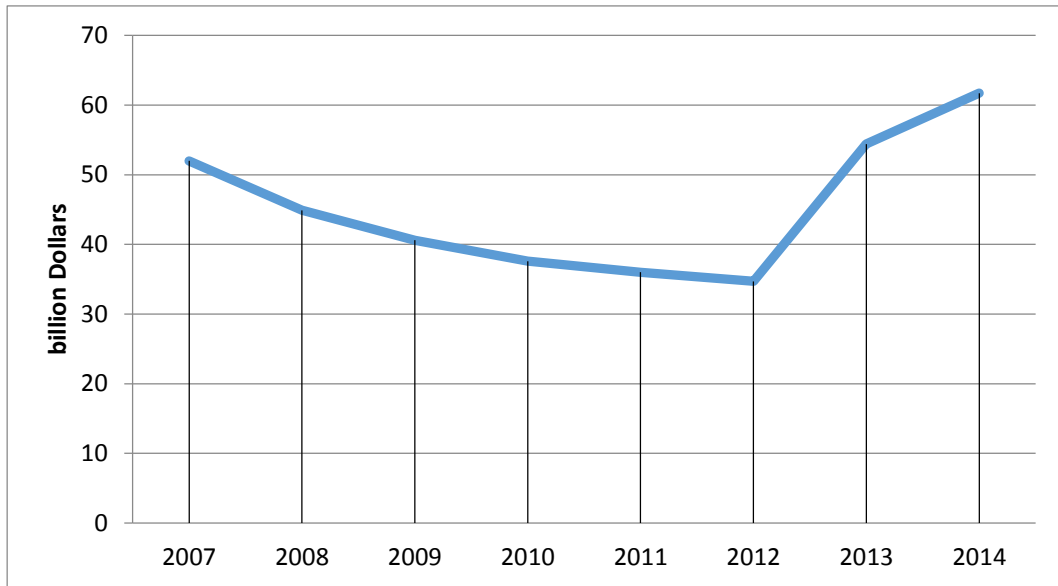
For 2014 the government predicted low inflation of 4.5-5.5% but now, after the first quarter of 2014 it is clear that inflation levels are going to be way higher than that – inflation for the first quarter of 2014 was 2.4%. So, if the tendency stays the same and the inflation will once again peak at the end of the year, it may rise above 7% this year. (Ministry of Economic Development of the Russian Federation 2014)

### **3.1.6 Debt**

The government’s debt rose by \$5025 million or 9.9% in 2013 and was equal to \$55.7942 billion by the 1<sup>st</sup> of January 2014. That is 2.7% of GDP. We can see a stable growth in the level of debt due to the deficit in budget that forces the government to borrow money abroad. And since the future budgets are having deficit as well, it is logical that the governmental debt of Russia will only be rising during the next years. However, that debt is one of the



lowest levels of governmental debt in the world. Due to such a low number Russia is known as a country-creditor. It actually is giving credits to countries like Cyprus, Ukraine, Belarus, etc.

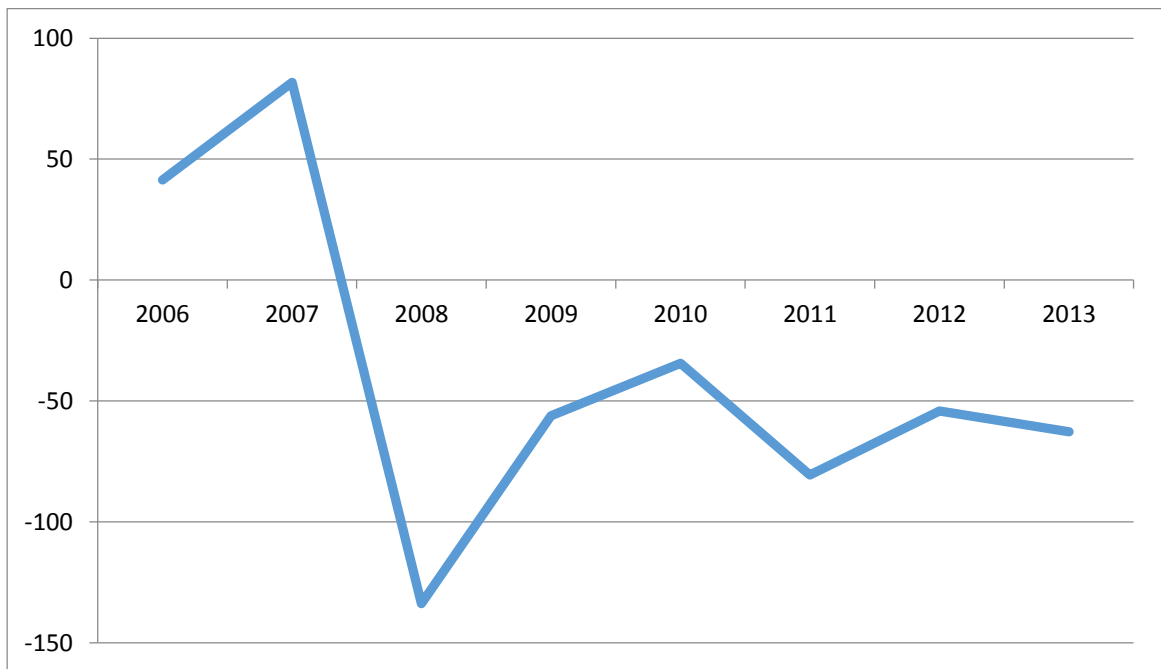


Graph 4. Russian Federation government's debt in billion dollars

As for the public debt, its amount at the 1<sup>st</sup> of January 2014 was 727.062 billion Dollars. It is a 14.25% increase from a previous year. Nonfinancial sector had its debt rise 20% during the 2013 and banks increased their debt by 6.6%. The total debt of Russian Federation is about 33% of GDP, and although it is rising at a pretty high rate, it is still at a low level. For example, in 2013 the USA had debt of 104.5% of GDP and Japan – 243%. Still, some investors are nervous as Russia might be borrowing more in the future especially if the oil prices are going to fall. (Ministry of Economic Development of the Russian Federation 2014)

### 3.1.7 Capital outflow

One of the main problems of Russian economy is the outflow of the capital.



Graph 5. Inflow and Outflow of capital in Russia in billion dollars

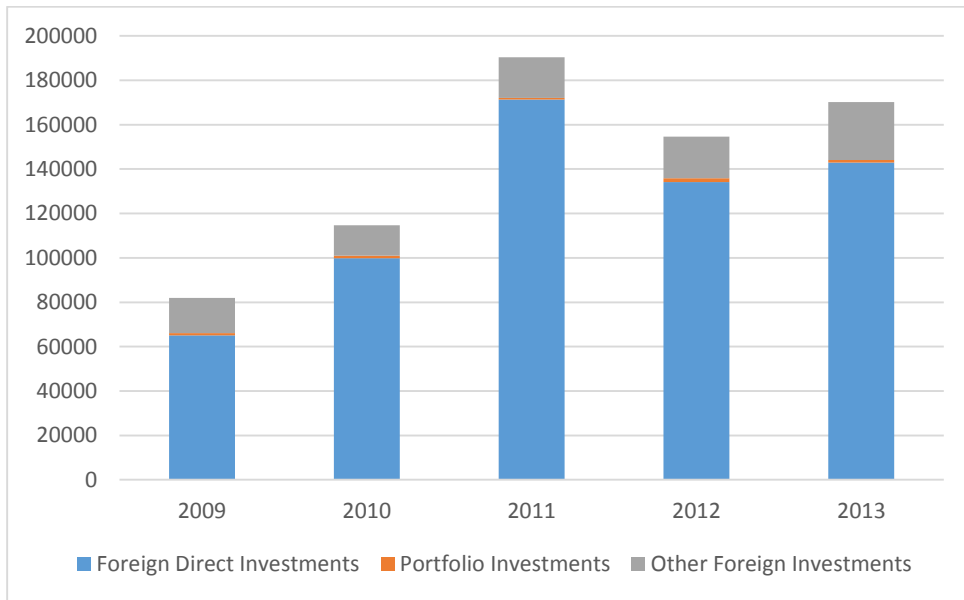
On the chart above we can see inflows or outflows of the capital from Russia. Basically, we see that from 2007 the capital was steadily flowing out of the country and the situation doesn't seem to be getting better.

In the past years Russian oil, gas and metal companies were getting high profits due to large market prices on those materials. So, they had to invest those profits in order to keep them and unfortunately they weren't able to find good investment projects in Russia, so they move those moneys abroad and invest them there. The outflow is also a result of Russian people tendency to move property abroad, especially in South countries, like Spain, where Russian residents own a large amount of property. Furthermore, it is a result of corruption and money laundering, as criminals want to move their money abroad to Switzerland, Netherlands or other countries, which would not give the information about the bank accounts to Russian police. One can guess that such high capital outflows show that Russian investment climate is far from great.

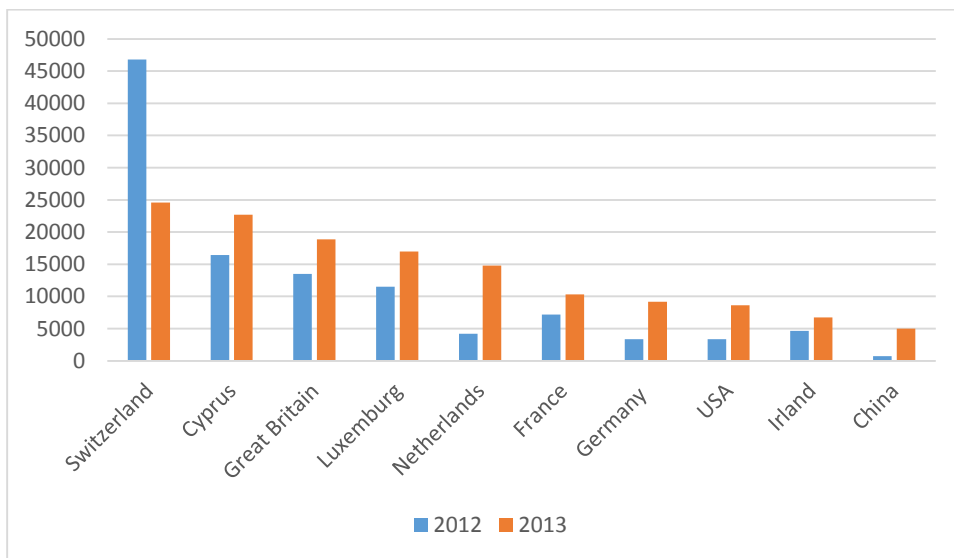
The situation only got worse due to the Ukrainian crisis, as the capital outflows reached \$222 billion in the middle of the year, according to the European Central Bank. Such numbers are very threatening to Russian economy, as it requires large capital investments. (Ambrose 2014)

### 3.1.8 Foreign investments

After the crisis of 1998 the price for oil has been stably rising and the Russian economy showed a good potential, as it offered large client base, fast developing market and good intellectual potential. All those factors helped Russia to see a huge rise of foreign investments into the economy in the beginning of the 21 century that continued until the world financial crisis has occurred. After crisis the investments continued to growth and we still are seeing good results.



Graph 6. Investment in Russia by type



### Graph 7. Investment in Russia by country

Most investments come to Russia from the banking centers of Europe, which is not surprising, as most investing companies are operating from there due to good taxation and privacy. Switzerland and Cyprus are the leaders and this is because companies from those countries own many Russian businesses, although they still belong to Russian businessmen that create such companies in order to maximize profits. Also, these countries are used for illegal schemes to launder money.

Britain is mostly investing heavily into service industries and is also interesting in the oil products. One of the largest foreign companies operating in the Russian oil industry is BP. France, on the other hand is not very interested in the oil industry and prefers to invest into production. The USA is mostly investing into the extraction of natural resources such as oil and gas. (Rosstat 2014)

#### **3.1.9 Credit rating**

Moody's: Baa1 with negative outlook.

S&P: BBB- with a negative outlook.

Fitch: BBB with a negative outlook.

Low credit ratings are explained by the poor results of Russian economy and bad outlook for the future. The oil extraction is falling this year and is predicted to continue falling if there are no actions. Therefore, future budgets will have fewer profits and will have to either cut spending or borrow more abroad. Huge spending on the assimilation of Crimea and the Olympic Games in Sochi probably have cost Russia several years of economic development. Moreover, sanctions from the West are limiting Russian ability to improve economic situation and make Russian economy unstable. (Trading Economics 2014)

#### **3.1.10 Predictions**

The Central Bank of Russia predicts that in the coming years the growth of Russian economy will stay at low levels, as Russia's main trade partners are experiencing economic troubles as well, leading to a lowering external demand. Also, the oil production is expected to grow in the coming years, as the countries are using the new methods of oil extraction and some European nations are aiming to lower their dependence on the Russian oil, although it's more

a political than economical matter. Therefore, the oil prices are expected to fall in the coming years and that is dangerous for the Russian economy with half budget revenues being oil and gas money.

The Bank of Russia is expecting consumer demand to be the main factor influencing the growth of the economy in the 2014. However, that is a doubtful prediction, as the levels of income of the population are falling, due to high inflation and low economic growth. The fall of the Ruble compared to Dollar and Euro is also a problem. Imported products are becoming more expensive and that affects consumers, as most electronic appliances, cars, medicine and even food are imported.

Therefore, the Central Bank expects Russian economy to grow 1.5-1.8% in 2014. However, Russian ex-Minister of Finance, Aleksei Kudrin, says that in 2014 Russian economy will face problems comparable to the ones it faced during the Financial Crisis in 2008. He predicts that Russian economy will grow around 0% (plus-minus 0.5%) and the capital outflow may be as high as \$150 billion. He states that it is the price Russia has to pay for Crimea. (RIA 2014)

In future, we will see how the sanctions will affect Russian economy and the most important thing is whether Russia we be able to develop under heavy limits impost by the West. The future of the Russian Federation as an independent country now depends on its ability to improve its economy on itself, without the help from the developed countries.

### **3.2 Legal**

When investing money in a foreign country investors not only look at the predicted profitability and gains but also at how safe they money will be. Western investors are used to government always being there for them and do not usually worry about how safe their money are. The legal systems in Western countries are serving the investors and are protecting their right and their money. However, when you invest in a foreign country you must understand how its legal system works. Through understanding the legal system an investor can estimate how safe his or her money would be in that country.

Russian legal system varies a lot from those of Europe and North America. It contains a lot of laws and documents, which can sometimes be difficult to find in English. Therefore, there arises a need for legal services for foreigners. Even then, you must remember that the Russian Federation is comparatively young country with a young legal system and thus the laws are constantly changed, rewritten or abolished. Such instability of the legal system may raise questions about how safe the money of investors are. For example, recently a new law came into force stating that all NPOs that take investments from abroad are to be called Foreign Agents. (Federal Law #121-FZ 2012) You can imagine that such a title is not very suiting for NPOs in Russia as they are called agents of the West and quickly lose trust of people. But together with political organizations that have lost all their credibility after this law, there is also a number of non-political NPOs that work with orphans, ill people, etc. These kind of organizations also lose their social credibility and therefore lose their power. The foreigners who invested in these organizations find their investments have more bad than good effect.

Another example is the law passed in 2008. The law limited the ability of foreign investors to invest in the industries claimed to be strategically important. These industries include telecommunication, meteorology, aviation, production of weaponry, oil and gas industry, etc. After the law has passed the foreigners are not able to acquire any control over organizations from those industries unless, the government allows them. This of course brought some problems for foreign investors, as they found themselves in a situation where their long-term investment projects occurred to be impossible to execute. (Federal Law #57-FZ 2008)

Anyway, most of all investors are afraid of other side of the legal system. They are afraid of government officials and criminals utilizing the laws in order to steal the money. Russian laws against economic crimes are harsh and many entrepreneurs got jail time for their commercial activities. According to the Council of Experts at the Business Ombudsman, there were around 110 thousand of people serving sentences for economic crimes in 2013. Prosecution of entrepreneurs has become the main type of bribed court activities. (Yashmanov 2013) Basically, people in business are using their connections and bribes in order to fulfill their business goals or get rid of competition. Foreign investors are not willing to get involved in the entrepreneurial activity in Russia, while the criminal justice is corrupt to such an enormous level.

A good example is the case of Khodorkovsky, the owner of the largest at that time oil company Yukos, who was serving a sentence in jail for an economic crime, which according to human right activists was fabricated and the result of Khodorkovsky disputes with the authorities, as well as his ambitions to become the president of Russia. Another example of the corruption in the legal system is the case of Hermitage Capital, a hedge fund that was accused of machinations with taxes. Although, it's difficult to understand what is true and what is not in that case, it is believed that the whole thing was just an attempt to steal the profits of the fund by some criminal organization with the help from the top officials of the criminal justice system. The lawyer of Hermitage Capital Sergey Magnitsky died in jail, waiting for the trial.

You can also see how Russian government is using the criminal justice system to fight their opponents. For example, Aleksey Navalny is constantly a figurant of one criminal case or another. He claims that government is trying to prosecute him for his activities as an opposition and his internet platform rospil.ru that is created to find cases of corruption in the governmental procurement system and making the public aware of them.

### **3.2.1 Foreign Investments Law**

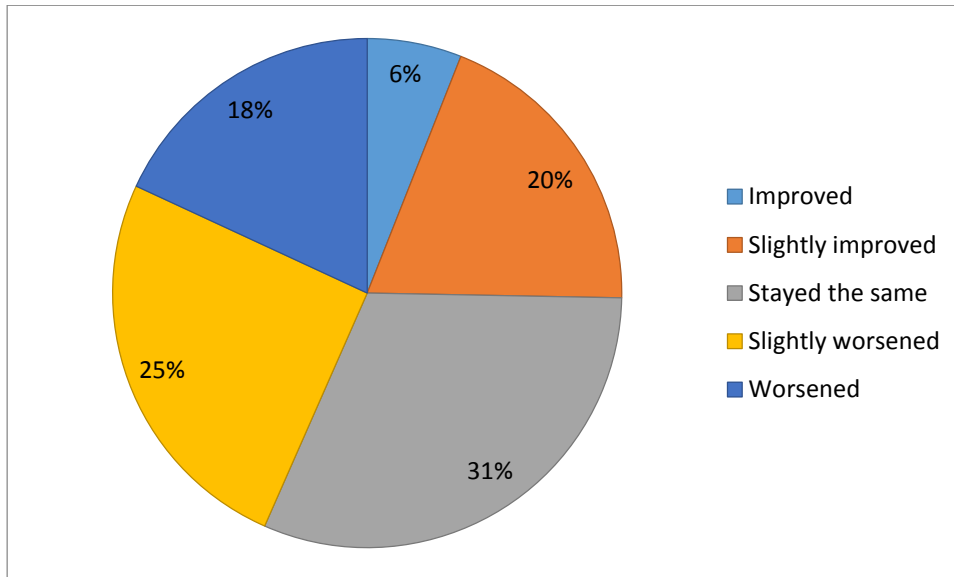
The main law for foreign investments in Russia is the Federal Law #160-FZ of July 09, 1999 "On Foreign Investments in the Russian Federation". The law determines the persons that can act as foreign investors in the Russian Federation. It also regulates the activities of Russian legal entities with foreign participation. The law sets the standards for legal protection and tax benefits for the investors as well as for Russian companies with foreign investments. The benefits for foreign investors set in the law are required for increasing the attractiveness of the Russian Federation for the investors.

### **3.3 Business in Russia**

Russian economy has always been known for its high level of bureaucracy and barriers for entrepreneurs. According to the "Doing Business" Russia is 92th in the list of countries by how easy it is to register and conduct business in those countries. Largest problems are listed to be Construction Permits, Getting Electricity, Getting Credit, Investor Protection and Trading Across Borders. (Doing Business 2013)

However, Russian businesses consider taxation system, lack of trained work force and lack of resources to be the biggest problems for doing business in Russia nowadays. Let's look at them separately.

If we take at Russian analysis of the entrepreneurial environment, made by the Russian Union of Industrialists and Entrepreneurs, we can see that business have quite mixed feeling about where it is all going.

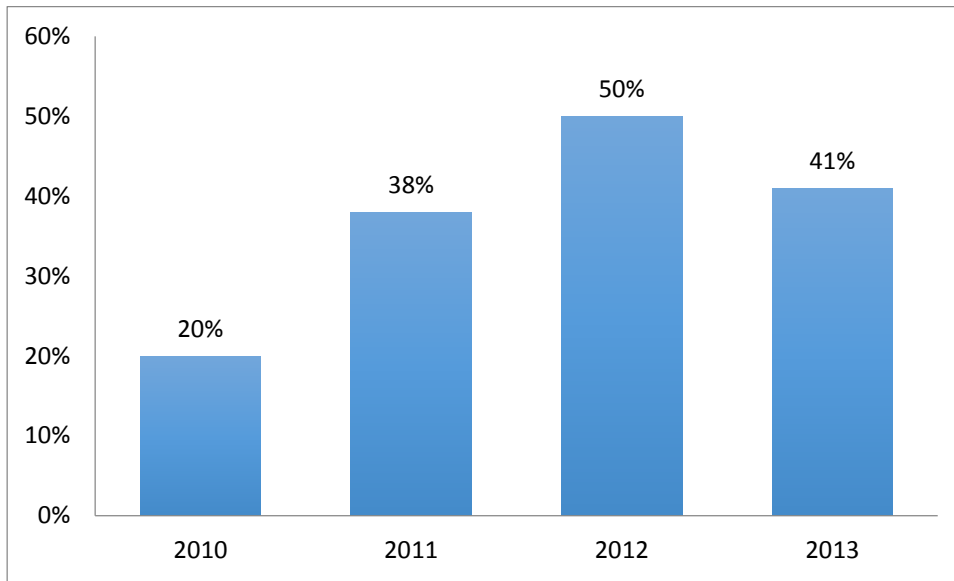


Graph 8. Business's opinion on dynamic of the business environment for 2013 (Russian Union of Industrialists and Entrepreneurs 2014)

The table above shows business's opinion on the business environment in Russia in 2013. We can see that almost half of the respondents thought that the business environment actually worsened and a third thought it stayed the same. The pie chart shows that Russian business is not happy about what is happening in the country and that there is a room for improvement. It also worth mentioning that in the previous year the attitude of businesses towards the business environment gradually worsened, as businesses lose trust in the government's ability (or will) to improve.

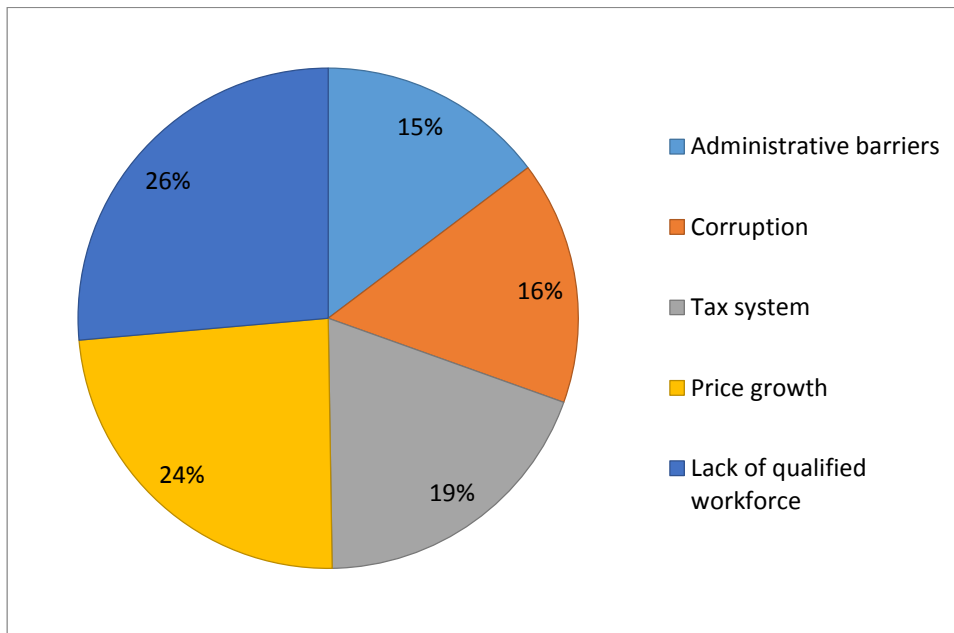
Moreover, after a quite successful in terms of investments 2012 amount of investments dropped in 2013, as shown in the chart below.





Graph 9. Companies implementing investments in fixed assets (Russian Union of Industrialists and Entrepreneurs 2014)

So, what do Russian businesses consider the worst problems in doing business in Russia?



Graph 10. Business's opinion on most important problems of doing business in Russia (Russian Union of Industrialists and Entrepreneurs 2014)

Now I will talk about each problem separately to give a better understanding of their importance and the ways to deal with them.

### **3.3.1 Taxation**

Tax system is one of the main problems addressed in the reformation of Russia's economy today. There is no other aspect of the reform, which was subjected to the same intense criticism and would be subject to the large amounts of heated discussion, analysis and conflicting ideas on reform. Anyway, the tax system is an essential element of market economy and has a large effect on how successful the country's economy is.

The existing tax system of Russia requires a list of serious reforms, because now it is not performing efficiently, i.e. on the one hand it should provide a high level of tax collection, enough to cover basic budget expenses. And on the other hand, the country's tax system should support the proper functioning of the state's economy, economic growth and development of regional economies.

From the economic point the view, the current tax system has following issues that have to be eliminated or minimized:

Russian tax system is primarily fiscal in nature, which obstructs the implementation of incentive and regulatory functions of taxation. Primarily, this is determined by the unreasonably high income tax rate (35%) and VAT (18%) compared to other developing economies, therefore the priority on tax exemptions in Russia accounts for taxation of business entities (legal entities). In the realities of market economy, such problem can be considered to be an anachronism. The main burden of taxation should be gradually shifted on individuals, but such process requires a consistent and targeted policy for many years.

In addition, indirect taxes (sales taxes, sales, fees) have a high proportion in the taxation system compared with foreign countries, and their share is gradually increasing.

Indirect taxes do not generally contribute to or stimulate the economy, or increase tax collection, rather the contrary.

Sub-optimal income tax from individuals is another problem caused by the fact that the gap between groups of people with the lowest and highest income is 1:25, and in the tax rates it is only 1:3. Therefore, the main tax burden falls on the poor, not the richest. The government is recognizing this problem and is planning to introduce the luxury tax, which is now being developed by the Ministry of Finance. However, when the law first went to the State Duma,

it was declined with the reasoning that the law makes no sense, since there is already tax on expensive cars and the tax on the property is on the way. (Zamahina 2014)

Insufficiently effective control over the collection of taxes, resulting in concealment of income (i.e., a large portion of the shadow economy), leading to the Russian budget system losing 30 to 50 % of tax income, according to various estimates (RIA 2013). Particularly important in this regard is the fight for the elimination of unaccounted by the tax system cash flows (so-called "Black tax"), which share up to 40 % of cash turnover. It leads to 20-25% loss in tax collection due to legal entities making payments not through bank accounts but by cash. Ministry of Finance is fighting the cash problem by forbidding paying by cash for anything more expensive than 600000 Rubles by the 2014 and then lowering that amount to 300000 in 2016 but the law was postponed, as it is not clear how to catch individuals breaking the law, since such acquisitions are practically impossible to trace when it's about an individual and not a legal entity. But even with legal entities the regulators have to go through a lot of paper work, deals and spend a huge amount of men hours to catch such deals. Even worse is that Russia citizens prefer cash to credit cards and the amount of cash on hands in 2013 was equal to 7.4 trillion Rubles or 11% of GDP. (Papchenkova 2013)

Ineffectiveness of existing tax benefits. Reduction of tax benefits will not only make the tax system more neutral with respect to individual members of economic activity and put additional barriers for abuse and corruption but also broaden the tax chargeable base. But the tax benefits related to the restructuring of the economy, small business development and promotion of investments into Russia have to be maintained and even expanded. Under these conditions, the tax benefits must be temporary and of directed nature. Moreover, they must be aimed at the participants of the economy, rather than at individual territories, as regional tax benefits eat up to 15% of budget revenues.

The complexity of the tax system of the Russian Federation. Currently there over 100 different taxes and fees together with local taxes in Russia. The system requires a significant simplification together with a substantial reduction of the total number of taxes and fees. A number of non-market taxes levied on revenue rather than profit (a transportation tax, housing fund tax, etc.) must be cancelled, as well as a number of "purpose taxes" (tax on road users for the development of road infrastructure, earmarked taxes to Police). The taxes aimed at the same taxation base must be united (for example, payments for the right to use

natural resources, excise tax on minerals and payments for reproduction of the mineral resources). Instead of a large amount of property taxes, there should be one property tax that unites all of them in it, to ease the taxation of the property process. Actually, the Ministry of Finance is working on it now but the law itself is aimed to be introduced the earliest in 2015 (Novaya Gazeta 2013). All the tax-doubles must be abandoned (taxes with one name but going to different budgets, e.g. income tax). Unified taxes with a legislative split of shares going to federal and regional budgets are more justified. And, of course, all the taxes in which the cost of its collection exceeds the amount collected must be abolished.

Permanent on-going changes in tax laws and tax rates, which is not conducive to long-term capital investments and growth. It is necessary to legally establish stable (over several years) basic norms of rates and deductions from major taxes (primarily those are federal regulatory taxes: income tax on individuals, profit tax, values added tax, as well as some others).

Other problems include, inadequate laws, inconsistency and intricacies of regulatory and taxation framework, the lack of operational communications between executive and legislative powers, which is expressed primarily in delaying the final adoption of the new Tax Code. According to various estimates, Russia now has from 600 to 800 different laws and other regulations in varying degrees affecting taxation. They must be unified and integrated into a single taxation law book. For the effective collection of property taxes there must be created a single inventory of land, real estate, automobiles, etc. and a single system managing the real estate property.

One of the important problems in the current system of taxation is a system of tax rates, which determine the amount of the tax exemption. It refers to a variety of taxes, primarily to income taxes. There is an interesting proposal to introduce (first in some regions) regressive income tax, which refers to a process of lowering the tax rate when the taxable amount is rising. This method would stimulate the desire to be transparent and show the full taxable revenues and not to hide them, as the larger the amount of the profits is, the lower tax rate is. But this requires further strengthening of control by the tax authorities and the tax police.

Speaking of tax police, it is another problem with the tax system in Russia, as it proves itself ineffective and quite corrupt. With a large amount of different authorities and departments for combating the economic crimes, their results are difficult to call satisfactory. Most of

those troubles are caused by the poor training of their employees, as they usually are unable to properly form a case, leading to many individuals and legal entities evading their responsibilities for concealment of taxes.

Shadow economy - the most latent economic activity, qualitatively different from all other violations and requires more effort and resources to deal with. In particular it requires the use of investigative methods, and therefore represents the most serious form of socially dangerous acts in taxation. The efficiency of formation of budget revenues at all levels, increased entrepreneurial activity, development of production and ultimately stabilization of the economy of Russian Federation depends on solving the problems stated above.

### **3.3.2 Lack of qualified workforce**

As the president of Russian Union of Industrialists and Entrepreneurs Alexander Shokhin said in an interview, the lack of qualified workers is the problem number one for the Russian economy today. (Expert 2013)

The problem takes place in almost every industry. Most companies lack a qualified management and many of them have to go abroad for hiring specialists. For example, during the Sochi Olympics foreign specialists managed most hotels.

Anyway, the largest deficit is present in the two main professional groups: highly specialists and skilled workers. Most companies lack workers from these categories. The companies working with the natural resources mostly lack qualified workers, while have no problem with finding high qualification specialist, due to the large salaries and good work conditions. As for the employees working with the documentation and information, there is no lack of them in the market.

The problem also depends on the region, as there are more specialists in the Western part of Russia, especially Moscow and St. Petersburg, than in Eastern part.

What led to such problem, in my opinion, is the gradual reduce in the quality of education in Russia. There is a huge demand for qualified teachers on the market but most of them seek job elsewhere since the teaching career in Russia does not pay well. Moreover, corruption is also present in the education system leading to diplomas being simply sold and places in

universities given not to those with best knowledge or skills but to those with better connections.

Moreover, the new examination system in Russia is questioned by a large number of specialists because, they believe, it showed itself as a badly working one, since it is based on simple ABCD tests. Such examination, while might be suitable for an engineering education, is not suitable for many others, like literature, philosophy, etc. Furthermore, children today are not taught with what they should know but with what they need to know to pass the test. School becomes a preparation for the exam course.

Also, there is a large demand for education in Russia and that led to opening of a vast amount of universities across the country. Most of them are not really prepared to teach students but are interested in the moneys they are paid. The new education reform is closing most of those universities today.

Overall, Russian government must pay more attention to the education system if it wants Russia to get a competitive advantage in the future (as Russia did in technology sector). And, I am very surprised that the new budget cuts spending on education without even creating a believable plan of improving it. In order to fix the situation, the government has to increase the spending on education and raise the quality of the education provided in the Russian universities. Highest priority must be given to the technical universities that are preparing workers for industrial manufacturing or engineering, as those are the ones economy is lacking the most. Together with that government has to improve the conditions of work for high level specialists, especially provide them with houses, to make the profession more attractive for the students.

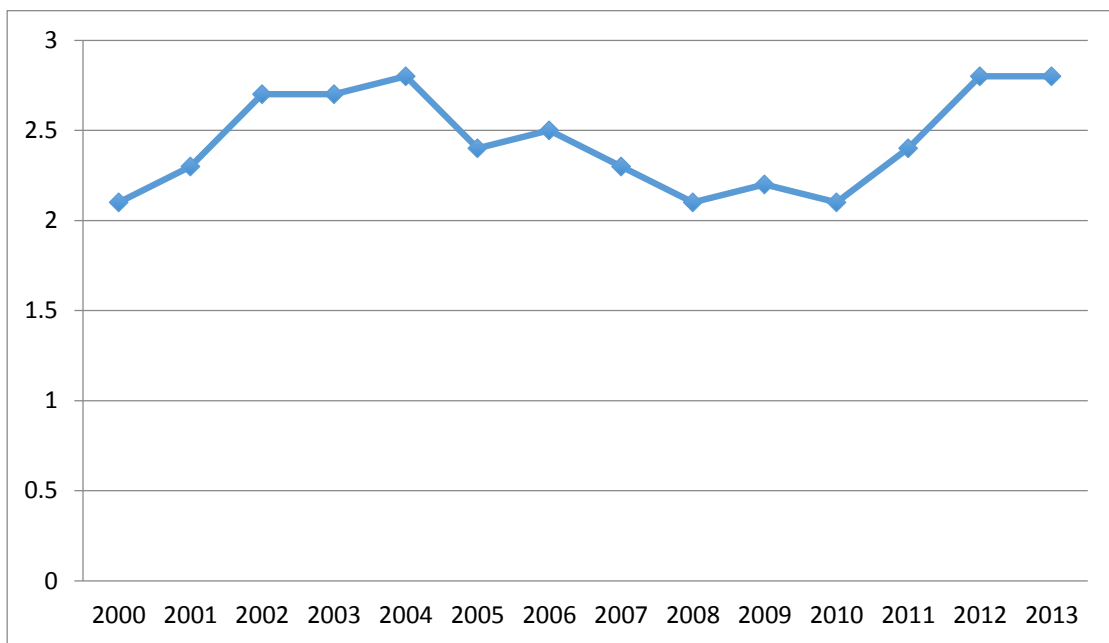
### **3.3.3 Corruption**

As the Head of the Presidential Administration Sergei Ivanov said: "Corruption - a threat to national security." (Volkova 2012) This is the exact evaluation that such high level of corruption in Russia deserves today, negatively influencing the government's ability to execute its main responsibilities: provide protection and justice.

Corruption in Russia is mostly caused by the 1800 redundant functions of the state, as the ex-Financial Minister Alexey Kudrin said to Russia president at that time, Dmitri Medvedev. For example, Singapore has around 500 functions of the state.

According to experts, corruption in Russia today is one of the most profitable and highly organized businesses with a turnover of about \$300 billion a year (the system of public procurement alone loses annually 1 trillion of Rubles). According to the Bank of Russia in the past year \$35 billion were withdrawn within the so-called dubious financial transactions in 2012. (Muravyev 2013)

In 2013 the loss from the corruption was estimated to be 26 billion Rubles, according to Russian Prosecutor General Yuri Chaika. (Komsomalskaya Pravda 2014) He also stated that the corruption levels are rising that makes us believe that the actions taken by the government are not enough to stop the illegal activity.



Graph 11. Corruption perception in Russia (Transparency International 2013)

From the graph above we can see that in the past years corruption was only growing, especially after the crisis years. That might be linked to the fact that government is spending more in order to fully restore the economy. Also, there have been extensive spending during those years on the Winter Olympic Games in Sochi and, according to different sources, there have been a lot of corruption in the process of preparing the Olympic Park and the city of Sochi for the games. Some specialists stating that corruption has eaten the economic growth in the past years and therefore must be addressed immediately.

The most corrupt sphere of society is local authorities and the traffic police. Police and the judicial systems are also one of the most apt to bribery. They are followed by the healthcare and education systems and also the large businesses. The main (by financial capacity) sectors of corruption activity are distribution of budget spending, management of various forms of state property, however they are not usually believed to be primary problem by the population of Russia, since those are hidden sectors and people don't intersect with them directly. To see better how the corruption is working in different spheres of the economy I have made the next list:

- Customs – letting forbidden goods through the border, return of confiscated goods and services, lowering the custom fees, unjustified delays of goods or custom fees.
- Tax authorities – not collecting the full tax, returning VAC, “closing eyes” to tax offenses, being paid for conducting tax examinations in competitors’ firms.
- Police and courts – opening and closing criminal cases, “closing eyes” on criminal offenses.
- Education – buying places in schools and universities, paying for grades, diploma, etc.
- Healthcare – buying places in best hospitals, paying for transfers to other regions’ hospitals, and forging medical record.
- Business – paying for contracts with cash is probably the most popular method of corruption in Russian business.

Most corrupt ministries in are: Ministry of Defense, Ministry of Transport, Ministry of Economic Development, Ministry of Healthcare and Social Security, Ministry of Finance.

The average amount of a bribe in Russia is 10000 Rubles (approximately 200 Euros).

So, what is the government doing to stop the corruption? Well, there is a pretty large amount of actions the governments does in order to prevent corruption and some of them are effective, while other might even lead to more corruption (as the money provided for fighting corruption being spread between the officials’ managing it pockets). In April president Putin signed a plan for preventing corruption for the years 2014-2015, which is pretty much a copy of the same programs that were operating in previous years. However, there are some new



things like a new information system that the Bank of Russia has to create to monitor if government high level officials have any property or accounts abroad. It also aims at increasing people's knowledge about corruption (especially among the young generations) and creating a system for news agencies to find and report corruption cases. Moreover, it includes anti-corruption actions for Crimea and Sevastopol. (Decree of the President of the Russian Federation 2014)

Also, a large amount of corruption cases were opened in 2013. For example, the case of "Oboronservis" was brought to the light and the Minister of Defense was fired as a result of it. Machinations of this organization caused more than 3 billion Rubles damage to the State and it's only the tip of the iceberg. Ministry of Defense officials picked the best and most prestigious property and land belonging to the organization. Then the Ministry invested heavily into that property, after which the property was sold for artificially low prices to the corporation owned by the officials of the Ministry of Defense, their relatives or business partners. Furthermore, many of those objects were bought with the money stolen from the "Oboronservis". Five criminal cases on fraud were opened.

Other cases include the Russian Federal Space Agency where police found a fraud for 6 billion Rubles in the satellite navigation program GLONASS, Deputy Minister for Regional Development Roman Panov was arrested for a fraud in preparation for APEC Russia 2012 summit where 600 billion Rubles were spent on preparation for the summit and development of Far East, etc.

These examples illustrate that there is a new vector appeared in the fight against the corruption – fight against people holding the highest positions in Russian government.

Moreover, many people with business or a large amount of property tend to leave Russian Parliament now, since they understand that it becomes more difficult to use political power to make illegal profits today. More than that, the government officials seem to limit themselves. For example, the Ministry for Economic Development plans to forbid government officials to buy luxury automobiles. Anyway, there are still holes in the legislation that some officials use. One of those holes is the families of officials. It is not rare that wives, children or parents of government officials become very reach without any real source of income. For example, Foreign Intelligence Service director Mikhail Fradkov's son

is the CEO of Export Insurance Agency of Russia. Minister of Defense Sergei Shoigu's daughter is a director of the Center for Emergency Psychological Help, etc.

### **3.3.4 Administrative barriers**

One of the main things that entrepreneurs say when asked what are the main problems of business in Russia are administrative barriers. The barriers include such problems as delayed decisions by local administration, unequal treatment of participants of the economy, officials demanding bribes, etc.

Administrative barriers exist in every economy but in some there are more of them and in others there are less. In Russia they grew to be a huge problem, slowing down the development of the business. In order to understand the barriers you need to understand the administrative management in Russia. Local government consist of city administration and city council. City council makes most decisions about the strategic development of the city. The participants of the council are not getting salary for what they are doing and therefore they have to seek profits somewhere else. Most councils consists of representatives of large and small businesses. Therefore, they must understand the problems that businesses face in the region and able to solve them. Why doesn't it happen then?

The most obvious reason is that the representatives of business see the council not as tool to fix the city problems but as a method do solve their own problems. They are using their positions to gain an unfair advantage compared to other businesses.

In order to fix this situation, public organizations must be more active during the voting process and gain more influence on the council, in order to stop businesses from using city council as a tool for fighting competition. But unfortunately public organizations and opposition are weak in Russia and in some places are simply non-existent.

## **3.4 Political**

The political situation in Russia today is stable. The ratings of the current president are high enough for him to even be reelected for the next term, although it is not clear if he is willing to yet. The main political party United Russia holds the majority of seats in the parliament.

Although, the lack of competition is bad, the internal political environment is stable. Other major parties (Communists and LDPR) mostly support the current president.

After the collapse of the Soviet Union Russia tried to take an example from the West and create a society controlled by modern day democratic institutions. So in the beginning of the existence of the Russian Federation there was a confrontation between the new democratic institutions like political parties, reformed courts, parliament, regional governments and the old social institutions that include police, KGB, prosecutors, etc. Today we can see that the old institutions have won that fight. We can see a growing power of police and FSB (ex-KGB). We see that the parliament is doing what the president wants it to do, and we see that the court, the parties are there just for the look of it.

However, there will not be a new Soviet Union, as many people are saying today. The ideology has outlived itself and it is not suiting for Russia in the XXI century. Today Russia is still in the formation process and is changing fast. It is not accepting the Western liberal ideology and values, and instead is promoting its own ideology that is formed on Russian culture and old European traditions. Therefore, we will see rising tensions between Russia and the Western world. What we see today is the development of new Russia, which is still an important player of the world's political arena and the strongest military power in Eurasia.

### **3.4.1 Foreign Policy**

For better understanding of Russian foreign policy, one should look at the world from its perspective. The world today is pretty one sided. The major power is the USA with NATO block countries, dictating their interests in most of regions. Russia, as the successor of the Soviet Union has plenty of zones of influence in the world and has to participate in the world politics, protecting itself.

One of the clear examples of Russia defending its interests in the world is Syria where Russia intervene and didn't allow the West to invade or support rebels even though later the West has anyway gave support to the rebel groups. Now we can see that Assad seems to be winning the conflict and Western intervention only led to creation of extremist organization of ISIS and the Western liberal media starts preparing soil for announcement that the West will cooperate with Assad.

In order to extend its influence and create a block of allies Russia creates the Eurasian Economic Unity together with Kazakhstan and Belarus. All three countries have good relationships and intertwined economies, therefore promoting the idea of a unity. Now Armenia and Kyrgyzstan also want to join EEU. The Ukraine was offered to join but after the recent events, it is doubtful that they would like to. The unity will abolish trade borders between the countries, thus boosting the production, lowering prices and making competition to the Western products. The EEU will be the world's 5<sup>th</sup> largest economy with the GDP of \$4.023 trillion. The EEU is a good example of the post-Soviet countries uniting for the prospects of better future.

Now that Russian economy has stabilized, Russia is expectedly increasing its military budget. The program of rearming the army is going to change 70% of all the equipment in Russian army to modern weaponry by 2020. New military equipment and machines developed in Russia, many of which don't have analogs in foreign armies, are making Russian army capable of competing with any opponent in the world. 10 Nuclear submarines of a new "Borey" class will be completed by 2020, armed with newest ballistic rockets "Bulava", new uniform with modern technologies and highest protection levels are distributed between the soldiers, 5<sup>th</sup> generation jet fighters are being prepared for mass production, etc. Such heavy militarization is reviving Russian VPK (Military Production Complex). The increase of production boosts R&D, creates jobs and helps the manufacturing industry in Russia to become competitive. VPK also promotes higher spending on the space program, therefore benefiting science in Russia.

Russia requires strong military because it is the largest country in the world with rich resources, fertile land and borders with many countries. In order to protect such borders the military needs to consist of at least 5 million soldiers but Russian army has only 1.2 million people serving in it and therefore it has to make every soldier count by producing modern equipment making the soldier the operator of the equipment, worth many soldiers with old equipment in battle.

Another reason for the heavy militarization is the move of NATO to the East in Europe. The NATO block is moving closer to Russia with every year and now there are even talks about putting a NATO base in the Ukraine. Before that the USA built a missile defense base in Poland, which is clearly aimed at limiting the Russian Nuclear potential (that is the guarantee

of Russian borders' safety). With the NATO bloc moving its bases next to Russia and supporting terrorist organizations that fight against Russian allies (Al-Qaeda, ISIS), Russian militarization seems to be an adequate response.

Another new development in Russia's foreign policy today is a large shift to the East instead of the West. We can see that Russian-Chinese relationships are becoming better and the trade is increasing between two countries. We can also see that China is supporting Russia in International Affairs, agreeing with it on Syria and taking neutral stance on Crimea. This movement might be the factor that will help Russia to become a strong country. There is definitely a large potential for cooperation between two countries, as Russia wants to develop its east and has a large amount of resources that China lacks. As an example of the shift, we can look at the agreement that was signed between Russia and China for the supply of gas in a medium-term. The total value of the contract is \$400 billion for the next 30 years.

### **3.4.2 Ukrainian Crisis**

Ukrainian crisis is the on-going conflict inside the Ukraine that involves Ukrainian government, rebels from the Southeast of the Ukraine and to some degree Russia. So far, the conflict led to a change of government in the Ukraine, Russian annexation of Crimean Peninsula and creation of not yet recognized Donetsk People's Republic and Lugansk People's Republic.

The conflict began from the protests that took place in the Ukraine at the Maidan square. The protest has been active for several months with some pauses and in the end led to armed conflict between the protestors and the forces of Kiev police. In the end, the president of the Ukraine Yanukovich was forced to make an agreement with opposition that returned the Ukraine to the constitution of 2004. However, the conflict continued and led to the change of the government in the country and a raise of nationalistic movements.

As the result, protests started in the Southeast of the Ukraine, where most Russian speaking people live. The protestors demanded legalization of Russian language and federalization of the country. In Crimea the local government resigned and a new one was formed that stated that they want to separate from the Ukraine and create a new Crimean Republic. After that they asked Russian president to send Russian forces there to promote peace and give them

an ability to have a referendum. On the referendum people decided that they want to be a part of Russia and therefore Crimean Peninsula became a part of the Russian Federation.

Meanwhile, in the East Ukraine government decided to stop protests with brutal force and sent army brigades there. That led to an armed conflict and creation of self-defense forces. After they claimed that Lugansk and Donetsk regions want to leave the Ukraine and form independent Donetsk People's Republic (DPR) and Lugansk People's Republic (LPR).

The newly acquired Crimea has population of 2.5 million people. It has a well-developed manufacturing industry, as well as tourism industry. It is also the home for a Russian largest navy base in the Black Sea. Crimean Peninsula is believed to be the key military location in the Black Sea region.

The future of DPR and LPR is still not clear and heavy fighting is taking place there. What is known is that the Ukrainian forces have heavy casualties and after some progress they started to fall back with several divisions being encircled. The poor results of the Ukrainian army are the result of the bad condition in which the army was before the conflict. Soldiers have poor training, are not fed well and have poor logistics. Moreover, aside from several nationalistic battalions that are used for propaganda, average conscript soldiers of the Ukrainian army do not want to fight their compatriots. Military equipment in the Ukrainian army is old and aside from several modified tanks and rifles bought abroad it mostly consist of the Soviet era equipment that has not seen any modification in the past 25 years.

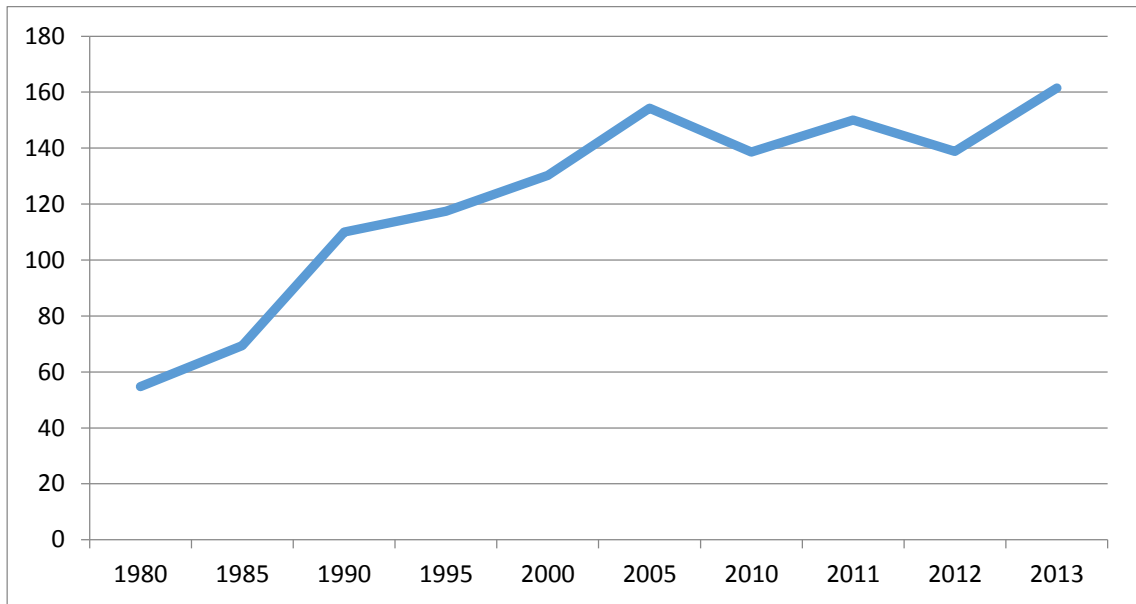
During the conflict a Boeing 777 of Malaysian Airlines was shot down above the Donetsk region, killing 283 passengers and 15 crew members. It is not clear yet how and by whom the plane was shot down and more importantly, why it was flying in the area of the conflict when there are constantly planes being shot down there. According to the U.S. officials, a surface-to-air BUK M1 missile shot down the plane. According to other sources, the Ukrainian army BUK M1 might have as well shot it. At the same time the oldest Malaysian newspaper New Straits Times claims that the plane was shot down by another aircraft. (Haris Hussain 2014) The truth is still unknown as no details of the accident are known to the public.

Due to Russian annexation of Crimea and its supposed (there is no evidence still) involvement in the on-going civil war in the Ukraine, the West has imposed sanctions on the Russian Federation. First sanctions included freezing bank account and banning enter to the

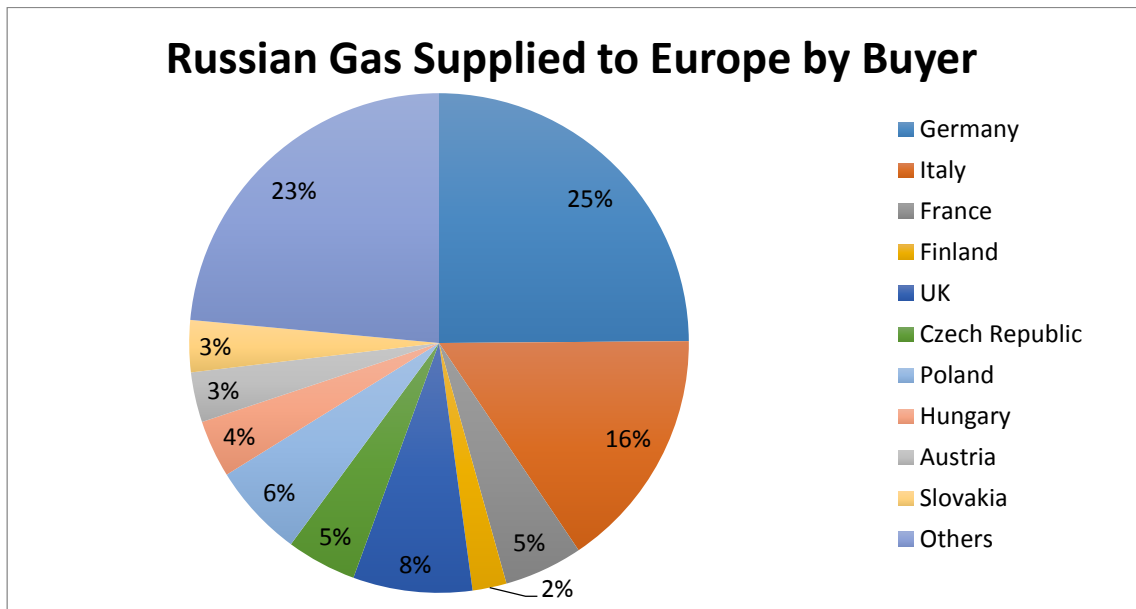
U.S. and European Union for a list of people that are associated with the annexation of Crimea or are close to Vladimir Putin. After that the list has increased. Later sanctions included the ending of cooperation between NATO and Russia, suggestions to block the building of the South Stream gas pipeline, forbidding the European Investment Bank investing money into Russian economy, limiting the sales of military equipment to Russia, limiting the sales of equipment needed for oil extraction in North, etc. Now there are talks about excluding Russia from the G8. The sanctions are pretty painful for some of the Russian companies. For example, Aeroflot's low-cost company Dobrolet has stopped operating, Lukoil has limited its investment program, Rosneft asked the government for financial support, etc.

Russia responded to the sanctions with a decision to ban the import of food from the USA, Canada and the EU. Russia is the second largest destination of the European food exports and the value of the food exports to Russia in 2013 was 12.2 billion Euros, which is less than 1% of the total EU export. However, even though the ban is not that painful for the EU in total, it hits some countries more than the others. For example, Belgium will lose 500 million Euros. The director of Belgium center for fruit industry said that the closure of Russian market is a catastrophe for the industry. Greek farmers are also losing money, as they have previously exported a large amount of products to Russia. Taking into account that Greek economy has not yet fully recovered, it is a bad hit for Greece. Another example is Finland, as 25% of its total export is going to Russia. After imposition of sanction Valio, 20% of which products go to Russia, had to stop all the production facilities in Russia. That is around 400 million Euros loss for Valio and therefore a loss for the Finnish government. After that the Finnish president said that he won't support any future sanctions against Russia, as he wants to make a dialog and promote trade between the two countries. Russian sanctions may have a negative effect on the weak European economy and even promote crisis in some of the countries.

Despite all those sanctions imposed before, I do not expect West, and especially the European Union, to continue with sanctions, as they now see that Russia is ready to answer them. Future economic wars may result in a new financial crisis in Europe and leave it without gas for the upcoming winter.



Graph 12. Russian supplies of gas to Europe in billion m3



Graph 13. Russian gas supplied to Europe by buyer (Gazprom Export 2013)

From the charts above, we can see how the European Union is dependent on Russian gas. In many countries, like Finland, Estonia and Latvia, Russian gas represents 100% of all the imported gas. The largest users of Russian gas are Germany and Italy. One of the reasons is that Germany is trying to get rid of nuclear power plants after the accident in Fukushima, Japan. Although Germany is trying to get more of its energy from the renewable sources like



wind, it's unable to satisfy the energy demand without large amount of Russian gas. Of course, there are more problems now, as the gas is transmitted through Ukraine and Ukrainian officials are not able to pay for it, so it brings Europe on an edge of energy crisis, forcing it to regulate the Russian-Ukrainian relationships. However, some countries, like Poland, are trying to get rid of the dependence on Russian gas through use of new technologies and methods of gas extracting like shale gas extraction. Still, shale gas extraction is claimed to be more expensive and harmful for both the environment and people living near the extraction sites.

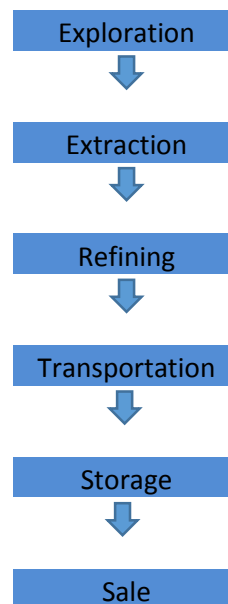
Other European countries economies' are dependent on Russia not only due to gas. For example, France has an on-going military contract with Russia for the building of Mistral-class amphibious ship. The contract was signed in June for the construction of 2 Mistral-class ship in France and 2 in Russia with a license from the French company. The contract was for 1.2 billion Euros. And although France is halting the process of testing the ships and threatened to cancel the contract, it is not likely to happen, as in that case France, according to the contract, would have to pay Russia a large penalty. More than that, there will be a lot of people fired, if the construction stops. France is not in a position to do that with its struggling economy. (BBC 2014)

Most sanction imposed on Russia are promoted by the USA, as it is most interesting in limiting Russian potential in the region. European countries are not interested in making Russia their enemy. Many European countries are on the contrary partners of Russia. For example, Finland's position as an intermediary between Russia and the West has allowed it to have a huge boost to the economy and years of stable growth. Germany is also a partner of Russia with a huge trade volumes between two countries. In my opinion, Russia and European countries, especially Germany, should make a closer bond in the future and move towards some kind of alliance. Such an alliance with Russian resources and market, and German production capabilities and know-how can create a super power in the future.

#### **4 PETROLEUM INDUSTRY INVESTMENT CLIMATE**

#### 4.1 Structure and key features of Russian Petroleum Industry

Petroleum industry – is a sector engaged in exploration, extraction, refining, transportation, storage and sale of oil, gas and related petroleum products. The basis of the oil and gas industries is Vertically Integrated Companies (VIC). But there are also plenty of companies that don't have the entire chain as their units. Mostly, companies prefer not to have their own transportation services as it requires large financial investments to create and maintain your own oil and gas pipelines, especially when the supply volumes are volatile. (Dannikov 2008)



Specificity of the oil and gas business is the high proportion of fixed assets, among which are the oil and gas fields, refineries and other assets. The need for such large fixed assets leads to two features of the oil and gas business. The first feature is an extremely high entrance barrier. Therefore new independent companies are something very rare in the industry. The second feature is that many of the companies are state-owned or have a significant share of the state capital.

Company's margin and profitability highly depend on the structure of that company. Sales of products can be divided into three categories reflecting the degree to which the price of 1 barrel of oil decreases: sale of crude oil and gas, B2B sale of refined petroleum products and B2C sale of refined petroleum products. Thus, the share of company's production in each of the three groups significantly determines its profitability.

Due to the significant stock of financial resources, high profitability and constant cash flow, company's equity is usually enough to cover current expenses and realization of investment projects. This raises another feature of the petroleum industry - low financial leverage. This feature is the result of the structure of the assets and high dependence on oil prices, which, as we know, are highly volatile. As a result, high leverage and the risk connected to it are not acceptable in the industry. (Wright 2005)

Another important characteristic of the industry is the fact that the product is standardized and has similar characteristics among all manufacturers. This leads to the situation in which the impact of the company's brand is limited and practically appears only in individual elements of the value chain like fueling. Furthermore, the level of R&D is also very low. The reason is that the majority of the companies' production is goods that have already been brought to its optimal performance and require no further development. The existing R&D is mostly working with the products aimed at retail, like motor oil and grease. Therefore, company's brand and its R&D capabilities have little impact on the performance of its business, while operating efficiency is considered to be the key feature of a successful company in the industry.

#### **4.2 Current State of Russian Petroleum Industry**

Petroleum Industry of Russia plays an important role in the economic development of the country, as well as in the international energy market. Production of oil and gas is the most competitive industry of the Russian economy from the standpoint of Russia's integration into the system of international economic affairs. Oil and gas are priority products of Russian export. Fast growth in the production of oil and gas and its large-scale export provided resources for the operation and development of other less development and profitable sectors of Russian economy.

The results of the petroleum industry operations are currently the main basis for the formation of Russia's balance of payments, support of the national currency, and actions aimed at restoring the economy after the crisis.

Activity of the petroleum industry in 2012-2013 brought good results: in 2012 it formed 54% of total budget revenues, 20.7 % of GDP and more than 70 % of exports. And although total numbers of revenues are not yet known for the 2013, we know that in 2013 there was 523.2

million tons of oil and gas condensate, and 668 billion m<sup>3</sup> of gas extracted, out of which 234 million tons of oil and 205 billion m<sup>3</sup> were exported.

The petroleum industry in Russia creates one of the largest multiplier effects in the economy, meaning it creates a high demand for the production of related industries. The development of the related industries is characterized by the indicator of the multiplier. In the USA the multiplier is 2.1, in Norway 1.7. In Russia it is 1.9, which is equal to the multipliers of the developed economies-exporters of oil and gas. During the realization of large investment projects in this industry 80% of the work is on the contractors, suppliers, etc. Therefore, the main effect of the development of the petroleum industry is felt in the regions specializing on the development of oil sites, minerals refining, production of machinery, production of electricity, and so on. And the side effect is the rise of the tax base of the country, creation of new jobs and, one of the most important effects, creation of demand for high-tech products.

There are two types of companies in the petroleum industry today: vertically integrated companies, made in 1990s and independent oil companies. In 2012 there were 301 companies executing the extraction of oil in Russia. And around 90% of all oil is extracted by the 9 VICs. Oil and gas resource base is formed by the approximately 1500 oil and gas fields, 800 out of which are under development. Anyway, this number is not updated frequently and therefore might be not correct as of 2014. Also, there are 28 large (production capability is more than 1 million tons a year) oil refining factories operating in Russia today. (RIA Rating 2014)

#### **4.2.1 Oil extraction**

If we take a look at the dynamics of the industry in 2013 we can see that the extraction of oil with gas condensate has grown 1.1% compared to the previous year and reached record levels. The increase is dictated by the increase in demand in 2013, as it also increased by 1.1% according to OPEC. One of the leaders of the growth is China with a demand rising 3.1%, as China tries to boost its economy. The rise in the oil extraction was affected by the USA increasing their extraction by 1.15 million barrels a day, Canada by 220 thousand barrels a day, Russia with 150 thousand barrels and Iraq with 120 thousand barrels.

Still Russia holds the first place by the amount of oil extracted in 2013.

	Mil barrels a day	Change from 2012
Russia	10,88	1,40%
USA	10,34	12,60%
Saudi Arabia	9,4	-1,20%
China	4,18	0%
Canada	3,98	6,10%
Iraq	3,07	4,10%
Mexico	2,89	-1%

Chart 4. Oil extraction volumes by country in 2013

We can see that the growth of the oil extraction in Russia is low compared to its main competitors and it is caused by the fact that the maximum capabilities of oil extraction on the old oil fields are already reached. And although oil fields in the East are helping to gain some growth, they are also nearing their maximum capacity. In order to provide a decent boost to the oil extraction in Russia companies need to start exploiting fields with difficult extraction, which have huge reserves of oil but are expensive to work with and oil companies want to get benefits from the state for working with them.

The government is trying to help the situation. For example, in 2012 the legislators introduced new benefit of 10% on export fee for the oil extracted from those hard extraction fields. This and other actions might help to boost the growth of oil extraction in the middle-term, while in the short-term the growth is expected to stay low, as no large oil fields are expected to be extracted.

The next list helps to better see who the main players in the industry are.

Company	2013 mil. tons	Grow from 2012
Rosneft	203	0,40%
Lukoil	86,9	1,40%
Surgutneftegas	61,5	0,10%
Gazpromneft	49,3	-0,50%
Tatneft	26,4	0,40%
Bashneft	16,1	4%
Russneft	8,8	-0,20%

## Chart 5. Main player in the petroleum industry

Rosneft alone extracted around 40% of all oil in Russia in 2013. The number is that big because it is the main government's oil extractor and because it has recently acquired another major player – TNK-BP. However the largest growth in oil extraction was made by Bashneft. They started to work with new oil fields and continued to do geological exploration on already existing field in Bashkiria. Due to those new oil fields Bashneft is probably going to stay the leader by the growth rate in oil extraction in 2014. The plan is to increase it by another 4%. Lukoil was able to finally get a growth in oil extraction after 4 years of negative dynamic. However, the growth is present due to its acquisition of Samara-Nafta.

As for the export, according to Russian Federal customs export of oil from Russia dropped to 236.6 million tons or 1.4% compared to 2012. At the same time the export to CIS countries grew 1%, while export to countries further away fell by 1.7%. The fall is attributed to decreasing dynamics of oil export to European countries, while Russia starts to export more oil to the East. By more I mean 30% increase. We can see that the growth in oil extraction is quite limited while the internal demand for it will at least stay the same but more likely it is going to growth. In that case the supply of oil to the East will come at an expense of cutting some of it from the West. All in all, RIA predicts the export of oil to drop 1-2% in 2014. To overcome this problem Russia has to either expand the extraction growth or buy oil somewhere else and sell it to third party. For example, Iran is interested to sell its oil to Russia, since it is under heavy sanctions from the USA and this is the way to avoid them. Average price of oil brand Urals was \$108 in 2013, which is 2.4% lower than in 2012.

If we look at the tax for the exporters of oil we can see that the custom fee for the oil has dropped 3% compared to 2012, due to a price decrease of oil. Also the government is trying to rework the taxation of oil exporters and therefore it is lowering the maximum custom fee from 60% to 59% and later to 55% in 2016. However the tax for oil extraction grew 5.2% due to a large default in Rubles value. Contrary to the custom fees, the tax for oil extraction is expected to grow. Unless the company is extracting from difficult extraction fields, in which case it gets benefits, as stated before. (RIA Rating 2014)

#### **4.2.2 Oil refining**

In the first quarter of 2014 the amount of refined oil reached a record amount for the set period with 71.6 million tons of oil refined, 6.4% higher than in previous year. Therefore, in the 2014 we can see a sharp increase in the refining of crude oil. Out of all oil extracted 55.3% were refined, which is a 2.5 basis points increase from the same period last year. The increase is the result of two factors, devaluation of the Ruble, which made the export of diesel fuel and oil fuel more profitable and the decrease of the tax on export of the oil products.

The production of almost all oil products increased during the first quarter of the 2014 with the exception of the automobile fuel, which had a decrease of 0.6%. At the same time diesel fuel had an 8.3% increase and the oil fuel had an increase of 6.2%. But the growth is mostly caused by the growth in oil extraction and therefore it is quantitative, showing that the modernization which is taking place in the industry is not causing any increase in the quality of oil production so far. The only factor that improved is the production of ecofriendly fuel. The production of the 5<sup>th</sup> eco class fuel has increased 15.2%, while the production of the less ecofriendly fuel has decreased.

The modernization of the oil refining factories is carried out according to an agreement signed between Rostehnadzor, Rosstandart, Federal Antimonopoly Service of Russian Federation and 20 companies from the industry. 15 processing plants started operating in 2012, 13 in 2013. In 2014 the investments into modernization of the refineries should reach 320 billion Rubles, 19% more than in 2013. As a result the depth of oil refining should reach 72.6% by 2015, which is however lower than in developed countries.

As for the export of the oil products, it has reached record amounts in both the growth rate and the amount exported. The summed export of oil products was 37 million tons, 16.8% percent higher than in the first quarter of 2013. The export to the neighboring countries rose 80%. As was stated before, the growth was a result of Ruble devaluation and tax reduction. Oil fuel and diesel fuel were the leaders of the growth. However the prices of fuel in Europe were falling compared to 2013, due to the decrease in the price of oil. (RIA Rating 2014)

### 4.2.3 Gas extraction

In 2014 the USA has reported the continuation in the growth of the gas extraction. And although the USA has extracted less gas in the first months of the 2014 than Russia, experts claim that by the end of 2014 the USA would be a leader in gas extraction, as gas extraction tends to be low during summer in Russia. The growth in the gas extraction results in low gas prices in the USA, however there was a significant jump in the first quarter of 2014 due to a cold winter.

The highest gas prices in the world are in South-East Asia. For example, in Japan the price for a thousand m<sup>3</sup> of gas was \$639. Meanwhile, Germany buys Russian gas for \$389, which is 5% lower than in 2013.

On the European spot market the average price for the first 3 months of the 2014 was \$346.4 in France and \$346.2 in Germany. So, the difference between the spot price for gas and the Gazprom's price is \$55, against \$30 in 2013. Anyway, the spread is not critical for Gazprom, as Russian gas supply is more secure, even after the recent events.

The demand of Russian gas in Europe is predicted to be falling in 2014 due to Europe's attempts to replace Russian gas and the fact, that Europe has plenty of gas in gas vaults after a soft winter. The difference between the spot price and Gazprom price is expected to stay around \$50.

The dynamics of gas extraction in Russia during the first quarter of 2014 was negative. The reduction is continues and is seen for a second year in a row. The decrease was 1.5%. The situation is caused by the falling domestic demand, as exports are growing.

If we look at the companies we can see that the largest player in the market – Gazprom is decreasing the gas extraction for the 4<sup>th</sup> year in a row. This year the reduction was 3.9% and reached the lowest amount from the 2009. At the same time, the company is able to significantly increase the extraction due to a newly opened Bovanenkovsk gas field. And although Gazprom can have a huge jump in gas extraction, its abilities are limited by the demand in the market. In 2014 Gazprom plans to increase extraction by 1.8%. However RIA's exports think that the domestic demand will at best stay the same and foreign demand is not expected to growth either, therefore Gazprom is not likely to increase extraction.



NOVATEK also decreased its extraction amounts by 2.4%, which is company's first decrease in some years. However in this case the falling extraction is caused not by lower demand but by the sellout of company's share in OAO "Sibneftegaz". Most oil companies increased their gas extraction. Their growth reached a surprisingly high number of 31.6%.

Gas exports reached a record amount in the first quarter of 2014. The exports grew 4% to 54.3 billion m<sup>3</sup>, however the profits didn't grow as the gas price declined. The growth of profits was 0.4%. At the same Gazprom reduced its supply of gas to foreign countries by 0.6%, mostly due to a sharp decrease of sales to Ukraine that occurred due to economic and political crisis in the country. Anyway, the sales to far foreign countries grew despite a warm winter. European countries seem to be buying more gas to fill their gas vaults, as they are concerned about future of gas supply through Ukraine, therefore the sales of gas to Europe might fall in the end of the year. (RIA Rating 2014)

### **4.3 Small and Medium Businesses in Petroleum Industry**

First of all, it should be mentioned that besides industry specific problems SMEs in the petroleum industry are having the same problems as other small and medium companies in Russia, which was already described by me before. This part is aimed at the industry specific problems that oil and gas SMEs face in Russia. Small and medium-sized companies are obviously attracting less attention than large VICs but they cannot be disregarded, as they are the ones that apply and develop new technologies.

Small companies find it difficult to operate in such a competitive market with huge entry barriers but they are still viable even in Russia. The main niche for small businesses in the oil and gas industry - is conducting works and provision of services in spheres that the big players find unprofitable. Mainly this relates to operating the fields with a small amount of oil and gas, or the fields that are difficult to extract. These fields might belong to the SME, as well as be lent to them by larger companies. Small businesses often resumes extraction from previously frozen wells, does repair and maintenance work, supplies and installs modern equipment. They also execute a large amount of environmental tasks, as disposal of unused oil products.

SMEs are relevant in the industry due to the next factors:

- Shifts in the resource base, increased importance of small and medium oil fields, increase in the amount of hard to extract fields, high price of maintaining a regional infrastructure.
- Lack of large companies' interest in development of some fields due to low profitability.
- The need for broad and rapid implementation of enhanced oil recovery technics.
- Low amount of innovations in the petroleum industry.
- Small companies are willing to work on the hard to operate fields while large companies prefer to work with large, easy to access fields.
- Small companies are able to make profits from those fields only due to the introduction of new technologies, leading to even higher costs.
- Small companies are usually oriented on the domestic market, exporting only a small share of their products.
- Small companies usually pay 1.5 times the taxes that the large players pay, as the rental payments are calculated without taking into account the quality of the field. On the other hand, large players pay smaller taxes.

The situation of small and medium-sized businesses is further complicated by the fact that the government gave a rather wrong assessment to its activities. For example, there are opinions that small companies are not interesting in selling their products in the domestic market and are oriented abroad. Moreover, some experts claim that independent companies are using obsolete equipment, not allowing them to produce a high quality product. These mistakes in assessment of independent companies lead to wrong conclusions and as a result to a misunderstanding of their importance. (Kadisheva 2008)

#### **4.4 Problems of the industry**

According to various sources oil reserves in Russia are estimated to be from 20 to 35 billion tons. Such large spread in the data shows how approximate and inaccurate the calculations are, which is the direct result of a sharp decline in geological exploration or an intentional distortion of information with a goal of attracting investors. In general, Russian oil industry is characterized by the deterioration of the resource base in terms of quantity, which is reflected by the falling extraction rates, and in qualitative terms, due to the increase in the proportion of hard to operate wells. The main reasons for this state are:

The loss of prepared resources base, as a result of collapse of the Soviet Union, that led to an intensive use of already existing oil wells, causing deterioration of the wells and a rise of hard to operate wells. The greatest danger for Russia in the long term is the fact that the reproduction of the mineral resource base has almost stopped. There are less and less wells that are easy to operate with every year. If the situation will stay the same, in ten years the oil companies will realize that there no ready-to-mine fields. The amount of investments in the industry is not sufficient for neither current problems, nor perspective difficulties. The reason of this situation is the bad situation in 90s, when companies were not ready to invest in expensive projects of geological exploration and preferred to center their activities on the existing wells that required little capital to work with. In the period from 1991 to 2000 explored reserves in Russia reduced by 14%, while the average amount of explored reserves in the world is growing 1.2-2% a year. By the rules of geology, a company must provide the government with more explored oil than it extracts. The usual amount is at least 15% more. But in Russia, oil companies struggled to explore even the amount that they extract. All oil companies in Russia were saving money on geology for the whole 10 years.

Deterioration in the structure of reserves. In Russia and other oil producing countries, the share of hard to extract oil has grown. The structure of the remaining oil reserves is complicated because of the intensity of extraction from the active part of the reserves and failure to refill the reserves with new values.

Reduction in the absolute value of explored reserves. Negative changes in the structure of the resource base, primarily related to the increase in the proportion of hard to extract oil, will dramatically affect oil production in the short term and. Now Russia has the largest amount of not operated wells since 1996 and still the amounts invested in repairs of wells are low.

The high degree of depreciation of technology in the industry, which is usually around 50% and in oil refining is up to 80%. Therefore, there are higher risks of failure and injures. However, the situation is improving with many new facilities starting operating as stated in the previous part. Another problem is low amounts of purchases of new equipment and low investments in new technologies, causing lower productivity. Now this problem may become even more serious, after the sanctions banning the sales of oil equipment to Russia. (Baikov 2012)

#### **4.5 Development prospects**

In the years after collapse of the Soviet Union, there was practically no stimulation of the development of small business in Russia. Despite many factors showing that increase of small companies' involvement in the petroleum industry is beneficial for the industry, the government support is staying low. As a result, independent companies represent only a small part of the industry and are practically irrelevant.

So, why are small companies important for the industry? The main reason is that 75% of all minerals are situated in the small well, the development of which is not attractive for large corporations. Therefore, they create a niche for small business. Moreover, large corporations often stop the development of fields if they face unpredicted troubles, see that the field contains less oil than predicted or there is simply groundwater. The amount of such abandoned fields is increasing with every year. Moreover, small businesses are always good for economy, especially during crisis. Many regions in Russia require higher business activity to fix their economy and unemployment problems. In addition, independent companies are able to create some competition for the corporation in the domestic market and therefore lower the prices for oil products.

What can the government do to help small and medium-sized companies in the petroleum industry? First, the government has to create a clear classification of what is a small and medium sized enterprise. This is important because petroleum industry has its own standards that differ from other industries.

Second, the government should introduce a stimulating campaign that may include for example an allowance for small companies to use existing oil pipes, logistical infrastructure and refining facilities. There are already some steps done. For example, there is a modern oil refining facility OAO "TAIF-NK" in Tatarstan that is accepting oil for refinery from small companies.

Next, as in every other industry, the business is lacking investments. Investments are crucial for the development of independent companies in Russia. Most of all they require money for R&D. There also should be a deeper development of relations between vertically integrated companies and small companies, as they are more allies than competitors.

#### 4.6 Key events of 2014

- Beginning of development of the Filanovski field by OAO “Lukoil”. Estimated capacity is 168.8 million tons.
- Building of the facilities for production of liquefied natural gas. Capacity 15 million tons a year.
- Building of the South Stream gas pipeline. Capacity 63 billion m<sup>3</sup> a year.
- Expansion of Eastern Siberia-Pacific Ocean oil pipeline capacity.
- Planned investments in the industry 321 billion Rubles, which is 1.2 times more than in 2013.
- Commissioning of 15 oil refining facilities, including those that were planned to be launched in 2013
- Technological preparation for the ban of class 3 oil fuel in 2015
- Realization of the first stage of construction of the oil pipeline Zapolyarye-Purpe (Novak 2014)

#### 4.7 Sanctions and Predictions

The sanctions imposed by the U.S. and Europe on Russia affected the petroleum industry. Specifically, the USA prohibited sales of any technologies associated with oil and gas extraction in Arctic. Europe on the other hand decided to implement softer sanctions and limited the sales of only the oil extraction technologies, leaving the gas industry as it is. Such step is predictable because, as was described in previous parts, Europe is highly dependent on the Russian gas and limiting Russian production possibilities may result in shortages in the production of gas or price increase. The aim of the ban is to limit Russia’s ability to develop deep-water wells and extract shale oil.

Why Arctic? As the analytic of Sberbank KIB Valery Nesterov said – “It was an expected blow to Russia’s long-term oil extraction prospects. The thing is, Russia is almost completely depends on Western technologies in developing the Arctic fields”. Russia is in the beginning of the development of Arctic oil fields and right now is starting to build the sea platforms and ships. The plans for Arctic are ambitious – 60 million tons of oil a year to be extracted from Arctic by 2030. Hence, the sanctions are not dangerous if they are cancelled in a year or two. However with the technologies, Russian companies also require Western consulting

and servicing companies and without them the process of preparation for Arctic oil might be inhibited.

Overall Russian oil industry may lose around \$1 trillion of future investments during the next 30 years, according to Bank of America Merrill Lynch, leading to a sharp decrease in the extraction of oil and loose of \$27-65 billion for the Federal Budget until 2020. The embargo of technologies will drive the yearly decrease of oil extraction to 3-5%. It will also force Russian companies to freeze some perspective projects. Russia still can buy the technologies from China but those are not of the same high quality and will not be able to be a full substitute.

All in all, this is a tough situation for Russia, as the old fields where 90% of all oil is extracted today are running low on reserves and the extraction rates are falling down. Russia lacks technologies for extraction of the shale oil and the small businesses that are eager to work with hard to develop field are not getting any support from the government, as stated before.

Anyway, right now it is not clear yet how long the sanctions will stay and what technologies can be acquired, so Russian oil companies are not changing the plans and are operating according to strategies set before. (Savchenko 2014)

But not only Russian companies are affected by the sanctions, as there is a large amount of international companies operating in the Russian market that may also face problems in their business operations. For example, British Petroleum owns a 19.75% share in Rosneft after Rosneft bought TNK-BP in March 2013. In case if BP has to give up its share in Rosneft it will lose 1/5 of its yearly profits. (Shohina 2014) ExxonMobil also has projects with Rosneft. One of those is \$500 billion exploration of Bazhenov oil field and \$15 billion liquefied natural gas terminal in Russia's Far East. (RT 2014). French Total owns 18% of Novatek and Halliburton and Schlumberger get from 4% to 5% of its sales from Russia.

## **5 CONCLUSION**

In this thesis I made an analysis of the factors that affect the investment climate of the Russian Federation the most. I went through the most important economic indexes that most investors look at first, I analyzed how suited the Russian law system is and how it is prepared for protecting investors and their money. Then I discussed the situation in Ukraine and the

geopolitics, which are popular today. In the petroleum industry section I went for as deep analysis as possible for such a work, since the industry is closed to outsiders because it is considered to be strategically important industry for the Russian Federation.

The situation in Russia this day is not as good as it was expected to be several years ago. The economy is still showing the aftermaths of the world financial crisis in 2008 and is struggling to show any growth. The inflation is rising and the Western sanctions are devaluating ruble. The low unemployment comes together with low paid jobs and little social securities for the workers. People employed in education and health care have to change their professions or work several jobs.

On the other hand, the future is not that dark for Russia, as it is able to utilize its largest competitive advantages: resources and intellect. Being the largest country Russia has all the resources that the world may need, from oil and gas to fresh water uranium. And the intellectual resources are able to exploit that advantage. Throughout the history Russia showed that it is able to innovate and sometimes even lead, so this time it might be the case in which Russia will have to change under the external pressure.

However, in order to create the innovative climate the government must create an environment for businesses, which is not in good shape now. Bureaucracy, corruption and administrative barriers are limiting the business, scaring the investors that are interested in starting something in Russia. At the same time the legal system fails to give investors a feeling of safety, while prosecutions for economic crimes growth with every year.

But what is most interesting today in the situation of Russia is the political environment that changes at enormously high speeds. Just this winter Russia was the spot the whole world is looking at, as it held the Olympic Games. At that time the European partners believed that Russia is a good and reliable partner and then in a matter of months the situation changed completely and today we face what some people call the second Cold War.

The amount of problems and uncertainties scares away risk averse investors but what for some seems like an unnecessary risk for others is the possibility for enormous profit. As some companies turning away from Russia, others come to the market that is still growing. Unlike most developed countries where investors expect small profits in the long run, Russia is able to offer huge profits that unfortunately come at the expense of a large risk.

As for the petroleum industry, it is rightfully considered to be the most important industry in today's Russia, as it provides up to half of the budget profits. It is doing better than most other industries and has large amounts of foreign investments. However, there is a number of problems it is facing. One of the most important ones is the diminishing oil reserves, as companies tend to spend little on geological exploration and focus on working with large existent fields. In the worst case scenario this problem may lead to huge fall in oil extracted and therefore to large fall in budget profits.

Anyway, oil companies seem to realize its problems and start looking for new fields, as well as cooperating with small oil companies that help them to operate smaller fields. Moreover, the quality of oil products and oil extracted in Russia is lacking, as largest corporations are saving money on the equipment and try to utilize older equipment to its maximum capacity. Furthermore, the Western sanctions are prohibiting the sales of special equipment needed to open and operate oil fields in Arctic, forcing Russia to postpone its goals and seek that equipment elsewhere. One of the options is China, which is able to produce such equipment with an acceptable level of quality. However, this equipment is not as efficient as Western. Therefore, sanctions have a direct hit at the oil industry and its future profitability now depends on the political environment.

On the other hand, there is a large amount of positive aspects for the investors in the petroleum industry as low taxes, large resource base and good human resources. Russia is giving foreign companies a chance to develop the lands with probably largest amount of minerals and such conditions will always attract new investors willing to take risks for a high gain.

In conclusion, Russian investment climate is far from perfect. Russia is lacking the stability and safety of the Western economies. It has a large amount of internal problems and its heading is unknown. Still, it has a developed petroleum industry that is making Russia attractive even despite the amount of problems. Risk averse investors will probably not look at Russia today but for those ready to take risks in a pursuit of a higher return Russia is an ideal market. A very important thing to understand is that Russia is not as risky as it seems, it is just different. And in order to succeed, one has to understand it.



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