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Vested and Invested Interests: The Role of Investment Protection in EU-Russia Relations

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Relations between the European Union and Russia have lately been improving. After years with a turbulent stop-go relation, fraught by Russian assertiveness and unpredictability, and the Kremlin's desire to regain its regional power, there are signs that the Russian leadership is warming up to a new approach that is more constructive and aims for deeper integration with world and European markets through new commercial policy deals. The crisis, which hit Russia hard, has forced upon Russia a more realistic notion about its economic statecraft and approach to foreign economic relations. Russia has reissued its application to join the World Trade Organisation (WTO) alone (and not as a Customs Union together with Belarus and Kazakhstan), and communicated a willingness to join the WTO sooner rather than later. And it has signaled an interest to press ahead with negotiations with the EU over commercial policy. The first step towards that end is a new Partnership for Modernization.

SUMMARY

This paper concerns Russia's investment policy and why Europe should put greater emphasis on its policy for improving investment protection in Russia. Russia still represents Europe's greatest geopolitical challenge. One of Europe's most important strategic tasks is to tie Russia to a world economy based on rule of law and the market economy. This is a long-term task – and it cannot be achieved by piecemeal concessions to Russia's demand for special treatments and respect for its authoritarian style of capitalism. The EU should show "visionary generosity" – but one of the greatest contributions it could make to Russia is to pressure it into obligations to respect core principles of trade and investment.

It simply is not possible for Russia to return to its pre-crisis model for investment protection issues, at home and abroad. The Kremlin conglomerate, or Kremlin Inc., does not have the necessary resources for it. Russia also needs to gear up its inward investment and overall raise the level of investment in the economy. It also faces a post-Lisbon Treaty European Union, with new powers to address investment protection issues. Russia's old strategy to divide Europe by cutting sweet deals with some governments had diminishing returns in the first place. At a time when Russia is short on cash for lavish investment projects in Europe, and when Europe is building up a collective approach for addressing investment concerns in Russia, the strategy will hit the buffers of political reality.

If the Russian leadership is clever, it will soon ratify the Energy Charter Treaty. It has already been ruled by a tribunal that Russia is bound by the treaty's obligations on investment protection – hence it does not matter now whether Russia is in or out of the agreement. Russia will no doubt have to live up to its obligations. It is also in Russia's interest to negotiate (sooner rather than later) an investment treaty with the EU.

These are positive signs. Yet it remains to be seen if and to what degree they will materialize in real decisions and concrete policies. There are plenty of reasons to hesitate to the idea of a Russia en route to a new type of economic model. Crisis measures have hardly reinforced the ambition to reduce the role of the Kremlin in the economy. And Russia has been given many offers in the past decade to prove its interest in proper and cooperative economic relations with the world, not least the EU, based on the rule of law, the market economy and predictable policy. Yet on many occasions it has failed to take up those offers.

The European Union should welcome the more cooperative approach from the Kremlin, but remain cool-headed about prospects for genuine change in Russia. The EU should stick to its core commercial-policy agenda of getting Russia to accept the rule of law and core principles of cross-border commerce. In fact, this will become even more important now as Russia will face some difficult choices over its model for foreign economic relations.

One of the choices concerns investment protection, or more precisely: litigation, under the Energy Charter Treaty (ECT), against the Russian state for expropriation of assets when it took control of the energy major Yukos. Last year an ECT tribunal ruled that Russia is covered by the ECT, despite Russia's claim that it had only signed but not ratified the ECT, and hence does not need to live up to the ECT's conditions for investment protection. The ruling was predictable.[1] What is not predictable, however, is how Russia will react if it loses the subsequent case over violation of investment protection provisions in the ECT. A refusal to accept an adverse ruling with damage claims, which is likely, will tarnish its reputation in a much more profound way than past examples of investment unpredictability in Russia. An acceptance of the ruling may provoke several other investors to bring claims against Russia under the ECT.

Russia, however, does not have many options. It simply is not possible to return to its pre-crisis model for dealing with investment protection issues, at home and abroad. The Kremlin conglomerate, or Kremlin Inc., does not have the necessary resources for it. Russia also needs to gear up its inward investment and overall raise the level of investment in the economy. It also faces a post-Lisbon Treaty European Union, with new powers to address investment protection issues. Russia's old strategy to divide Europe by cutting sweet deals with some governments had diminishing returns in the first place. At a time when Russia is short on cash for lavish investment projects in Europe, and when Europe is building up a collective approach for addressing investment concerns in Russia, the strategy will hit the buffers of political reality.

This paper concerns Russia's investment policy and why Europe should put greater emphasis on its policy for improving investment protection in Russia. Russia still represents Europe's greatest geopolitical challenge. One of Europe's most important strategic tasks is to tie Russia to a world economy based on rule of law and the market economy. This is a long-term task – and it cannot be achieved by piecemeal concessions to Russia's demand for special treatments and respect for its authoritarian style of state capitalism. The EU should show "visionary generosity" – but one of the greatest contributions it could make to Russia is to pressure it into obligations to respect core principles of trade and investment.

THE ECONOMIC CONTEXT FOR INVESTMENT POLICY

The recent approach to investment protection issues in Russia was determined by overall economic conditions and resurging economic philosophies close to economic nationalism. Russia experienced a spectacular economic boom in the past ten years. Its first transition period ended abruptly in 1998 with Russia's severe financial crisis. A raft of macroeconomic reforms by the Yeltsin and Putin governments restored confidence in the overall macroeconomic management of Russia. Growth picked up early in the 2000s and subsequently took off as world commodity prices hit through the roof. From 2002 to 2008, Russia's economy boomed. Increasing oil prices (gas prices follow oil prices with a time lag of approximately six months) enabled Russia to follow an export-led economic growth model, with increasing revenues coming through the balance of trade. Reserves soared and fiscal revenues enabled Russia to balance its books and, later, run a significant fiscal surplus. Capital also accumulated in the private sector and a new breed of Russian financiers and capitalists emerged – some of them domestically focused; others with an appetite for

investing abroad and acquiring foreign assets. A domestic investment boom followed on the heels of the commodity boom. Asset prices in Russia increased rapidly and a considerable part of net savings ended up in real estate. Despite distributive concerns about the newly acquired wealth, the past ten years saw the emergence of a Russian middle class, rapidly proliferating, with incomes enabling them to travel abroad for holidays and seek a lifestyle vastly different from life during the era of communism or under the turbulent period immediately after the fall of the iron curtain.

But everything is not all and well in the Russian economy. The economic crisis has hit Russia hard. Oil process went from roughly $150 per barrel in mid 2008 to $30 per barrel in early 2009. For an economy dependent on resource extraction, especially in the hydrocarbon sector, the effect of such contraction is felt immediately. The oil price contraction soon flattened out, and has picked up since then, but with commodity prices expected to remain in the low-to-middle regions (approximately half the price of the pre-crisis level) in the next few years Russia is not likely to return to pre-crisis levels of growth anytime soon.

There is another, and arguably bigger, set of problems related to Russia economy and institutions for economic policy. Economic institutions and management are weak, unstable and largely in the hands of the political leadership. Its special form of economic growth in the recent past – based almost entirely on rising prices in the hydrocarbon and mineral sectors (and ensuing expansion of non-tradables through the income side of the economy) – have been conducive to (and fostered) the authoritarian style of economic management that emerged from 2003 onwards. As its economy grew in the last decade, the regime led by President and Prime Minister Vladimir Putin also became increasingly authoritarian and assertive also on the foreign economic and geopolitical scenes. It set out a policy to gain back its lost influence over the area that used to constitute its former Soviet empire. The means to achieve this have been economic, rather than military. The war in Georgia in 2008, however, signalled that Russia's rise can breed international instability of a different magnitude than those caused by its economic statecraft. The economic crisis has prompted commentators to believe that Russia's assertiveness will abate. This, however, is an optimist proposition.

Russia's growing hydrocarbon-based economic power has caused concerns for its European neighbours. Economically, Russia depends more on the EU than vice-versa. Indeed, its growth depends on its exports of hydrocarbons, of which a considerable part is engineered for Europe. The latter represent two thirds of Russian exports. Yet Europe's energy dependency on Russia, its fragmented energy market, and the absence of a common foreign policy have made the EU a weak partner of Russia and created an asymmetric bilateral relationship. European interests have been neglected time and again. Its investors have been stripped of invested assets in Russia. Russia has been able to play such games with Europe as its main energy partners have been offered sweet energy deals too lucrative to say no to. European attempts to diversify its gas import and introducing a common energy market have been torpedoed by a number of powerful EU member states which Russia has cultivated with preferential access to its energy assets and strategic bilateral relations. This situation has harmed the new EU member states in particular. They have brought with them a pipeline network that is a Soviet legacy – their higher energy dependence on Russia has made them the biggest victims of the three-week gas disruptions that occurred in early January 2009.

Differently put, Russia has been skilled at using its economic statecraft: it is leveraging its energy sources and trade for other purposes. It is also punching above its weight. Russia is still an emerging market. It is a populous country, but the size of the economy is smaller than the big European economies. In volume terms, the annual economic growth in the past years has approximately averaged the volume increase in two big European economies. Russia, then, has exercised an influence on regional policy (economic and political) in Europe which is bigger than these hard economic measures suggest it should be.

INVESTING IN RUSSIA

Russia has gone through a reversal of past political and economic reforms, in particular since the end of Vladimir Putin's first term as President. The turning point was the nationalisation of Yukos, Russia's then biggest oil company, in 2004, and the imprisonment of its owner, Mikhail Khodorkovsky. The Putin regime, assuming high offices in 1999-2000, set itself the task to recentralize power.

A key move was to gain control over the tycoons – more famously called the "oligarchs" – that had come to own major private conglomerates in the privatization era of the 1990s and to dominate the political scene. In an analysis of the new power configuration, Clifford Gaddy and Barry Ickes have labeled this system Putin's "protection racket"[2]. "In that deal, the oligarchs agreed to abide by a few clear rules about their behavior inside and outside Russia; in return, Putin guaranteed them not only protection against expropriation by the state but also, and even more important, protection against each other", writes Gaddy and Ickes. Russia's economy has progressively been re-monopolised and put back into state hands. The private sector's share in GDP was reduced from 70% in 2004 to 65% in 2005, according to EBRD data. Direct government stakes in State Owned Enterprises, the JSCs (Joint Stock Companies), increased. Less than 50% state ownership was the norm in 2002 in more than 75% of JSCs. In 2008, 100% ownership was the rule for more than 50% of Russia's JSCs[3].

This process was accompanied by a dramatic rise in levels of corruption. Eminent Russia scholar Anders Åslund argues that nationalisation under Putin has not been driven by ideology, but by corruption itself. Åslund writes: "No economic rationale is evident. The most likely purpose of renationalization is corruption".[4] The methods used by the government can be summarized as follows: "State enterprises are buying good private companies either at a high price in a voluntary deal, which is accompanied by rumors about sizable kickbacks, or the sale is forced and the price is low."[5]

Many government members, often with a secret services background – the secret services have become a strong political force in the wake of Vladimir Putin's arrival to power – sit on Russia's state-controlled companies. This contributes to considerable conflicts of interests. The boundaries of politics and business are blurred.[6]

The Russian court system has been corroded. Law in general, but, for the purposes of this paper, commercial law in particular, is used selectively and manipulated to support moves to strip assets from rival or subsidiary companies by state-backed companies, or by powerful "oligarchs" themselves. Law is also manipulated for political purposes. For example, after Yuganskneftegaz, the biggest Yukos subsidiary, was passed onto state-owned Rosneft after Yukos' seizure, all the back tax claims that had been made on Yukos were withdrawn. The prevailing system is dubbed "Basman justice" in reference to the Basman Discrict Court that heard the Yukos case.

The solidity of the Russian state's finances at the start of the financial and economic crisis has allowed the political and economic system not to change in any significant way. Russia had accumulated the third largest foreign currency reserve. The government had established a reserve fund to catch the windfall of the last commodity boom. This was meant to bolster macroeconomic stability. Ironically, the government cash has served to save many big Russian conglomerates from bankruptcy, thus perpetuating the prevailing political and economic system which under normal circumstances would probably have collapsed. Russian companies were overexposed to debt in the international financial markets. When global credit dried up for Russia in 2008 and 2009, Russian companies faced bankruptcy. About $200 billion – more than one third of the country's foreign currency reserves – was spent at the height of the crisis to stop the ruble from falling. This is widely believed to be a policy that has helped the large Russian corporations to adjust to the loss of income and to the drying out of international credit, making debt service cheaper than it otherwise would have been[7]. According to a report issued in 2009 by economists and former government members Boris Nemtsov and Vladimir Milov, 1.3 trillion rubles were transferred, via state development bank Vneshekonombank, to cover the foreign debts of banks and corporations in 2008 and early 2009.[8]

In the current post-crisis environment, economic power configurations are in a greater state of flux, as is the financial situation of the Russian government and some of its protégés. It appears that brutal asset grabbing is being replaced by somewhat softer methods. Lip service to reforms is being paid. However, as will be shown below, the underlying framework and pattern of behaviour of the government and the major companies operating under its protection has not changed.

Minority shareholder rights continue to be fragile. Recently this has been exemplified in court battles between metals magnates in the Maxi Group/NLMK cases, or

Progonz/HRG[9]. Powerful majority shareholders aim to force minority shareholders to sell out their shares at lower prices, or to be driven out of the company through declaration of bankruptcy[10]. These are classic battles between oligarchs.

In early 2010, Russian tycoon Alexander Lebedev – the owner of the United Kingdom's Evening Standard – was believed to have been coerced into selling his shares in the Russia's national flag carrier Aeroflot with an 18% discount. This was part of a move in late 2009 and early 2010 by the government to save the sector from bankruptcy – and thereby monopolising it further. Regional airlines are to be merged with Aeroflot. Alexander Lebedev was critical of the way Aeroflot was managed.[11] However, in July 2010 his sale was postponed with improving economic conditions. He is attempting to obtain better financial conditions from the government. The government is currently reorganizing in the telecommunications market and aims to put it under the leadership of state-owned Svyazinvest. It is trying to put independent mobile phone services providers under the company's control.[12]

In such an environment foreign investors in Russia cannot but have it at least as hard as independent Russian entrepreneurs, competitors to the big state-owned or well-connected companies, and minority shareholders. Foreign investors have no major role to play in the Russian and oligarch's strategies. Foreign company's survival in Russia depends much on good relationships with the government. These relationships are not ruled by law, but by the prevailing political priorities. Treatment of foreign investors in Russia has followed a similar pattern as the treatment of minority shareholders or independent producers in Russia itself as described above. Often it involves some form of asset stripping. This is orchestrated either directly by the government, or by a powerful and well-connected tycoon. In both cases, courts and administrations are used to put the target company under pressure and close enough to bankruptcy to convince it to relinquish assets or management control under the terms set by its opponent.

Rising monopolisation, state-ownership and concomitant economic nationalism were reaffirmed by the Law on Strategic Enterprises issued in 2008[13]. Although the law formally clarified under which conditions foreign investors would be allowed to invest in sectors deemed "strategic", it has not only restricted access to Russia's markets, but also made life more difficult for many foreign investors. The law lists 42 sectors of the economy for which foreign investment is subjected to controls. This involves predictably the defence and hydrocarbons sector. It is also involved banking and telecommunications. As a general principle, no foreign company may own more than 50% of a company on the list of strategic industries. Prior authorisation to invest is required. For companies involved in subsoil prospection and extraction of minerals the cap on foreign investment is 10%. Companies in which the Russian state owns more than 50% of the shares are not subject to the law – which means investment into the great state-owned behemoths in not only energy, but also banking and telecommunications, is subject to government discretion.

Whilst the law is generally considered to have been applied relatively consistently, it has not protected foreign investors from discriminatory treatment after approval of the foreign investment. This has been the case for example of Archangel Diamond Corporation (ADC), a Canadian subsidiary of South Africa's De Beers, which was allowed to acquire a 49.9% stake in Arkhangelskoe Geologodobychnoe Predpriyatie (AGP). The deal was formally approved by Vladimir Putin himself before the law on strategic investors came into force. But the Government Commission on Monitoring Foreign Investments then subjected authorisation to the obligation to process the extracted diamonds in Russia in amounts that were to be agreed. There was never an agreement on this amount. ADC ultimately pulled out and sold its stake to a fund specialising in managing assets involved in litigations[14]. Furthermore, uncertainties in the formulation of the law and loopholes mean that the legal environment for foreign investors remains uncertain, as is highlighted in a report by the Association of European Business[15]. In March 2010, the government launched legal cases against foreign companies who allegedly did not comply with the Strategic Sector Law[16].

The economic crisis has led the government to make new overtures to foreign investors and foreign governments. This is a move to appease relationships with the West and to support a new programme of economic modernization launched by president Medvedev. President Medvedev

initiated a reform of the strategic sector law. The new law reduced the number of Russian companies deemed "strategic" from 208 to 41 without altering the entire framework, however. It proposed changes to corporate taxation to attract long-term investment.[17] The Presidency also launched a special zone for Research and Development in advanced technologies in Skolkovo, outside Moscow. Foreign investors have responded positively to the invitation. For example, the US high tech company Cisco has pledged to invest $1 bn in Russia and base its operations in Skolkovo. Top executives from Silicon Valley have taken on advisory roles in the development of the Skolkovo project[18]. There are many doubts about the sustainability of the project because it is as yet not been accompanied by reforms to improve the investment climate in Russia. The track record of the 16 Special Economic Zones established in 2005 to attract foreign investment – only $4.7 bn was invested amidst a global investment boom, way below the government's expectations – does not bode well for the Skolkovo project[19].

In order to improve investor confidence, ongoing conflicts between foreign investors and the Russian authorities would require to be resolved by lawful means. Not much points to a real change of direction in Russia. In the summer of 2009, Russia pulled out of the Energy Charter Treaty (ECT), the treaty established in the 1990s to regulate energy trade on the Eurasian continent. The Energy Charter foresees investor protection, enforced through international arbitration, including investor-to-state dispute settlement. Under this treaty, shareholders of Yukos, who had not received compensation for the nationalisation of the company, resorted to international litigation to determine whether Russia was bound by the ECT. Russia had not ratified the treaty. But it had not officially repealed the text's clauses stating that signatories were required to apply the treated provisionally, as it could have. Consequently, an international tribunal ruled that Russia was bound by the treaty[20]. Russia's decision to pull out of the ECT came in advance of this expected ruling. There is currently no sign that Russia wants to reverse course on its approach to the Energy Charter.

Recently, the Supreme Court in the Netherlands upheld a ruling of a Dutch court that required Rosneft to pay $420 million compensation to a group of foreign Yukos shareholders. Yukos claimants used the Dutch court system to get a Moscow arbitral court decision of 2006 enforced. In August, Rosneft announced it has paid [21]. The foreign investment community often complains that Russia does not pay up to international arbitral awards emerging from investor-state dispute settlement cases. It required a Supreme Court judgment from a major European partner of Russia to convince a Russian state behemoth to pay up and not risk a major damage to its reputation. This step is a sign of Russia's new, more accommodative, stance.

There are many spectacular cases that remain unresolved in Russia. The Hermitage Capital Management case[22] is one of them; the Telenor case is another. For several years, the Norwegian telecommunications operator and the Alfa Group Subsidiary Altimo, fought over the composition of their shares in Vimpelcom, Russia's second largest mobile operator, and in Kyivstar, in Ukraine. The conflict was resolved in the spring this year. Telenor was the one to agree to the terms set by its partner. This followed an arrangement found after two Russian court rulings in 2009. The first demanded compensation payments to an obscure minority shareholder affiliated to Altimo, and the other ordered the sale of almost all the 30 per cent stake it owned in the company[23].

In the energy sector, TNK-BP, the conflict-ridden Russian-British joint venture, is about to lose its licence to operate the Kovytka gas field in Russia. BP-TNK was forced into talks with Gazprom in 2007. These talks have faltered as Gazprom recently announced it was not interested in investing in the Kovytka field. There are suspicions that BP-TNK was coerced in 2010 into providing a financial $1.7bn investment in Rosneft orchestrated by the government[24].

An equally worrisome action of Russian authorities, at the height of the economic crisis in 2009, has been the treatment of MOL, Hungary's gas major. This incident has direct repercussions on the EU's own internal gas market. MOL operates a field in a joint venture with Rosneft, (Zapadno-Malobalyk, ZMB). ZMB was subjected to administrative pressures and threatened with the withdrawal of its licence. These moves were held in conjunction with, and are generally seen as directly linked to, the move by the Rosneft subsidiary Surgutneftegaz to buy a stake in MOL from Austria's gas major OMV. MOL considers it has been coerced into this deal and is trying to buy back

Rosneft's share in its company. MOL had previously (in 2008) brought Rosneft to court in Moscow for stealing oil from their joint field. MOL lost the court case.[25]

The cases mentioned above have made international headlines. On a daily basis, however, many foreign investors in Russia face, outside the media limelight, significant hurdles to their operations and numerous encroachments on their property rights. On reading the Association of European Businesses (AEB) latest Position Paper[26], it appears that there are two overarching concerns. Firstly, large-scale intellectual property right violations, especially during license applications and registrations of patents and trademarks. AEB even talks of "patent rackets" in the automotive sector[27]. Other issues concern violations of copyrights and cybercrime. Secondly, corruption. This umbrella term includes issues such as discriminatory tax treatment, corporate raiding, and bribe taking at various levels of operation and registration of businesses. Most recently, commercial real estate has come to the fore with the spectacular case of IKEA, the Swedish retailer, and the biggest foreign investor in Russia outside the hydrocarbons sector.

Even Russia's foremost allies are starting to lose interest. This is the case for Germany's E.On Ruhrgas, for example. The German gas major is one of Gazprom's main allies and has been a voice in support of Russian energy policies throughout the decade. It is the only minority shareholder in Gazprom (3.5%). It has just announced its intentions to sell its stake. E.On's management argues that its stake does not provide it with any "strategic advantages". The seat on the management board that comes with its stake does "not bring advantages [E.On] could not foresake"[28].

HITTING THE BUFFERS OF POLITICAL REALITY

Old habits die hard. Yet it should be clear to Russia that its approach to investment policy is getting the country into trouble – and that it is not sustainable. It is hitting the buffers of political reality. What are the problems?

A. Investment gap: Russia is short on capital

Russia is underinvested and short on capital for investments. It will need to import capital in the near-to-medium term future – and the composition of foreign direct investment (FDI) needs to be different from the pre-crisis era when commodities and real estate had disproportionate shares of inward FDI. Most importantly, there is an enormous need to scale up investments in the non-commodity industrial sectors. There are two interesting aspects of Russia's FDI performance. The first one is that Russia has for decades been exporting capital to countries; outward FDI (OFDI) has been surprisingly extensive. Secondly, the accumulated stock if FDI in Russia is comparatively low – it only represents around 10 percent of GDP. The composition is also indicative; the vast part has gone into the oil and gas sector, followed by real estate and business services. What Russia in particular lacks is foreign investment in the industrial sector.

Russia's industrial production growth reached decent levels in the years prior to the crisis. Industrial production grew by 7-8 percent in 2007 and 2008 (see Table 1). It contracted sharply in the late 2008 and early 2009, but picked up again in late 2009, reaching 6 percent on a year-on-year basis. The recovery was temporary: Russian industrial production growth contracted yet again. It fell by almost 10 percent in the first part of 2010. Later data suggests a new recovery is on the way, spearheaded by increasing demand for chemicals and the Russian incentives to its domestic car industry. Yet estimates for 2010 and 2011 suggest it is a moderate recovery in consumption, not industrial output, which will be the base of growth.

Yet even pre-crisis growth levels in industrial production are insufficient for an economy like Russia's. Industrial growth needs to be far bigger for Russia to re-industrialise and the sector to take a greater share of the economy. In the pre-crisis years, domestic production in the construction and retail sector grew by a much higher factor, reflecting the asset boom and the fact that Russia's growth was highly dependent on domestic consumption. The increase in gross capital formation did actually reach decent levels in pre-crisis Russia, but the composition of those investments were far too skewed towards the property boom.

TABLE 1: GDP GROWTH BY MAIN SECTORS (VALUE-ADDED)

	2006	2007	2008	2009
Total GDP growth	7,7	8,1	5,6	-7,9
Tradable sectors	3,4	3,9	1,8	-9,4
Agriculture, forestry	3,8	2,6	8,4	0,3
Extraction industries	-3,3	-2,6	0,2	-3,1
Manufacturing	7,3	7,8	0,9	-15,3
Non-tradable sectors	9,7	10,3	7,4	-6,8
Electricity, gas, water	5,7	-0,7	1,2	-7,9
Construction	11,8	9,3	13,2	-17,0
Wholesale and retail trade	14,1	13,7	8,4	-8,6
Financial services	10,3	12,5	6,6	-3,0
Transport and communication	9,6	3,4	6,9	2,4

Source: Rosstat

The hydrocarbon sector, too, has a pressing need for investments. In the past years, money has been used to invest abroad rather than upgrading the pipeline system at home. It has been estimated that Russia needs to invest around $7 billion a year to upgrade its pipeline system in the course of the next ten years. Yet only around $1 billion was spent annually in the pre-crisis years. Furthermore, too little resources have been invested in bringing new sources on stream.[29] Russia may have a big part of the proven gas reserves in the world, but if one only judged on the basis of investment, the conclusion would hardly be that Russia looks intent on exploiting this natural asset.

Foreign investments will no doubt be needed to develop new fields and bring them on stream. Contrary to popular perception, Gazprom is actually short on capital and have cancelled or postponed many investment projects. It needs to prioritize among a plethora of needs, but it is likely to continue prioritizing investments in new supply routes that help them to keep a dominant position in some countries gas supply (Nord Stream, South Stream) and exert monopolistic pricing power. Gazprom has seriously neglected investments in new fields and is rather looking for scaling up its import of gas in the short-to-medium term future, from Azerbajan in particular. Investment protection is thus becoming increasingly central also to Gazprom's business model.

Now, the problems of Russia's capital structure are not new, nor were they provoked by the crisis. Russia had a great investment gap already before the crisis. Furthermore, Gazprom has since long been investing heavily outside Russia. Yet none of this motivated leaders to move to an investment policy regime of international standard; investment policy remained based upon the interests of selected oligarchs and the short-term revenue interest of the Kremlin. So why would the Machiavellian spell of investment policy be broken now?

It may not be broken. But the crisis has changed one thing: the underinvestment in the industrial sector – and the heavy dependence on commodity export revenues – has been displayed with brutal force during the crisis. This does not necessarily lead to a change for the better – but it has certainly undermined the material base for the past approach to investment issues. This is why recent Kremlin rhetoric has become more accommodative of investor concerns.

B. Old model too expensive

Russia's past approach towards investment protection (for inward as well as outward FDI) will not work in future – not even for the narrow interest of the oligarchs, the state-owned enterprises and their allies in government. The past approach has been to negotiate Bilateral Investment Treaties (BITs) with relevant countries, but these treaties have suffered from chronic problems, like exemptions of key sectors. Yet the BITs have only been one part of policy. Equally important has been the Kremlin strategy to tie itself close to important economic interests in countries it seeks support or loyalty from. Companies from selected countries have been granted favours not available to the many. In return Russia has demanded good protection for its foreign investments – and political support on matters important to key Russian interests.

Germany is a case in point. German firms, especially in the energy sector, have been granted preferential and lucrative access to Russia and Russian assets. German firms have also formed partnerships with Russian state interests outside Russia. Consequently, Germany has always been a resistant factor in EU policy initiatives to establish improved – or, more neutrally, changed conditions – for commercial integration between Russia and Europe, like a single market for energy in Europe. Cyprus and the Netherlands (albeit for somewhat different reasons) have also been loyal allies in many crucial policy decisions.

This approach poses two problems for Russia. Firstly, the selective and arbitrary approach – in contrast to a treaty based general approach – may temporarily work when the country's predominant interests are in the energy sector and linked directly to the short-term revenue interest of the government (as owner or tax authority). But it is less effective over time: the medium-to-long term revenue interest is to expand value-added production, which is vastly different from the short-term focus on output and fiscal revenues in the old model.

Furthermore, it is outright counterproductive when the sectoral dispersal grows, in outward as well as inward investments. Despite appearances, the Kremlin does not have the management capacity to use the selective and arbitrary approach when the interest of Russia is dispersed on many different sectors. No country has that capacity. It needs to resort to more of a generalist approach with less discretion for, and demands on, the central government.

Secondly, the past approach is expensive, especially as a way to buy loyalty. Political loyalty does not come cheap, in the first place. More importantly, countries are less willing to be loyal when the flow of investment diminishes. For example, in advance of and amid a good stream of foreign direct investment from Russia, many governments would have an interest to act loyally with the Russian government. But once the investment has been established, the power balance between the origin and the destination of the investment changes. Then it is the originator who has an interest to act loyally with the destination country in order to protect the fair treatment of the established investment. Hence, if Russia aims to buy loyalty by foreign direct investment, money needs to keep rolling into other countries from Russia. Russia does not have that capital. Russia is not the first country to hit the buffer of political reality. Many resource rich countries in the past have followed similar tracks. But as countries and economic development mature – and get stock of outward investments to protect amid slowing OFDI per country – the approach has had to change.

This is inarguably a simple, but not simplistic, model of the political economy of foreign direct investment. But it helps to understand the complexities facing a country which has been viewing investment through the nexus of money and power. The problem for Russia is that the crisis has made visible the shortage of capital that state-owned firms, like Gazprom, or debt-ridden oligarchs suffer from. Furthermore, the drop in commodity prices (the oil price in the next few years is likely to remain at current levels – roughly 50 percent of the price at the peak of the boom in mid 2008) has contracted export revenues and generally dried up resources. And, Russia's interest in its outward FDI is now dispersed on too many countries for the past approach to be an effective tool for investment protection.

In sum, Russia's interest is increasingly to have a general investment protection approach (based on reciprocity, the rule of law, and general openness) that helps to secure fair treatment without a steady stream of capital.

C. Little power to wield against Europe

Investment policy in Russia's most important investment partner (the European Union) is under change – and future development will hardly be compatible with Russia's past preference for arbitrary and intransparent deals with selected countries.

The Lisbon Treaty mandates the EU to negotiate investment treaties on behalf of the member states. After a process of grandfathering current BITs agreed by EU member states, the EU is likely to seek new investment treaties with other jurisdictions. Russia is widely believed to be one of the first countries the EU will target for a new investment treaty. Hence, the EU and Russia will start negotiating in a new type of political economy context. It will be a reciprocal deal and if Russia is not prepared to accept European terms, it may lose some of the protection that Russian investor now enjoys through BITs with European countries. Furthermore, the EU is also widely believed to seek an agreement which has stronger provisions on investor-state dispute settlement than Russia prefers. The EU is not likely to accept current Russian policy on "strategic sectors", which in many respects is nothing but a protectionist ploy.

In such a circumstance, Russia has little power to wield against Europe. True, it can threaten with brinkmanship, like seizing the property of European investors inside Russia, or acting uncooperatively through its investment in Europe's energy sector. But that would not take Rus-

sia far. Not only does it need increasing investment from Europe, it also has a lot of investment in Europe it needs to protect.[30] And at a time when competition to Russia's pipeline based gas export to Europe is increasing, brinkmanship will deliver few gains to Russia.

The power balance does not speak in favour of Russia. Europe is Russia's most important partner for both inward and outward FDI. The vast part of Russia's outward FDI stock is in Europe. But only a small part of Europe's outward FDI stock is in Russia. Hence, Russia is not in the position to gamble its overall outward FDI in the hope of maintaining policies that only helps a few coddled oligarchs and state-owned enterprises. Those vested interests will have to be balanced against the general invested interests of Russia.

TABLE 2: RUSSIA'S OUTWARD FDI FLOWS, FIRST QUARTER, 2009 ($ MILLION)

Destination	Amount
EU	25,776
United States	4,944
Belarus	1,943
British Virgin Islands	1,298
Switzerland	1,181
Ukraine	102
Total	38,454

Source: Andrei Panibratov & Kalman Kalotay (2009) *Russian outward FDI and its policy context*. Columbia FDI Profiles No. 1, October 13, 2009; own calculations

Table 2 gives a good indication on the destination of Russian OFDI. It is data only for the first quarter of 2009 – it is notoriously difficult to get official accounts of Russia's investment profile – but it shows that two thirds of Russia's OFDI is destined for the EU.

CONCLUDING REMARKS

Russia's policy towards investment protection will have to change. If the Russian leadership is clever, it will soon ratify the Energy Charter Treaty. It has already been ruled by a tribunal that Russia is bound by the treaty's obligations on investment protection – hence it does not matter now whether Russia is in or out of the agreement. Russia will no doubt have to live up to its obligations, and hopefully there will soon be new cases brought against the Russian government that will address past expropriations. It is important to settle these disputes – to clear the deck – because they gum up current relations between Russia and individual countries. Europe cannot, and should not, agree with Russia on a new investment agreement if there are old investment disputes that have not been settled.

It is also in Russia's interest to negotiate (sooner rather than later) an investment treaty with the EU. Investment policy will get more complicated in the EU. Investment policy, like trade policy, will get linked to a host of other political ambitions. There might be a new authority to screen inward FDI in the same way as the Committee on Foreign Investment in the United States (CFIUS) reviews, and occasionally blocks, investment to the US. Such a development would pose problems for Russia – and it would increase the overall political cost for Russia's outward FDI.

Some voices inside Europe still argue for a "soft" line towards Russia – meaning that the EU should cater to the demands of the Kremlin. These voices will increase in force as Europe moves closer to the point in time when it will seek a new investment agreement with Russia. But not only is this view profoundly wrong – the interests of the Kremlin (as they have been manifested in the past years) are vastly different from the interest of the Russian people – it is also hurting the ability of Europe to tie Russia firmly to the world economy and its basic rules of behaviour.

Changing Russia's policy will not be easy. Old habits die hard. There are strong vested interests that protect the old order. But it should be clear to the Russian leadership that there are diminishing returns of the old model. It will not deliver in future what it has delivered in the past. Russia will not only need increasing inward investments in the medium-to-long term future to help finance the upgrade of Russia's industrial sector. It also needs to offer its outward investors good conditions in a world that is changing fast. That the old model cannot do.

1. Fredrik Erixon (2008) *Europe's energy dependence and Russia's commercial assertiveness*. ECIPE Policy Brief No. 7/2008.

2. Clifford Gaddy and Barry W. Ickes (2010), "Russia after the Financial Crisis", Eurasian Geography and Economics, Vol 51, No.3, pp. 281-311

3. Carsten Sprenger (2008), "State-Owned Enteprises in Russia – Presentation at the OECD Roundtable on Corporate Governance of SOEs", Moscow, October 27, 2008.

4. Anders Aslund (2007), *Russia's Capitalist Revolution*, Peterson Institute for International Economics, p. 254

5. Ibid.

6. Russian companies that have seen their assets stripped via dubious administrative and judicial methods include, Nortgaz, Russneft or Tambeineftegaz.In 2005, Nortgaz saw its right to produce gas and oil from the North Urengoy field denied by a Moscow court before the company was sold off to Gazprom .A similar pattern holds for the company Tambeineftegaz, operator of theYuzhno-Tambeiskoe field – it was threatened with a withdrawal of its licence by a Moscow court before entering into an arrangement with Gazprombank which bought a stake in the company. In 2007, Russneft, a mid-sized, independentoil producer was subjected to a tax probe before being brought under custody of Basic Element, a company controlled by billionaire Oleg Deripaska. Michail Gutseriev left Russia under mysterious circumstances. He was prosecuted for tax fraud, and then for "illegal entrepreneurship". However in 2010, he was allowed back to Russia and charges against him were dropped . In June 2010 he was reinstated to his post. His company is was bought and is now co-managed by the Russian conglomerate Sistema. A representative of the state-owned bank Sberbank sits on its board . Not only the oil and gas sector has seen such methods. In 2005, the company operating Domodedovo airport in Moscow East Line Group (whose onwhership remains unclear) lost the rights to operate Domodedovo Airport after a Moscow arbitration court annulled on unclear charges and at the behest of the State Property Fund the management company's 75-year lease on the country's most modern gateway.

7. Clifford Gaddy and Barry W. Ickes (2010), p. 301.

8. Boris Nemtsov and Vladimir Milov, *The White Paper, III*. February 2004, 2009.Available online at: http://larussophobe.wordpress.com/2009/02/24/another-original-lr-translation-the-nemtsov-white-paper-volume-iii/ Quote: "*quietly (...), Putin has allocated $41.2 billion to loyal oligarch Deripaska to enable him to take personal control over Norilsk Nickel. Next in line for largesse were his Rosneft friends Sechin and Bogdanchikov who received help from state banks to the tune of $4.6 billion. This despite the fact that Rosneft made $13 billion profit [in 2008]. Then it was time for Putin to help his friend Roman Abramovich, whose company Yevraz received $1.8 billion. In line after him stood national leader S. Chemezov of Rostechnologii, who asked for over $ 7 billion.*".

9. Former owner and now minority shareholder of a steel group Maxi Group, Nikolai Maksimov, contested the results of a 2009 auction, in which the main shareholder NLMK, won control over two Maxi Group daughter companies. NMLK is the metals group that had bought a majority stake into the company several years ago. It belongs to the new Forbes 2010 richest man of Russia, Vladimir Lisin . Maksimov had been in previous court battles with NMLK and continues to do so . In this context, in July 2010, Maksimov's minority shares in state-owned Sberbank were seized. The circumstances and rationales for this move are not clear, but highly revealing of the fates minority shareholders face in court. Similar methods appear to apply in the ongoing case involving Prognoz, a company owning majority shares in HRG, a company running one of the world's biggest silver mines in Russia. Prognoz belongs to Alexei Mordashov's,one of russia's most prominent steel magnates. Prognoz is attempting to buy out minority shares in the HRG. Taking advantage of current crisis-related financial difficulties, the majority shareholder has launched a bankruptcy case for HRG.

10. John Helmer (2010), "Russian bankruptcy charades – Maximov is the first of the Russian steelmen to fall", June 29, 3010, available on http://johnhelmer.net/?p=1301, and "What is really happening to Prognoz, Russia's biggest silver lode? Who is that preparing to eat another asset at a bargain price?" , June 28, 2010 http://johnhelmer.net/?p=3511

11. Reuters, "The Russian Bear awakes", Anaylsis and Opinion, March 1, 2010. http://blogs.reuters.com/reuters-dealzone/2010/03/01/the-russian-bear-awakes/

12. Ibid.

13. OECD, "Russian Federation – Strengthening the Policy Framework for Investment", *OECD Investment Policy Reviews*, 2008.

14. Jesse Heath et al. (2010), "Russia", in The International Lawyer, Spring 2010, Volume 44, Number 1, p. 740-741

15. Association of European Businesses, "European Business in Russia: Position Paper", Spring-Summer 2010, pp. 122

16. The Moscow Times, "State to Sue Over Strategic Sector Violations", 2 March 2010

17. The Moscow Times, “Medvedev offers promise of change”, 21 June 2010. Available on http://www.themoscowtimes.com/mobile/article/408714.html - last viewed on 19 July 2010
18. Financial Times, “Cisco to invest $ bn in Russia”, June 24, 2010
19. The Moscow times, “Investment in Special Zones Hits $4.7 bn”, 12 July 2010.
20. See comment on ECIPE’s weblog: “Let’s welcome Russia to the world economy”.http://www.ecipe.org/blog/lets-welcome-russia-to-the-world-economy
21. RIA Novosti, ”Rosneft pays $400 mln to Yukos”, August 10, 2010, via Business New Europe
22. Hermitage Capital Management was Russia’s largest foreign investor. It engaged in hedge fund activism that led to uncover wide-spread corruption in the management of Russia’s state-owned enterprises, such as Gazprom or Sberbank. In 2005, its CEO William Browder was denied a visa to Russia on the grounds that he was a danger to national security. His firm was subjected to raids and to lawsuits for tax fraud. During raids, the police confiscated vital documents from his lawyer’s office in Moscow. After which his holding companies had been stolen re-registered in the name of a convicted murderer in a provincial city. Mr. Browder said he had learned that his former holding companies had been used to embezzle $230 million from the Russian treasury. More details for example in New York Times, “An Investment Gets Trapped in Kremlin’s Vise”, July 24, 2008. Available on: http://www.nytimes.com/2008/07/24/world/europe/24kremlin.html?_r=2&hp=&pagewanted=all – last viewed on July 19, 2010.
23. AFP, “Telenor ends Russia telecoms dispute”, Oct 5, 2009.
24. Business New Europe, “Where’s Tony?”, June 23, 2010 and Reuters, “The Russian Bear awakes”, ibid.
25. Eurasia Daily Monitor “Moscow Pressures Hungarian MOL’s Russian Joint Venture”, Volume 6, Issue 138, July 20, 2010; *Energypedia*, “Hungary may buy back Surguneftegaz stake in MOL” 31 May 2010 http://www.energy-pedia.com/article.aspx?articleid=140544 – last viewed on 18 July 2010
26. Association of European Businesses, “European Business in Russia: Position Paper”, Spring-Summer 2010.
27. Ibid., p. 25
28. Reuters, “Zeitung – E.On verkauft womoeglich bald Gazprom-Anteil”, 28 June 2010.
29. Erixon (2008).
30. Russia has the second largest stock of outward FDI among emerging economies. Only Hong Kong has a bigger stock of outward FDI. See Andrei Panibratov & Kalman Kalotay (2009) *Russian outward FDI and its policy context*. Columbia FDI Profiles No. 1, October 13, 2009.

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