Russia Continuing to Rely on High Energy Prices

During the past 12 years, the *annual average* price Russia has received per barrel of crude oil has risen from a low of $20.78 in 2001 to an estimated high of $103.38 in 2012. According to the latest estimates for 2012 from Russia's Central Bank, oil exports stood at $ 180 bln last year and together with other oil products ($103.1 bln) and natural gas ($63.3 bln), represented some 59% of the $593.8 bln in total exports of goods and services, adding weight to the view that recent and future performance is over-reliant on a factor beyond Russia's control – global energy resource prices.

Monthly Overview

In late January, 2013, the World Economic Forum released *Scenarios for the Russian Federation 2013*, drawing attention to the progress Russia has made in a little over a decade in terms of growth, employment, and income, as well as the potential for achieving more progress in the near future. However, the report also highlights that much of this recent progress has been propped up by the significant rise in global energy prices during the last decade coupled with the country's abundant energy resource supplies. Further, higher oil prices have not only simulated exports and investments, but they are also linked to the expansion of consumer spending, increased government revenues and have overshadowed development potential in non-energy sectors as well as the relatively low quality of the business climate.

According to the report, which takes into consideration the views of over 350 experts and decision makers, the country is currently at a cross-roads and must make critical policy decisions while facing considerable uncertainty, risks, and challenges going forward. With the aim of supporting a discussion on what is needed to support future development, three scenarios are used to shed light on what might be in store for the country going forward under different combinations of domestic and global conditions.

The first scenario considers what the country might look like if some of Russia's regions are able to move forward, despite stagnation in central institutions, to introduce improved business climate conditions and seize new opportunities in global markets related to agriculture, other sectors, and establish stronger trade links. The second scenario considers a significant drop in energy prices (namely oil) and the impact this could have on government revenues, exports, as well as the fallout this could have if this crisis led to more government intervention in the economy to pursue stability and control. The third scenario considers the near future under higher oil prices, but with the benefits result in continued reliance on the energy sector, a lack of development elsewhere, and further complacency in terms of introducing much needed broader-based reforms to unlock the potential in the rest of the economy.

While it remains nearly impossible to predict exactly which future conditions Russia will face, these three scenarios help draw attention to the country's need to focus on improving the business climate and reduce reliance on energy by paying more attention to other areas of the economy that show promise. The country continues to perform poorly, for example, in terms of political institutions, corruption, and the quality of infrastructure and educational programs. At the same time, the country has potential in sectors and regions outside of energy, such as in agriculture, technology, trade and transportation.

Although there is a need to highlight and address the important role energy prices have played in Russia's performance as well as the risk it poses to the country's future, an important stimulus for Business Climate reforms could benefit from placing greater stress on those sectors, regions and activities of the Russian economy that are performing below their potential. This would help to identify specific barriers different activities face as well as which policy supports and regulatory changes are needed to unlock the country's potential beyond energy.

Monthly Highlights

BCDM's highlights aim to provide a brief summary of announcements related to new investment activity that can reflect changes in the quality of Russia's business climate from one month to the next that could be overlooked in less frequent or more aggregate reports.

New Investment Announcement Activity in February was high across sectors of the Russian economy with a noted decline in the Energy Sector.

Energy

- **Gazprom** Neft intends to invest RUR 100 bln into the Novoportovskoye deposit in the North of Russia in 2013-15 and develop five oil deposits nearby**;**
- **Gazprom** plans to invest RUR 1 bln to construct 17 automatic gas fillers in 10 regions in 2013;
- **Lukoil** has entered a $ 1.4 bln contract with Tecnicas Reunidas S.A. to upgrade its Volgograd refinery and increase output its output by 1.8 mln tons per year.

Autos and Aviation

- *Components and Parts*: **Federal Cargo Company** and Germany's **Knorr-Bremse** plan to invest in a joint venture to produce braking equipment while Italy's **CNL** will invest up to EUR 50 mln to construct its second Russian auto-components plant in Togliatti, with an initial investment of EUR 1 to2 mln required for the first production line and **Yokohama Rubber** plans to invest $ 5.3 mln to expand capacity at its Russian subsidiary plant from 1.4 mln to 1.6 mln tires annually;
- **Transmashholding**, a railway equipment maker, and **Wartsila**, a Finish power equipment supplier, plan to invest RUR 1.8 bln to construct a diesel engine plant in the Penza Region in July-August with a production capacity of 250 – 300 units and estimated revenue of EUR 67.2 mln by 2015;
- **KamAZ** will invest more than RUR 5 bln in production line upgrades by developing an unmanned vehicle and a truck that runs on electricity, and up to a total investment of RUR 60 bln by 2020;
- **Aeroflot**, **Rostech** and Switzerland's **SR Technics** plan to invest in creating two joint ventures, the first focusing on repairing and maintenance for planes and the second for carrying out repairs on aircraft details;
- Canada's **Bombardier** and **Rostech** are considering investing about $ 100 mln to construct a Q400 assembly facility in Ulyanovsk;
- **MAN Truck and Bus** production plan to invest an undisclosed amount to launch a facility in St Petersburg with plans to construct more facilities in Russia in the future;
- **GAZ Group** will begin producing a new LCV, the GAZelle, in July, the investment required for this new line has been estimated at RUR 5 bln.

Metals, Minerals and Mining

- **Magnitogorsk Iron & Steel Works (MMK)** intends to invest $ 7 bln in strategic development over the next 10 years aiming to achieve a 30% share of Russian pipe making, 50% share of hot-rolled plates for ship building and to boost a footing in the auto sector to 50%;
- **Uralvagonzavod (UVS)** and **Zarechnaya** coal mining company are planning to invest an undisclosed amount to create a joint Russian industrial corporation;

- Australia's **Tiger Realm Coal** is considering taking part in investing with two Russian sovereign funds to develop Siberian coal mining deposits close to Russia's eastern Pacific Coast, requiring a total estimated investment of $ 1.5 bln;
- Russia's **UMMC** plans to invest RUR 25 bln in expanding coal production in the Kuzbassrazrezugol mining company to 50.6 mln tons by 2016, RUR 17 bln of which will be in mining equipment, and is considering investing RUR 2 bln to construct a new mine shaft, Yuzhny, to double capacity to 400 000 tons of copper and zinc ore at the Buribayevsky mining and processing plant in the Republic of Bashkortostan, another RUR 8 bln to modernize copper smelting facilities, reconstruct zinc production and upgrade copper refining facilities and a total RUR 3 bln by 2015 in its new OMK tube plant;

Transportation and Infrastructure

- *Cluster*: RUR 1 bln will be invested to launch the **Sinergia industrial cluster** in the Republic of Tatarstan by April 2014, which aims to provide facilities for companies focusing on raw materials processing, polymer production, computer chips assembly and pharmaceutical products;
- *Terminal*: Russia's **United Grain Company (UGC)** and **Novorossiysk Commercial Sea Port (NCSP)** are considering investing RUR 1.5 bln to construct a terminal to transship and load vegetable oil to be launched in 2015;
- **Russian Highways** entered an agreement with the Moscow Region government for a RUR 550 bln investment to complete 25 large scale projects in the Moscow Region by 2024, RUR 50 bln is planned for 2013;
- *Fuelling Stations*: **Gazprom** will invest RUR 2 bln to construct 37 methane fuelling stations in 2013-14 while **Lukoil** plans to open at least 12 new fuel stations in Leningrad Region as well as expand its oil depot and build an oil pipeline in the Vyborg district;

Agriculture

- *Logistics Complexes*: A wholesale agricultural market and logistics complex, **Novaya Tura**, will be launched in the Republic of Tatarstan in 2015 with plans to create five similar projects in other regions of the country for a total investment of RUR 50 to 60 bln;
- **PhosAgro** plans to invest an estimated $ 785 mln to construct a new ammonia plant in Cherepovets with an annual capacity of 760 000 tons to be completed in 2016-17;
- **Cherkizovo** plans to invest RUR 6.4 bln to develop pork production in the Penza Region in 2014-15;
- St Petersburg based **Belousov Group** plans to invest in launching a dairy plant in the Astrakhan Region and create a livestock breeding farm by 2018 to boost output with plans to launch similar projects in 40 of Russia's regions totaling more than RUR 40 bln;
- **Plemzavod Yubileiny**, a Russian agricultural producer, will invest RUR 3.8 bln to construct a plant for processing wheat and the production of lysine in the Tyumen Region by the end of 2015;
- **Ptitsefabrika Mezheninovskaya**, a poultry producer based in Tomsk Region, will invest RUR 1 bln to construct a milk farm in 2014.

Other Non-energy Sector Investment Activity

- *Theme Parks*: **Regions Group**, a Russian developer, plans to invest $ 3 bln to construct three theme parks under an agreement with **Dreamworld Animation SKG Inc**. scheduled to open in 2015 in Moscow, St Petersburg, and Yekaterinburg expecting to be the largest year-round indoor entertainment zones in Europe;

- *Pharmaceuticals*: **PharmSynthez** plans to invest RUR 90 mln to construct a new plant in the Leningrad Region in 2015-17 with a capacity of 2 mln capsules and 15 mln tablets p.a., Russia's **Nanolek** and Sweden's **Nanologica** intend to invest in developing medicines using nanoporous materials: investment sums were not disclosed, and India's **Cadila Pharmaceuticals Ltd**. is considering investing in building a drug factory in Astrakhan Region;
- **IKEA** plans to invest in building a furniture plant in the Novgorod Region although no investment sums have yet been disclosed;
- BoD of **SVEZA Group** plans to invest in constructing a new particleboard plants with a capacity of 500 000 cubic meters aiming to supply markets of Volga, the Urals, and Siberia to be launched in 2015;
- **VimpelCom** will invest in launching its 4G network in Russia in late 2013 in six Russian cities;
- **PPG Industries**, a producer of industrial coatings, is considering investing $ 75 mln to construct a paint plant in the Tver Region to be developed in stages over the next 10 years.
- *A number of investment plans in consumer retail were announced*:
  - **Parus Invest CJSC**, currently undergoing registration procedures, is planning to invest in launching three online retail projects: kidstore.ru, day5.ru (furniture and home appliances) and parfy.ru (cosmetics and makeup);;
  - **Kesko Oy**, a Finnish retailing conglomerate, will invest in opening three large scale grocery stores in Russia in 2013 after opening its first in St Petersburg in 2012;
  - **Verny**, a discounter chain, plans to expand outside Moscow and St Petersburg and into Siberia by investing in opening 130 shops in 2013.
  - **Svyaznoy**, a mobile retailer, plans to invest in launching Apple Premium Reseller mono-brand stores in 10 Russian cities with populations exceeding 1 mln people;
  - **Respublica**, a Russian book store chain, plans to invest in opening three franchise stores in St Petersburg and Nizhni Novgorod in 2013 with future expansion plans into Yekaterinburg, Novosibirsk, Krasnoyarsk, and Vladivostok;
  - **McDonald's** plans to invest in expanding its Russian chain by opening at least 150 outlets over the next three years;
  - **Yum Brands Inc**, owner of KFC, plans to invest in opening 60 and 70 restaurants this year in Russia and the CIS;
  - **Rosinter**, a restaurant holding company, will invest RUR 300 -370 mln to develop catering services at Moscow railway stations in 2013-14 under its key brands: Il Patio, Costa Coffee, Planet Sushi, and T.G.I. Fridays;
  - **Bashneft** will invest RUR 6.5 bln to repair and rebrand its fuel stations in 2013-15, with changes taking place in 244 of its 488 stations;

Outward New Investment Announcements

Outward new investment announcements in October were noticeably more diverse than usual with announcements made outside of energy in fishing, autos, banking and telecommunications.

- **Lukoil** intends to invest about $ 400 mln in 2013 to explore wells near a recent oil find off the Ivory Coast; its currently exploring three Ivory Coast offshore blocks and is expanding to a fourth and is also considering investing $ 100 mln by 2016 in a machine oil plant in Kazakhstan;

- Russia's **Sintez** is planning to invest about EUR 5 bln in Greece to build new pipelines and modernize DEPA's (Greek gas distribution company) Liquified Natural Gas (LNG) terminal;
- Russia's **Tikhvin Railway Car Building Plant (TVSZ)** plans to invest in creating local car repair enterprises in the Baltics and CIS region after reaching agreements with authorities in the respective states;
- Russia's **Uralkali's BoD** and Belarus' **Belaruskali** plan to invest an estimated CFH 200 000 to create a joint venture, Soyuzkali, for trading in fertilizer, to begin operations in 2013;
- Russia's **Inventive Retail Group** has expanded the number of re:Store shops in Germany by 3 to 15 and plans to invest in opening another five this year.

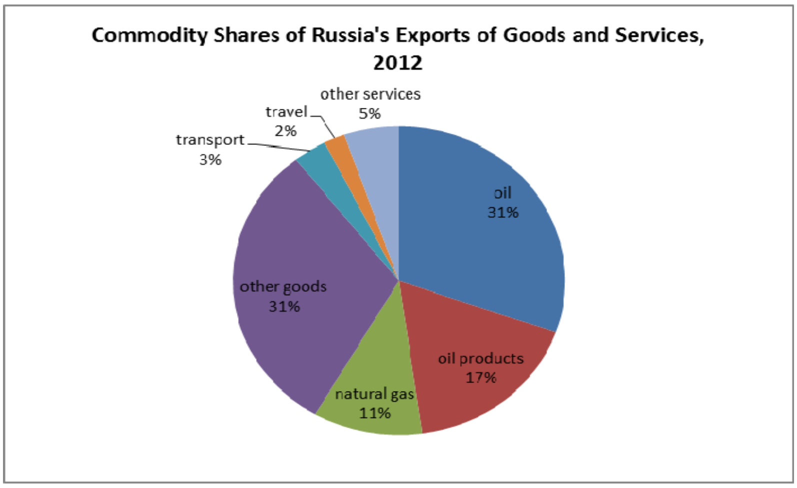
Business Climate Indicators

BCDM's indicators aim to provide a monthly snapshot reflecting important trends, challenges, and changes related to Russia's business climate.

This month's indicators highlight the role high energy prices play in the value of Russia's exports while also providing some evidence of investors' interests and intentions to invest outside the energy sector. This draws attention to the dominance of the energy sector while, at the same time, the potential and need for Russia to direct more attention to her "under-reliance" in non-energy activities.

- **Figure 1** shows the latest estimates of the total value of exports of goods and services by major commodity group for Russia in 2012. About 59 % of $ 593.8 bln was in oil (31%), oil products (17 %) and natural gas (11%) while other goods (31%) is typically comprised of metals and precious metals (about 13%) followed by chemicals (about 6.5%), machinery (about 6%) with agriculture typically below 5%. In other words, exports are not only dominated by energy resources, but the vast bulk of exports are tied heavily to raw materials exploitation.

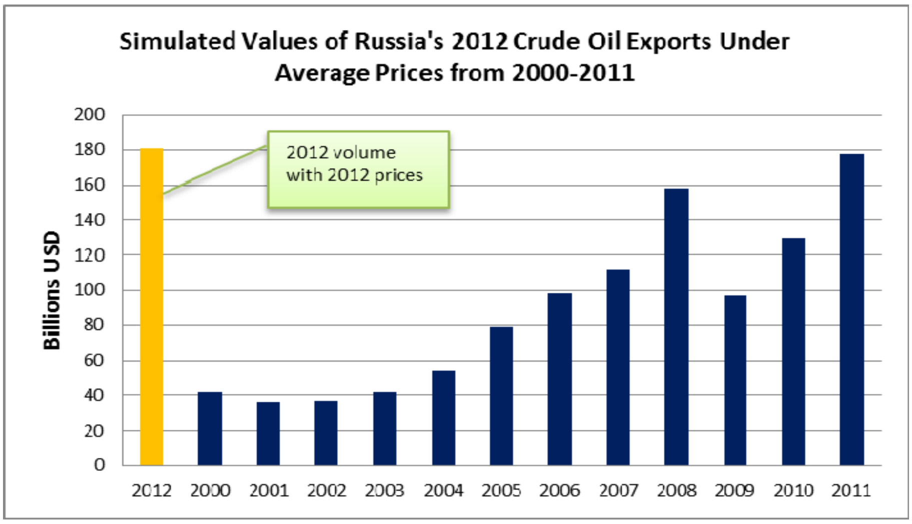
Figure 1



- During the past 12 years, the average price Russia has received per barrel of crude oil has ranged from a low of $ 20.78 in 2001 to a high of $ 103.38 in 2012. Production has grown during this period and export volumes have risen from a low of 144 mln tons in 2000 to a high of 260 mln in 2004 and are estimated at about 240 mln in 2012.

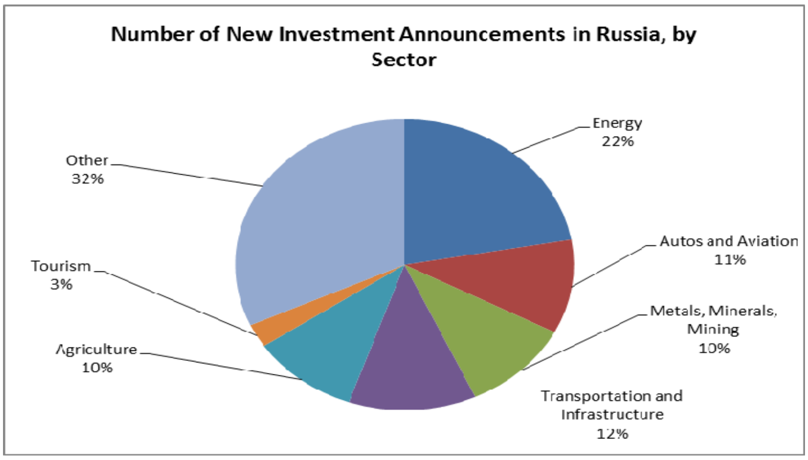
- **Figure 2** shows the estimated value of crude oil exports in 2012 (in yellow) followed by how much this export value would be if the country received the average prices for each year between 2000 and 2011 instead (the volume of exports is held constant at the 2012 level and only the price changes).
- This simple simulation highlights, on the one hand, how important the recent growth in crude oil prices has been for one of Russia's chief exports. This growth in export value for crude oil, not to mention for other energy and raw material exports, is not really due to domestic conditions, and as a result, on the other hand, it shows how sensitive and exposed the country is to a potential drop in oil prices. State budgets, exports, and much of the invesment attracton, as well as the spillover effects on other sectors, revolves around these prices.

Figure 2



- Not surprisingly, 79% of the $1256 bln in New Investment Announcements **BCDM** tracked between Dec. 2011 and Dec 2012 were in the energy sector. These announcements data can be used, with caution, to indicate where investors intend to invest over the next several years, and in terms of value, energy remains the focus for now and in the near future.
- **Figure 3**, however, shows the *number* of New Investment Announcements tracked over the same period (*Sector brakedowns are available in BCDM's Annual Report, released in January, 2013*). Energy investments only account for 22% of the number of investment announcements, behind the "other" category, which is mainly comprised of retail expansion. Also notable is the activity taking place in other mining activities, agriculture, autos and aviation, as well as transportation and infrastructure.

Figure 3



Although there is ample data to show the important role that energy production and global prices play in Russia's economy as well as their tendency to dominate and overshadow potential in other sectors outside energy, broad intentions to invest outside energy point to an even greater potential. Instead of focusing on the country's over-reliance on energy, the discussion on which business climate reforms are most needed where could benefit, instead, from paying greater attention to the economy's under-reliance on activities currently performing well below potential.