

## ***Without Business Climate Reforms Soon, Russia's Future Dimmer***

**Citing a lowering of real oil prices and oil production, Russia's Ministry for Economic Development lowered the long term growth forecast to 2030 from 4.3 to 3 % in mid-November; further highlighting the dominant role Russia's energy sector plays in the country's performance despite other promising sectors, such as agriculture, manufacturing and services.**

### *Year in Review*

*For the last monthly issue in 2013, BCDM's Year in Review provides a brief look at a selection of events related to Russia's Business Climate that took place during the past 12 months that could be overlooked in less frequent or more aggregate reports.*

At the beginning of the year, Russia's Ministry for Economic Development announced that it has taken into consideration the impact of the cancelling of the Shtokman Project on the country's development to 2030, highlighting by doing so Russia's continued reliance on a small number of high value investments tied to the energy sector for economic performance and risk, should energy market prospects weaken.

The London School of Economics' 6<sup>th</sup> *Annual Russian Business Week* highlighted the country's need to develop non-energy sectors of the economy to achieve adequate growth rates, the need to improve Russia's image to foreign investors and concern over corruption, arbitrary rule of law and low cost sources of long term financing.

During the past 12 months, Russia's Ministry for Economic Development has lowered forecasts for 2013, first from 3.6% to 2.4% in late March, then to 1.8% in August and finally to 1.4% in December, citing lower than expected investment levels, weak demand in Europe, and stagnation. The further drop in expectations through to 2030 due to weaker energy sector prices and output further highlights that the country needs to diversify the economy and unlock the potential of other sectors.

Forbes released its ranking of the *30 Best Cities for Business in Russia* in May. Focusing on the 40 largest cities by population and highest level of average incomes, the sample of cities were compared using data and information across a total of five categories: labor shortages, access to finance, inadequate infrastructure, problems with tax authorities, and closed cities. The top three in this year's report were Kaliningrad, Ufa and Krasnodar (Forbes, 2013), further reflecting varying qualities of the business climate at the sub-national level.

The quality of Russia's Business Climate has received a mixed review across several major indexes. In Bloomberg's *Best Countries for Business Index*, released in January, Russia had fallen to 56<sup>th</sup> place out of 161 countries from its position last year at 48<sup>th</sup> out of 160 while in the IMD's *World Competitiveness Center* in May Russia's position improved to 42<sup>nd</sup> out of 60 from last year's at 47<sup>th</sup> out of 59 (48<sup>th</sup> out of 60 when adjusted). In the World Economic Forum's *Global Competitiveness Index*, Russia has improved slightly to 64<sup>th</sup> from 67<sup>th</sup> out of 148 countries while in the World Bank's *Doing Business Index* the rank improved to 92<sup>nd</sup> out of 189 from 112<sup>th</sup> out of 185 last year.

**Russia's weakening economic growth performance not only reduces the prospects of achieving the 5% target announced by the country's Prime Minister earlier this year, but also the country's dependence on energy markets. The further reduction in long term outlook forecasts through to 2030 should draw even more attention to the need to both speed up and deepen business climate reforms, particularly across other sectors, to boost growth, diversify the economy, as well as attract and retain investment activity.**

## Monthly Highlights

*BCDM's Monthly 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.*

***In November, New Investment Announcement activity was dominated by the energy sector with notable low numbers of announcements in Agriculture and Metals, Mining and Minerals. There continues to be no announcements related to tourism.***

### Energy

- **Exploration: Rosneft** will invest in developing the Kharampur deposit in Western Siberia with about RUB 1 bln in the field's exploration in 2013-2014 and will invest a further RUB 92.1 bln in 2013-2015 in the Vankor field in East Siberia;
- **LNG: Novatek** is considering investing in increasing the capacity of the LNG plant at the Yamal LNG station to 24-30 m T p.a., **Gazprom** will invest in building a gas liquefaction terminal in the Kaliningrad Region with a capacity of 2.4 m T of LNG p.a., while **Gazprom's** investments in the Vladivostok LNG project are estimated to be \$ 13.5 bln with the first line to start supplying in 2018 and the second to be commission in 2020 with each having a capacity of 5 m T p.a.;
- **Solar Power: Avelar**, a unit of the Renova Group, intends to invest \$ 600 to \$ 700 mln in solar power projects by 2017 while **EuroSibEnerg** plans to invest RUB 500 mln to build a solar power plant in Abakan, a city in the Siberian republic of Khakasia;
- **Gazprom** and **Sibur Holding** are planning to invest in the construction of a gas processing plant and a gas chemical combine in the Amur Region, with Gazprom building a 60 bcm plant in 2025 producing ethane and other components and Sibur a gas chemical combine;
- **Lukoil** will invest over RUB 4 bln to maintain oil production and develop retail business in the Republic of Tartarstan;
- **TGC-2** plans to invest an estimated RUB 9.8 bln to launch a 110 MW combined-cycle gas turbine plant in at the Vologda thermal power plant in Northwestern Russia by the end of 2013;
- Russia's **EN+ Group** and South Korea's **Posco** plan to invest in building a steel mill and electric power plant in the Irkutsk Region with capacities of 260 000 T of rolled stock p.a. and 1.26-GW at the Lenskaya power plant respectively and to develop the Kupsy gas block to supply the power plant;
- **E4 Group** plans to invest an estimated RUB 13 bln in the construction of the Novobereznikovskaya thermal plant in the Perm Region;
- **Transneft** plans to invest in the construction of a route to feed new crude into the ESPO pipeline by the end of 2013 to deliver up to 15 m T oil p.a. to ESPO by 2017, with investments estimated to be RUB 172.3 bln to extend the capacity of the ESPO pipeline to 80 m T annually by 2021;
- **RAO ES Vostok's** Sakhalin Energy Company plans to invest RUB 1.5 bln to launch a power transmission line on the island in 2014 while the company is also planning to invest an estimated RUB 30 bln in the construction of the 370-MW Ussuriisk thermal power plant in the Primorsky Region, to be launched in 2016;
- **Rosneft** will invest RUB 1.3 trln to increase the capacity of the Eastern Petrochemical Company in the town of Nakhodka to 30 m T from 10 of oil with another RUB 738 mln until

2015 allocated for investing in software for designing field development and innovative projects management;

- **L1 Energy** plans to invest \$ 20 bln in energy projects over the next three to five years;
- **Atomash** is planning to invest up to RUB 700 mln in developing production in 2014.

#### Autos and Aviation

- *Discount Airlines:* **Ryanair**, an Irish airline, is considering investing in new routes connecting Moscow and St Petersburg with Dublin in early 2014 after gaining permission to fly from Russia's Federal Air Transportation Agency;
- **A-group** plans to invest in setting up an aviation company in 2014;
- **Renault-Nissan** will invest in building a second engine with AvtoVAZ and aims to overcome a decline in Lada sales with the country's car market expected to overtake Germany's within two years;
- **Volkswagen** will invest EUR 1.2 bln to develop its business in Russia to the end of 2018;
- Russia and Italy will invest in establishing a joint venture company to manufacture Sukhoi Superjet airplanes;
- **GAZ Group** will invest up to RUB 8 bln to create new car and bus models within three years, with RUB 3 bln going to prepare the production of cars and buses of the Sobol Next brand name to be launched in 2014;
- **United Aircraft Corporation** will invest a total of RUB 250 mln in a plant producing composite wings for the passenger plane MC-21 in Ulyanovsk expected to open by the end of this year.

#### Metals, Minerals and Mining

- **SU-155** will invest RUB 7 bln in an armored concrete plant with a 150 000 m3 capacity and in housing construction in the Penza Region to be launched in 2017;
- **GV Gold** may invest up to \$ 6 mln on exploration operations to be completed within 14 months in the Krasnoye gold deposit in the Irkutsk Region under the operations of Sweden's **Kopy Goldfields**.

#### Transportation and Infrastructure

- *Space Station:* **Boeing** will invest \$ 70 mln into the International Space Station in an agreement signed with Khrunichev State Research and Production Space Center;
- *Postal Services:* **Russian Post** will invest in building eight automated logistics centers by the end of 2016 to process letters and parcels and the Russian Government will invest RUB 140 bln in the Post's development until 2023;
- **Russian Grids** will invest an estimated RUB 32 bln for launching a 330-kV power ring in St Petersburg to increase reliability of the city's power supplies;
- **Rosneft, Gazprombank** and **Sovcomflot** have signed an MoU and will jointly invest in the creation of a ship building cluster in the Far East, the Zvesda ship yard, which will be completed by 2016;
- **Roman Abramovich** will invest up to \$ 1 bln in the Skolkovo Park, which is expected to be completed by 2018;
- Urals **IDGC** will invest RUB 2 bln to construct the Zaostrovka power transmission lines and substation in the city of Perm;

- **Uralvagonzavod** will invest RUB 2 bln in equipment to switch to the production of innovative rail cars;
- **Federal Cargo Co.** will invest RUB 25 – 35 bln in its development in 2014.

#### Agriculture

- **PhosAgro** will invest in developing its trading network and create traders in key markets in Russia and the CIS in 2014 after deciding to shut down a representative office in China;
- **Danone** will invest jointly with a local firm, **Damate**, in constructing a new dairy farm in the central Tyumen Region and the Bashkortostan Republic to secure long-term milk supplies, an investment worth an estimated RUB 14.4 bln.

#### Other Non-energy Sector Investment Activity

- *Mobile Telecoms:* **British Virgin Group** may invest in launching a mobile operator in Russia and the group's unit, BeMyMobile has applied to the IFC for a development loan, no financials were released;
- *Rubber:* **Rosneft**, **Rostec**, and **Pirelli** plan to jointly invest in the development of high-technology rubber and associated materials after signing an MoU;
- *A number of investment plans in consumer retail were announced:*
  - **MegaFon** plans to expand its Monobrand chain by 200 stores to 2100 in 2014;
  - **Detsky Mir** is planning to invest in tripling its chain to 610 units by 2018;
  - **Auchan** plans to invest in opening 10 to 14 stores in Russia in 2014 and to launch online sales through an Auchan Drive store brand.

#### Outward New Investment Announcements

**Outward New Investment Announcement activity in November was highly concentrated in the energy sector, although the energy activity is also diverse in terms of location and energy type (nuclear, gas, oil) and activity (plants versus exploration).**

- *Exploration:* **Rosneft** plans to jointly invest in the exploration, development and transportation of hydrocarbons with **Enel** after signing an MoU and will consider other possible areas of cooperation in South America, South Europe and Africa;
- *Upgrades:* **Gazprom Neft** will invest in an upgrade to its Dung Quat refinery after a framework agreement was reached with **Petrovietnam**; the two will invest in a joint venture to produce 500 mcm of gas engine fuel annually;
- **RUSAL** is planning to invest up to \$ 6 bln in building a bauxite smelter pending certainty concerning Indonesia's mineral export regulations;
- **Rosneft** and Italy's **Eni** are planning to invest in a new logistics center near Venice while **Rosneft** also plans to invest \$ 13 bln in five projects in Venezuela over 5 years;
- **Gazprom** is considering investing in the construction of thermal plants in Turkey and the Balkans;
- **RusHydro** is investing an estimated RUB 24 bln in the construction of the Verkhne Narynsky hydropower complex in Kyrgyzstan;
- **Uralvagonzavod** will participate in an investment in a plant that will assemble its cars and locomotives in Vietnam, no financial estimates have yet been released;
- **Rosatom** is considering taking part in a \$ 20 bln investment in Turkey's first nuclear project.

## Business Climate Indicators

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

**December's BCDM provides an overview of those indicators that reflect the quality of Russia's Business Climate that are publicly accessible in the World Economic Forum's *Global Competitiveness Index* and the World Bank's *Doing Business Index* to draw attention to those barriers that remain for diversifying the economy, unlocking greater potential, and in particular this year, boosting growth<sup>1</sup>.**

- In this year's World Economic Forum *Global Competitiveness Index*, Russia's rank improved slightly to 64<sup>th</sup> from 67<sup>th</sup> out of 148 countries. The Index uses 114 indicators across 12 pillars to assess those conditions in a country that affect its productivity; how well resources can be combined to produce output. Countries with higher levels of productivity are more competitive since they can produce goods and services at lower real costs, thereby attracting economic activity relatively more than those with lesser conditions with similar potential.
- [Figure 1](#) below shows the worst 15 of the 114 indicators in the GCI. Of particular note is that beyond energy, Russia also has great potential in agriculture, yet road quality, agricultural policy costs, property rights as well as trade barriers and customs procedures are likely candidates for barriers holding this sector back in addition to having implications for the development of other sectors (i.e. food processing, manufacturing, services).

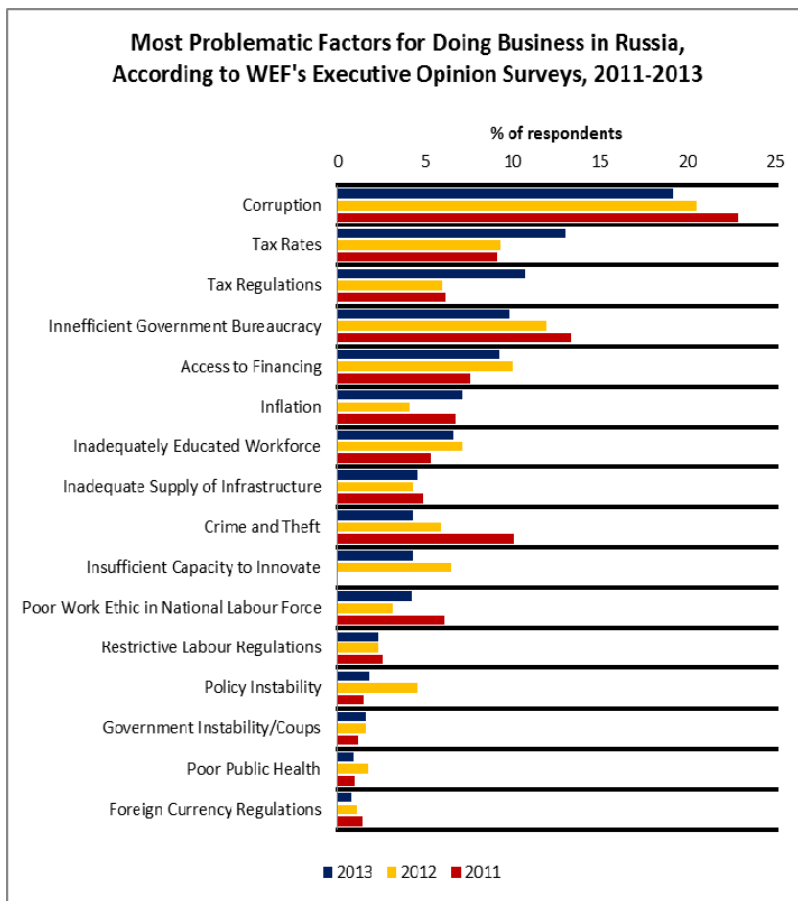
**Figure 1**



<sup>1</sup> Note that IMD and Bloomberg have not provided publicly the results of their 2013 Indexes, and only the aggregate rankings.

- **Figure 2** below shows the results from the World Economic Forum’s *Executive Opinion Surveys* for the past 3 years. These results provide a view from those who are actually operating in the country about what they consider to be the most problematic barriers for doing business. Rather than being based purely on the perception of Russia from potential investors, these types of survey results can play an important role in suggesting concrete areas where reforms are likely needed to retain investment activity. The results must be used with caution since it is not known what the consequences of each of these issues are nor what the costs of reforms would be.

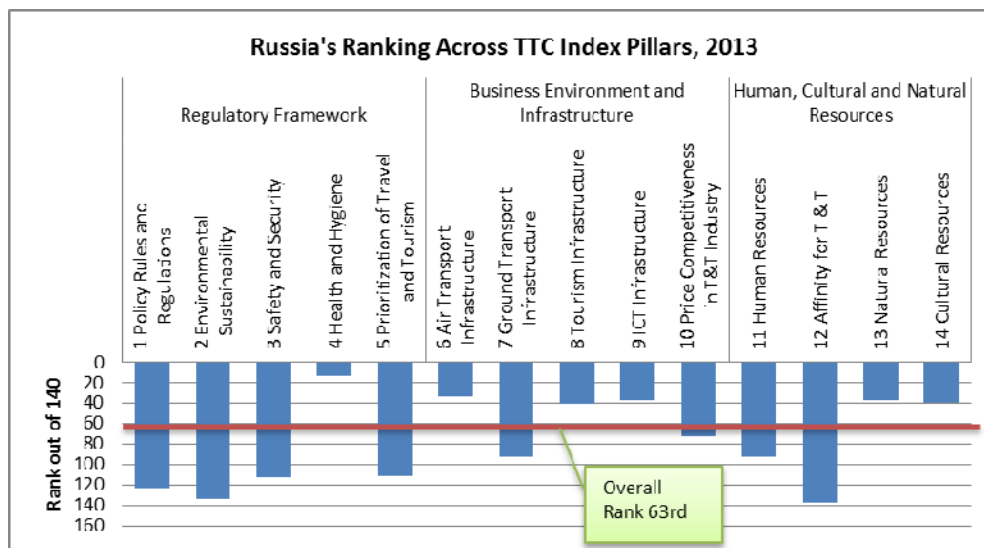
**Figure 2**



- Although **Figure 2** shows a high degree of consistency over the past 3 years, which is partially not surprising since these barriers would take some time to remove or reduce, they draw attention to the view that corruption, tax regulations, bureaucracy and access to finance are seen as problem areas.
- These types of barriers are likely to be an especially significant burden on new start-ups and those types of investments which are not large-scale, multi-year investments like in the energy sector, and thus, also indicate issues that need to be addressed to improve diversification, job creation, and value added more broadly within the country.

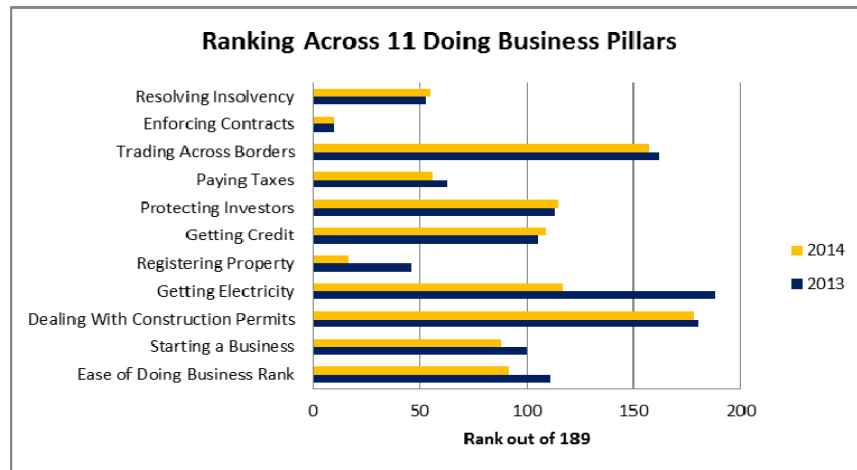
- **Figure 3** provides the results of the World Economic Forum's *Travel and Tourism Competitiveness Index* in which Russia ranks 63<sup>rd</sup> out of 140 countries. Although the country has potential for development in the tourism sector, BCDM has tracked almost no new investment announcement activity in tourist related activities monthly for the past two years.
- While the index shows that the country ranks high with natural and cultural resources, as well as basic conditions such as hygiene and infrastructure, price competitiveness is an issue as well as policy rules and regulations, safety and security and a lack of focus on this sector.
- Further, this index draws attention to the need to ensure that different interests outside of the energy sector are involved in the business climate reform process since there are likely to be sector specific, or economic activity specific, potentials, barriers and priorities that need to be addressed to boost performance.

Figure 3



- **Figure 4** below presents the latest results from the World Bank's *Doing Business Index*, released at the end of October, 2013. This index uses indicators across ten pillars reflecting the ease of conditions involved in starting, operating and closing a business; the lifecycle of a business. Although this index is narrower in coverage than the *Global Competitiveness Index*, it does provide insight into specific areas where the business climate can be improved in terms of reducing specific bureaucratic procedures and the time and costs involved with complying with regulations.
- Although Russia improved to 92<sup>nd</sup> from 112<sup>th</sup> last year, much of this progress has been made in terms of one specific indicator, "getting electricity", while many of the remaining conditions are unchanged.
- While "enforcing contracts" and "registering property" appear to be relatively highly ranked when compared to other countries, the country's business climate would improve with further progress in virtually all remaining areas covered by the Index.

Figure 4



- Given that President Putin has specifically identified the goal of achieving 20<sup>th</sup> place in this Index within 6 years, the pace and breadth of reforms would have to significantly increase.
- It should be noted, however, that this index does not reflect conditions in the rest of the country. The Doing Business Index indicators reflect conditions in the capitals of countries and, as a result, investors and entrepreneurs are likely to find the quality of conditions, and potential, varying across a country as vast as Russia. This is reflected in the subnational report released in 2012 ([World Bank](#)).

**The slowdown in growth forecasts both for 2013 and the years up to 2030 has a silver lining. Although evidence indicates that much of Russia’s high performance during the past 12 years has been due to high energy prices and the downgrade in future performance appears to depend largely on conditions and output expansion in this sector, there is lots of room for improvement in terms of specific business climate reforms. Given the country’s non-energy potential, a well designed reform package should boost productivity stimulating business and employment creation, investments, and diversification.**