

The authoritative Russian daily “Nezavisimaya Gazeta” uses the term “giant corporations” to describe the large concentration of holdings or super-holdings that have been set up or are in the process of being set

# Konsolidatsija along Gazprom lines in Russia

RUSSIA

by Piero Sinatti

up in Russia – a new phenomenon for the country. The benchmark is obviously Gazprom, the super-holding with a monopoly on Russian gas and a lead player on the world energy market

**G**azprom, an open joint-stock company with 470,000 shareholders, is the world’s largest producer of gas, and the largest company in Russia and the third-largest company in the world in terms of market capitalization (over US\$100 billion). It is the leading company in the world in terms of production, distribution and export of gas (see article appeared in the issue no. 7 of **east**). No fewer than 165 companies make up Gazprom, which owns a 100% shareholding in 62 of them. The Gazprom companies explore, extract, transform, transport, sell, distribute and export gas. Gazprom, the oldest of the Russian holdings, actually emerged in 1989, in the Soviet era, through the transformation of the Soviet gas ministry into a State *kontsern*. It was partly privatized in the space of a few years but remained under State control. Unlike what happened in other sectors, particularly raw materials, Gazprom has kept the unity of the sector and the size of its business intact. Its founders and managers stood up to pressure from the “great privatizers” (Anatoly Chubais and Egor Gaydar) and Western interests – “experts”, economists, governments and supranational

organisations such as the IMF – for Gazprom to split up in the name of the market and efficiency.

Principles were not the only reason for this choice. Unlike the petrol industry, which was spread over Russian territory, the gas industry was fundamentally concentrated around the Kola Peninsula and the region of Tyumen (a district of Kanty-Mansy). Secondly, Viktor Chernomyrdin and Rem Vyakhirev, the founders of Gazprom, became its majority shareholders as well as its top management. The former was Prime Minister from the end of 1992 to 1998, a crucial period for the transformation of asset ownership in Russia. The latter was chairman of Gazprom until 2002.

In the early 2000s, “new men” – St Petersburg corporate managers close to President Vladimir Putin, such as managing director Aleksei Miller and Chairman Dimitri Medvedev (now also the government’s first deputy prime minister) – were called upon to manage Gazprom.

With the multiplication of its assets and size and its expansion outside Russia in the last five years, Gazprom has become not only the world leader in the sector (with 547.9 billion cubic metres extracted in 2005

and 17% of world reserves) but also a player in Russian foreign policy in Europe and worldwide.

### Splitting up and re-composition

All the other materials sectors – petrol, aluminium, steel, nuclear, arms and aerospace, on the other hand, were split up. We are now witnessing the new phenomenon we mentioned earlier: the attempt to fully or partly re-compose these split-up sectors, which had subsequently led to corporations with private ownership, management and strategies under State control.

It is now possible for Russia to play a leading role in the great game of globalisation. However, this can only happen if Russia also experiences the operations that have taken place in advanced countries in recent years: mega-alliances, mergers, acquisitions, absorption and union, processes that frequently occur in vital sectors such as finance, energy, minerals, metallurgy, airline companies and the aerospace industry. It is the only way for companies to protect themselves and emerge as stronger competitors in the Darwinian global market.

In Russia, these operations are called *konsolidatsija*, a term the Russians use to define the process – currently in its initial phase – of unifying the activities of the holdings or individual companies working in the same or related sectors that were set up by the complex and murky processes that followed the splitting up of Soviet State-owned businesses, the privatizations and subsequent dramatic re-organisations in the second half of the 1990s.

One might be inclined to think of it as a sort of walk backwards towards the old times, but this is not so. In fact, there is a trend – one that is by no means secret – towards reviving or strengthening State control over raw materials holdings. One example is the increase in the State's Gazprom stake from 38% to 51% a year ago.

However, it is the majority (private) shareholders of the major holdings concerned who are the lead players of the *konsolidatsija*. None of them is planning forms of revived State ownership or re-nationalisation, let alone Soviet-type planning.



Putin's objective is to have the State participate in drawing up strategic policies for the major groups, so that the pursuit of their specific interests does not clash with those of the State or encourage privileged access to raw materials for big foreign companies, especially in the energy sector. Rather, Russian companies should be encouraged to make a competitive entry into international markets so as to make Russia a lead player in the great global economic game.

### A recent example of *konsolidacija*

Officially announced in October, the first major *konsolidacija* concerns the two Russian holdings Rusal and Sual, leaders in the aluminium sector – a metal used mainly by the mechanical and chemical industries, the price of which has more than doubled in the 2000s because of growing world demand.

The Rusal-Sual affair is emblematic. With total production of 2.7 million tons, Rusal – Russian Aluminium – accounts for up to 10% of the world aluminium and 75% of the domestic Russian aluminium market. Sual – the Siberian-Ural Aluminium Company – is the sixth-largest world producer and the second largest in Russia, with total production of 1.05 million tons (2005 figures). Together, they produced a total of 3.75 million tons in 2005, a volume bigger than the average production (3.5 million tons) of the top two international holdings, U.S. manufacturer Alcoa and Canada's Alcan, which have so far dominated the market for aluminium. According to various estimates, the new super-holding is likely to be worth anything from a maximum of \$22 billion to a minimum of \$15-17 billion. It will be the world leader of the aluminium industry, a kind of Gazprom of the sector, able to account for 14% of total world production on its own.

News items inform us that the operation took place with the "personal approval" of, if not pressure from, President Putin. The authoritative "Kommersant", which was the first to announce the merger, talked of "great Russian aluminium", emphasising the Kremlin's national design or strategy that led to this operation and those already underway or in the works.

The strategy drawn up by Putin and his ideologists, such as his assistant Igor Shuvalov, is aimed at giving Russia a role in the global economy that will match its resources and potential.

### Rusal and Sual aluminium

Set up as holdings in 2000, Rusal and Sual typify the fragmentation of the aluminium sector in the first half of the 1990s and the subsequent unification and structural reorganisation in the second half of the decade.

The 38-year-old oligarch and president of the Bazovy Element (Basel) conglomerate, Oleg Deripaska, set up the Rusal holding, which he also controls, by merging various aluminium producers and smelters acquired in the second half of the 1990s.

The smelters, which produce aluminium and related raw materials, are generally located in Siberia near the big hydroelectric plants (Bratsk, Sayansk, Krasnoyarsk) that were the pride of Soviet electrification, thereby ensuring attractive electricity costs for an energy-hungry industry such as aluminium.

Rusal also acquired control of a large aluminium manufacturing company from the Millhouse Capital conglomerate. The majority shareholder of Millhouse is the oligarch (and until recently oil magnate) Roman Abramovich; Eugene Shvidler is its chief executive.

Sual, for its part, started out as the Siberian-Ural Aluminium Company towards the mid-1990s through the merger of a dozen aluminium plants in Siberia and the Urals between Irkutsk (Siberia) and Uralsk. The murky business ethics of Sual's founder and majority shareholder, the historic oligarch Viktor Vekselberg, 58, have, like Deripaska's, sparked plenty of discussion.

Vekselberg is also the founder and chairman of the big investment company Renova, which has stakes in metallurgical, mechanical and oil companies such as TNK.

\_The SUAL-RUSAL merger, with Glencore as a partner (photo: Vekselberg and Deripaska, chairmen of the two Russian companies and Glasenberg, CEO of Glencore) has created the world's top aluminium manufacturer



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Rusal-Sual is the result of a lengthy process of re-assembling and merging the scattered components of the aluminium sector. The merger will give the Russian aluminium sector more capital and *konkurrentosposobnost'* (competitiveness) on international markets. This is what counts the most in Putin's national strategy. In recent years, Rusal has acquired control of important aluminium-sector companies in Africa (Nigeria and Guinea), Guyana and Australia (Queensland Alumina), with investments totalling about \$1 billion. The new unified company will have Switzerland's Glencore International AG, founded in 1974, as a partner. The Swiss company's core business is marketing commodities such as ferrous and non-ferrous metals, oil and agricultural products to industrial consumers. Glencore will hold a 14% stake in the new company, with Rusal owning 64.5% and Sual 21.5% respectively. Glencore will include its bauxite and aluminium assets in Italy (EurAllumina in Sardinia), Jamaica and Ireland in the tie-up.

**Oil and Rosneft**

The large-scale spread of mining companies across the federal territory, unlike the territorial compactness of the gas industry, has prevented the oil sector from following in the footsteps of the gas sector. In the privatization period, the oil industry was dismembered to produce myriad companies whose production fed massive currents of illegal and contraband exports and formed the first major "primitive accumulation" of capital in line with the chaotic development of the new financial capital.

In accordance with the privatization plans, the State sold the fundamental assets of the sector to private investors at throwaway prices.

The buyers, or rather the beneficiaries – the businessmen – of the new financial capital, the future oligarchs, who were essential to the central and regional authorities in a context of corruption, swindles and often even violence, proceeded through successive acquisitions to create the major new oil companies.

Thus the big private oil holdings came into being in the second half of the 1990s,



headed by historic oligarchs such as Boris Berezovsky, Roman Abramovich (Sibneft), Vladimir Khodorkovsky (Yukos) and Viktor Vakselberg (TNK), as well as a former Soviet oil minister, the Azerbaijani-Russian Vagit Alekperov, founder in 1990 of the Lukoil holding, which however followed a different course compared to that of the other companies.

Rosneft was the only oil company in which the State held a majority stake. Set up in 1993 on the basis of the former oil industry ministry, it became a joint stock company two years later, but in the years that followed it lost the control of its fundamental assets and risked disappearing into the maw of the massive 1998 Russian financial crisis.

It was then that Rosneft's management changed entirely. Sergey Bogdanchikov, a specialist (now 48) who had always worked in the oil sector, took over as chairman and still heads the company.

Rosneft overcame the crisis in 2000 and has since multiplied its business and market value. In a few short years it became the seventh-largest oil company in the country thanks to government approval of its plans to explore new oil fields, including those in the Sakhalin-1 and Sakhalin-5 projects.

### The Yukos crisis

In the early 2000s, Yukos, together with Lukoil, became the biggest, most dynamic oil company in the country. Its political crisis exploded between 2003 and 2005 and redefined the assets of the sector. Its founder, majority shareholder and chairman Khodorkovsky was arrested and condemned to eight years in prison for fraud and tax evasion. Yukos was dismembered and Rosneft seized its biggest field, Yuganskneftegaz, in a move that was anything but transparent to become the leading company in terms of volumes of extraction.

Rosneft thereby jumped to third place (after Lukoil and Surgutneftegaz) among the Russian companies. It is present from Murmansk to Sakhalin, from the Jamal Peninsula to the North Caucasus (Dagestan and Chechnya).

In July 2006, Rosneft mounted an IPO at the London Stock Exchange, raising \$10.4 billion from investors (principally major



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foreign oil companies and oligarchs such as Abramovich). The holding's market capitalization subsequently went up to nearly \$80 billion, the second largest in Russia after Gazprom's.

Meanwhile, Rosneft also entered the gas sector in a kind of interaction with Gazprom, which had entered the oil market in its turn mainly thanks to its acquisition of Sibneft, the big company that Abramovich would have sold to Yukos in 2003 if the Kremlin's frontal attack on Khodorkovsky's company had not taken place. It was originally thought that Sibneft would be added to Rosneft's other lines of business, but Gazprom bought it instead. The strategy attributed to the Kremlin would have Rosneft as the pivot around which the process of *konsolidatsija* of the oil sector is to take place.

It is worth mentioning a singular and worrying circumstance. Igor Sechin, whose studies (he specialised in Romance philology) and career make him unfamiliar with the energy sector, but only too familiar with the KGB and Putin's St Petersburg entourage, has been named, alongside Bogdanchikov, to the Rosneft board of directors. Sechin is said to be responsible for the anti-Khodorkovsky strategy.

Rosneft is not the only player in the *konsolidatsija*, as the non-acquisition of Sibneft also shows. Gazprom too has created a new subsidiary-holding, Gazpromneft (Gazprom Oil) and entered the oil sector in a big way by purchasing Sibneft for \$13 billion.

Moreover, in Russia the oil major Lukoil has to be taken into account. It cannot be absorbed into a possible *konsolidatsija* of the sector. Lukoil is the top Russian oil company in terms of production and export volumes, primarily to Europe. The State holds 9-10% of its shares.

Lukoil has assets in 30 countries, from the



\_Other page: Sergei Bogdanchikov, chairman of Rosneft, responsible for the rebirth of the Russian oil company, which has multiplied its activities and market value thanks in part to some targeted acquisitions including Yukos (photo above: the controversial current Yukos chief Khodorkovsky), which was once one of the leading companies in the country together with Lukoil (facing page: a plant)



CIS countries (with joint ventures in Kazakhstan, Azerbaijan and Uzbekistan) to the former Comecon and former Yugoslavian countries (with big refineries and fuel distribution networks). Lukoil also arrived in America in the early 2000s, buying a chain of gas stations stretching from New Jersey to Virginia as well as some refineries.

### Attacks on foreigners

Something else is new in the oil sector. In recent months, Moscow has indirectly demonstrated its desire to review the PSAs (Production Share Agreements) that grant some foreign and mixed companies preferential conditions (including in fiscal terms) in the exploitation of new gas fields (e.g. the Russian-British company TNK-BP's exploitation of the Kovytko field) and oil fields (the Sakhalin-2 project managed by the Anglo-Dutch company Shell and two Japanese companies, Mitsuki and Mitsubishi). In October, the Russian minister of Natural Resources threatened to revoke these companies' licences to exploit the fields on the grounds of the delays in

...Above left: Mordashov, president of the board of directors of Severstal, with Kinsch, chairman of Arcelor. Their merger fell into pieces in June. Above: the model of a Sakhalin Energy Company project

TNK-BP's Kovytko project and the serious environmental damage caused by the operating companies.

Strangely enough, Russian company Lukoil was also threatened, the same month, with the revocation of some of its licences for these two reasons.

Besides being a predominantly private company, Lukoil has a foreign partner, the American multinational ConocoPhillips, which holds 20% of its shares.

Negotiations to give a foreign multinational a major stake in Yukos were one of the reasons for Khodorkovsky and Yukos's misfortunes.

As for the PSAs, they were signed in the 1990s, when gas and oil prices were low and Russian companies (and the government) did not have sufficient capital to invest in the energy sector.

Now the scenario is totally different. The Russian energy sector and its prices have



Grazia Neri / TASS (6)

\_Above: Valery Khoroshkpvsky, chairman of the Evraz Group. If a Severstal and Metalloinvest merger with Evraz were to come through, as Putin desires, a steel super-holding would also come into being

climbed steeply in the last five to six years. And Russia's international role has changed thanks to this dual circumstance. Hence the desire to review the PSAs in Moscow's favour, even though they remain entirely legal.

Another event demonstrates Moscow's desire to go it alone in the big new energy projects. In October, Gazprom managing director Aleksei Miller backtracked sensationally on all the previous declarations and commitments he and Putin had made by announcing that Gazprom would exploit the big offshore gas field of Shtokman in the Barents Sea on its own, with no help from foreign partners.

These positions (which are incidentally anything but firm) also demonstrate the Kremlin's national strategy and Putin's desire to strengthen and consolidate the sectors that hold up the Russian economy.

### Not just aluminium; gas and oil

The objective of *konsolidatsija* also concerns other sectors – principally steel. At the end of June, contrary to the commitments – including formal ones – undertaken previously, Severstal, the second largest Russian steel manufacturer's plan to enter the European metallurgical sector's top firm, the French-Spanish-Luxembourg Arcelor, by acquiring 25% of its stake, worth about € 13 billion, fell to pieces. It would have been the most significant and major investment by a Russian company outside the gas and oil sectors.

In fact a far higher bid by Mittal Steel, owned by the British businessman of Indian origin, Lakshmi Mittal, beat the Severstal offer. Alexei Mordashov, the chairman of the Russian company (whose recent acquisitions include a former Ford steel mill in North America and a large chunk of the Italian Lucchini Group) had made his move with the Kremlin's blessings.

A year before, Mittal Steel beat its Russian competitors to win the privatization auction for the largest Ukrainian steel mill, Kryvorizhstal.

Between June and September, an operation was conceived (apparently once again by Putin) to merge Severstal and Metalloinvest (the third largest Russian steel company) with Evraz, Russia's top steel holding. Founded and headed by two fortysomething oligarchs, Frolov and Abramov, Evraz has acquired significant interests abroad (in Italy, the Czech Republic and South Africa) over the last two years. The *konsolidatsija* is to be financed with a capital injection by Roman Abramovich, who is very close to the Kremlin, and enriched by the sale of Sibneft to Gazprom.

If the Evraz operation goes through – over and above the strong hostilities and rivalries that the affair conceived by the Kremlin has provoked – it would lead to the birth of a steel super-holding, with the guarantee that defeats similar to the Arcelor-Mittal deal will not happen again.

### Nuclear energy

The nuclear sector, which went into crisis in the post-Soviet years because of scandals such as the supposedly undue appropriations by the former Russian ministry of the Nuclear Industry Adamov

and, above all, because of the collapse of investments, has only remained active in recent times in terms of exporting nuclear plants and machinery to India, China and Iran.

This year, the president of the Federal Agency for Atomic Energy Sergei Kirienko, named to the post by Putin a year ago, has announced a major revival of "nuclear energy for peaceful purposes" in Russia, invoking the end of the "Chernobyl syndrome" alongside Putin. Russia will build 40 new nuclear reactors from 2007 to 2015. The share of nuclear energy in the total national energy production is expected to rise from the current 16% to 25 percent. The basis of this programme is expected to be the re-integration into a single holding of uranium producing companies and on the basis of the two key companies in the sector, Rosatom and Atomenergomas (machines and plants). The concerned sectors of other CIS countries (Ukraine, Kazakhstan and Uzbekistan) are expected to be associated with the process of "renewal" or konsolidatsija of peaceful nuclear activities.

### Arms

The arms sector is the only manufacturing industry sector, apart from the aerospace industry, in which Russia plays a leading role on international markets.

This sector too is the focus of a konsolidatsija project. Sergei Chemezov, the Putin-named president of the big State-owned company that handles arms exports, Rosoboronekспорт (Russian defence exports) has elected himself spokesman for this requirement.

In a speech this summer, he announced that his company intends to acquire large stakes and board memberships of the main Russian arms producing companies. He bemoaned the fragmentation and lack of coordination and investments of these companies. Chemezov called for the unity of the sector, in which Russia maintains a place at the very top at the international level, to be rebuilt quickly, under the aegis of the State, of course.

It should be noted that about 80% of arms manufactured in Russia find their principal sales outlets in China and India. Exports of Russian arms to South America (principally



...The chairman of the Federal Agency for Atomic Energy, Kirienko (photo: between Iskhakov, Far Eastern Federal District and the governor of Chukotka, Ambramovich) has announced a strong re-launch of nuclear energy for peaceful purposes in Russia

Venezuela) and the Middle East are increasing, causing alarm (not only at the political level) in the U.S., the world's leading arms manufacturer and exporter. The exhibition of new weapons in July at Novy Tagil (a major metallurgical centre in the Urals) was a big success, with representatives of 250 Russian and foreign companies participating.

However, some observers wonder whether the strong growth in Russian arms exports is truly due to their competitiveness or rather because of the Western embargo on some of Moscow's clients.

### Other konsolidatsija sectors

The fragmentation in the early 1990s of the big State-owned airline Aeroflot led to the creation of myriad regional airline companies in Russia. This caused incalculable damage to the aviation sector in terms of finance and security (plane crashes are a frequent occurrence), with the loss of the former Soviet Union and Soviet bloc markets, the collapse of investments, management that can be defined casual at best and dangerously obsolete aircraft. All this has had a huge negative impact on Russian aviation for the last decade and



more, not to mention the crisis in the aeromechanics industry.

There were signs of a reversal of the trend in 2005. The civil aviation sector witnessed the creation of AirUnion, an “alliance” that merged some of the major Siberian and Central Russian airlines as well as Moscow’s Domodedovo airport (flights to the east and southeast).

The State has a majority shareholding in this alliance. According to finance minister Gref, the alliance could extend to other domestic airline companies, while Aeroflot would once again acquire a dominant position in international flights.

Finally, there is the aeronautical industry: here, the OAK project, i.e. “Corporation of United Aeronautical Constructions”, which is currently underway, is worth mentioning. It is a *konsolidatsija*, a super-holding that is expected to merge the major civil and military aircraft construction firms. These are famous names, the *crème de la crème* of Soviet aviation: MiG, Irkut, Ilyushin, Tupolev and Yakovlev. The merger will be concluded in the first quarter of 2007 and the state will have 75% of the shares. Shares will be floated on the stock market in 2008.

There are two significant aspects to be considered. Firstly, Defence Minister and first deputy Prime Minister Sergei Ivanov has been named chairman of OAK (with Aleksei Fedorov, head of MiG and Irkut, as managing director). This emphasises the

strategic nature of the new corporation. Secondly, Vneshtorgbank (VTB, the biggest Russian foreign operations bank) has bought a 5% stake in EADS (European Aeronautic Defense & Space), the French-Spanish-German group that holds 80% of the shares of Airbus Industrie, U.S. company Boeing’s chief rival on the world’s markets.

The shares VTB has purchased will be transferred to OAK, establishing a kind of bridge between Russia and the biggest European aeronautical company. Another significant detail is that EADS had previously acquired a 10% share in Irkut, which manufactures the renowned and very and competitive SU-27 and SU-30 Russian fighter aircraft.

Another major new ongoing factor should be added to this description of the new ongoing processes in various Russian industrial sectors: the significant growth of Russian FDI (foreign direct investment), which has gone from \$20 billion in 2000 to \$142 billion (or \$120 billion, depending on the estimate) in 2005.

However, the sectors that shore up modern economies – high-tech (apart from aeronautics) and the consumer goods and service industry are conspicuously absent from all these dynamic processes. Defence minister Sergei Ivanov said in September that “the Russian electronics industry is still using 1980-1985 models” and that its technical standards are “those of yesterday and even earlier”. He added that its products are not competitive, and that Russia has therefore been swamped with a wave of imports from abroad and that its role is now reduced to assembling components manufactured abroad.

This is the traditional weak point of the Russian economy, the effect of a bulky Soviet heritage from which Russia has obviously not yet freed itself. It demonstrates a lengthy delay or backwardness that has kept Russia back in comparison not only to the developed countries but also to developing countries such as China, India and Brazil.

This is a surprising phenomenon considering Russia’s superior levels of human capital with its scientists, engineers and technicians. It would be extremely interesting to examine this issue in detail.