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Kremlin tightens the screws

It is becoming clear that the flirtation with political reform under Dmitry Medvedev was simply a brief deviation, writes *Charles Clover*

Flying high? Vladimir Putin's latest back-to-nature photo opportunity was designed to signal nothing has changed AFP

Many people might be surprised to see their president piloting a hang glider, scuba diving, or riding an absurdly large Harley Davidson at a leather clad motorcycle gang rally. For Russians, however, this is an important signal of normalcy.

In what has become a late summer ritual every year, Vladimir Putin takes to the Siberian Taiga, Arctic Sea, the central Asian steppes or some other wilderness backdrop for his annual televised action man adventure. Mr Putin's back-to-nature photo opportunities are carefully designed to portray the 60-year-old ruler as young, fit, outdoorsy and in charge.

So, on September 5, the public took it in its stride when Mr Putin, clad in a billowing white coverall and bulbous crash helmet, took to the cockpit of a hang glider in order to lead a flock of endangered cranes to new nesting places in the arctic Yamal Peninsula.

The stunt not only provided an awkwardly executed metaphor of paternalistic rule (only two of 15 cranes flew with Mr Putin to the new nesting ground on the first flight), but also was seemingly designed to send an important signal. In the wake of the social upheaval of the past year, the birth of a protest movement and sinking approval ratings, nothing has changed. Mr Putin is still Mr Putin, and the Kremlin sees no compelling reason to change its 12-year-old system of managing political life and public opinion.

"The only cranes that didn't fly were the weak ones," he told a news conference with characteristic bravado. "Sometimes the leader accelerates at such a fast clip that not all can keep up."

The president has good reason for confidence. Less than a year ago, when protests over rigged elections filled Moscow streets with chanting demonstrators, the Russian state seemed to wobble. A newly emboldened urban middle class took to the streets, demanding new freedoms and an end to authoritarian rule.

> The rubber stamp parliament is busy passing repressive laws to discredit opponents

But predictions that Mr Putin's third term would descend into crisis have proved wrong, or at least, premature. Today, he is firmly in control, having won re-election, and is showing his opponents that he will not go down without a fight. Rather than reform in a sop to opponents, he has challenged them by tightening the screws of an increasingly authoritarian system even further.

The rubber stamp parliament, for example, is busy passing repressive laws designed to discredit and hamstring opposition. A recent law makes libel a criminal offence, for example, while another law passed in July put in place the legal and technological foundations to censor the internet.

Kremlin forces are selectively picking off opponents – punk band Pussy Riot felt the sharp end of an authoritarian regime when in August three members were sentenced to two years in prison after performing an anti-Putin song in Moscow's Christ the Saviour Cathedral. In September, Gennady Gudkov, an opposition parliamentary deputy, was stripped of his seat in the Duma and his immunity from prosecution in a move orchestrated by the Kremlin. In both cases, the opposition has blustered impotently, but has been shown to be incapable of taking on the Kremlin's might.

"The regime is making it clear that they have a near infinite ability to stick it to almost anyone in Russia and get away with it," says Andrew Weiss, director of the Center for Russia and Eurasia at the US-based Rand

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Little scope to spend way out of trouble

Refining: government must grapple with the new reality of steady or potentially falling oil prices Reuters

Economy Biggest difficulty is managing expectations, writes *Catherine Belton*

When Vladimir Putin returned to the presidency earlier this year, his campaign was run as if Russia were still celebrating the boom years of his first two terms, promising large spending hikes for doctors, teachers, education and healthcare.

But the pledges – representing an additional Rbs2.8tn or $85.2bn from 2013 to 2015 – presented his government with an enormous headache as it sought to put together a budget for the next three years that also reduced the deficit.

The government must now grapple with a tough new reality – steady or potentially falling oil prices. The previous 12 years had seen mushrooming expenditure, fuelled by a 388 per cent rise in the oil price between 2000 and 2008. The boom helped Mr Putin agree to wage rises averaging 30 per cent a year for budget workers in his first two terms, while Dmitry Medvedev, his protégé, agreed to increases averaging 10 per cent a year.

"The biggest challenge for the government now is going to be managing expectations," says Peter Westin, chief economist at Aton investment bank. "There was a large part of the electorate who voted for Putin in the hopes he will repeat what happened in his first two terms, but this is impossible. This will never be repeated."

Not only is there little room for the government to spend its way out of difficulty, but the huge oil windfall has left the budget extremely vulnerable to oil price swings. This year, the budget will break even at about $117 a barrel, compared with $20 to $30 a barrel in the years up to 2007, according to Alfa Bank.

While the central bank has accumulated $500bn in reserves and the government has gathered nearly $150bn of windfall revenues into rainy-day funds, these buffers may not last long in a prolonged oil price downturn, and the government is scrambling to reduce the so-called non-oil deficit to 8.5 per cent of GDP by 2015 from the current 10 per cent.

But many economists believe this is not enough. Odd Per Brekk, head of the International Monetary Fund's Moscow office, says the government could reduce the deficit to as little as 5 per cent by rolling back support for state enterprises, reducing tax exemptions and increasing, over time, the pension age.

The government is also faced with the increasingly likely prospect that it could end up with a current account deficit by 2015, even if oil prices stay where they are. A consumer boom and a relatively strong rouble is driving up imports, while manufacturing lags far behind and capital outflows continue apace.

Economists say a shift to a current account deficit could be tempered by moves towards a floating rouble exchange rate. But any sharp and prolonged fall in the oil price would take Mr Putin's regime into unknown territory and could lead to a big devaluation. "For the central bank, this is a problem," says Natalya Orlova, chief economist at Alfa Bank. "It is difficult for me to imagine that Russia will have a negative current account. It's more likely that the rouble exchange rate should depreciate significantly. This will bring new risks, including the risk of a worsening social environment and deteriorating political ratings, but I don't see any other way."

Economists and business people say the only way to mitigate risks is for the government to take urgent action to improve the investment climate. This would help stem capital outflows that, while slowing, are predicted to reach $65bn this year, from $80bn last year.

$65bn

The rate of capital outflows predicted for this year, down from $80bn last year

While the economy is growing at a respectable pace of 3.5 per cent, the slowdown is reducing investment and further fuelling the outflows. The government needs to radically change its model of governance if it is to fuel growth but, so far, vested interests are standing in the way.

Mr Westin says more attention should be paid to stimulating small business growth.

Other investors just want to see more consistent action. "They need to take concrete steps to tackle some of the problems, such as governance issues and corruption," says James Friel, head of Rothschild in Russia.

"There are only so many unknowns and uncertainties that investors are willing to accept. In an environment where commodity prices are fluctuating wildly, and the effects of Europe's banking sector woes are still being felt, regulatory or political uncertainty can prove too much.

"It's not a question of only making one or two changes. There has to be a demonstrable, sustained and real change in the way these issues are approached. Only then will there be substantive inward investment."

Sberbank sets example for further state sales

Privatisation

Other companies on the list may not be as well run, writes *Courtney Weaver*

If Russia was looking for a deal to kick its long-awaited privatisation programme into full gear, it could hardly have hoped for anything better than the public offering of Sberbank, the state lender and investor darling.

Beloved for its strong retail lending figures and a management team that has transformed the business since 2007, Sberbank – and its $5.2bn deal – set an example that all other state companies should aspire to, investors say.

The question is whether the bank's success will rub off on other companies hoping to list.

Investors and analysts say that one of the things Sberbank did right was securing a number of "anchor investors" to participate in the deal ahead of time – a strategy that helped produce book that was three times oversubscribed.

But the deal also benefited from Sberbank's strong underlying fundamentals and good corporate governance. "Sberbank is improving at the customer service level…They are making strides in different areas and you have to give them credit for it," says Steven Dashevsky of Dashevsky & Partners, a Moscow-based investment fund.

Mr Dashevsky says Sberbank is one of just a few companies with the type of corporate governance and transparency that blue-chip investors feel comfortable with. The same cannot be said for most of the other state companies on the privatisation list, he says.

"What's on offer is a collection of not very well run, sometimes corrupt state-owned enterprises," he says, adding that, in most cases, the state would not even be relinquishing its majority stake. "It is not even a management stake that would allow investors to institute more changes."

VTB, Russia's second-largest lender, has already announced that it plans to follow in Sberbank's footsteps. Also on the block are diamond miner Alrosa and transport and infrastructure groups such as Russian Railways and Sovcomflot, the shipping company.

The IPOs of other Russian groups will depend on global markets' risk appetite

Interest is building around Alrosa given that the stock would be one of the few ways for investors to tap the diamond mining market. But the other groups may prove harder to sell. While transport groups are expected to benefit from long-planned modernisation, there are still questions about the way the companies are run.

VTB, meanwhile, is still under scrutiny for its disastrous 2011 acquisition of Bank of Moscow. After discovering unexpected losses in the bank's portfolio last year, VTB was forced to ask the central bank for a $14bn bailout.

Andrei Movchan, chief executive of Moscow-based Third Rome Investment Solutions, says investors' attitude towards the state reflects a wider scepticism about Russian stocks, the main reason the Moscow stock market is perceived to be so undervalued. In the first half of the year, stocks traded at an average price to earnings ratio of about five times, against a multiple of about 10 for emerging markets as a whole.

The Sberbank offering represents the end of a long drought in London public offerings from Russia and the former Soviet Union, but now the deal has gone through, others are hoping to follow.

Private healthcare company MD Medical Group, for instance, completed a $311m London listing in October shortly after Sberbank.

Dimitri Kryukov, chief investment officer at Verno Capital in Moscow, notes that while many investors remain bearish because of negative headlines produced by the controversial trial and jailing of punk band Pussy Riot, from an investment point of view there are a number of noticeable improvements.

"Russia is due to have a central securities depositary by the end of the year," he says. "Since I first started trading Russia in 1994 people were talking about the central depositary. And 18 years later the time is here."

Moreover, Russian groups are starting to pay sizeable dividends – "not just at companies like [the privately owned] TNK-BP, but also at [state-owned energy groups] Gazprom and Rosneft," Mr Kryukov says.

Ultimately, initial public offerings will depend on global markets' risk appetite – a factor that has a lot more to do with the situation in the eurozone and global monetary policy than any Russia-specific fundamentals. But the Sberbank precedent is at least a good sign, Mr Kryukov says.

Putin's Kremlin tightens the screws

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Corporation. It is also becoming clearer that the flirtation with political reform under Dmitry Medvedev, previous president, now prime minister, was simply a brief deviation from the arc of the "Putin era" of Russian history.

Mr Medvedev responded to protests by legalising a number of new political parties and allowing for the election of governors. But, with his return to power, Mr Putin has annulled many Medvedev decrees – and made clear he will ignore the spirit of the rest.

So far, the protest leaders have proved ineffective. "It is hard to beat your head against a wall over and over," says Vladimir Tor, a nationalist opposition leader.

All is not well in Mr Putin's circle, however. With the defection of much of the urban middle classes to the ranks of the opposition, the Kremlin has been forced to rely for support on the more conservative elements of society.

More rural, less educated and older, they respond well to Mr Putin's newly nationalist and slightly paranoid rhetoric as defender of the Orthodox faith from blasphemers such as Pussy Riot, and protector of the nation against foreign plots.

"This is the public relations model known as 'fortress under siege'," says Lev Gudkov, head of the Levada Centre, the independent sociological research agency, "and it seems to be working for the time being. People do respond to the imperial rhetoric".

But there is a question of how sustainable this is. The ability of the president to remain popular is being questioned following poor showings in opinion polls, which reveal a steady decline in his ratings.

Meanwhile, the main challenge for his next term might be economic rather than political. While Russia is growing at a fast clip, the economy is more heavily dependent on oil revenues than before the financial crisis. Its budget deficit, excluding oil revenues, is more than 10 per cent of GDP, the International Monetary Fund says.

'This is the PR model known as "fortress under siege"'

Oil will determine whether Mr Putin can spend his way out of crisis – during his election campaign he pledged billions of dollars in federal salary increases and defence budget hikes, which economists say represent 1-4 per cent of GDP a year.

Another problem will come in the middle of his term from the probable end of the petrodollar trade surplus. The central bank has forecast this will end as early as 2015, though this could be avoided were the rouble to depreciate or oil prices rise dramatically.

Without this buffer the economy may become more dependent on international borrowing and vulnerable to external shocks, which would make it more difficult for Moscow to thumb its nose at the west with a domestic crackdown or, internationally, by playing a spoiler role

Russia's support for Syria's regime, for example, has drawn widespread condemnation in the west. But Mr Gudkov says the policy may partly be for domestic consumption. "Foreign policy is the only area where Putin continues to poll well. It is a big incentive to be seen as standing up to the west."

Host of holes on potential road to riches

Russia's Far East

Courtney Weaver reports on efforts to connect its Pacific border with Asia

Over the summer, Vladivostok's Novy-Patrokl highway became a chronic reminder of the battle that Russia faces in developing its Far East region.

Built on the occasion of the country's first hosting of the Asia-Pacific Economic Cooperation summit, the 40km road has faced more problems than its Rb29bn (£936m) price tag would suggest. In June, two months before the Apec meeting and one week before a visit from the prime minister, a retaining wall crumbled on to the road during a storm, causing its opening to be delayed.

In September, just days after the summit ended, a different retaining wall collapsed, prompting another closure.

While Russia has big ambitions for developing its Pacific border, a gateway to some of the world's fastest growing economies, it faces a host of problems in developing the infrastructure required to connect the region with the rest of the country.

> 'Far East touches on the most dynamic region in the world, where all the action is'

Sergei Karaganov, a faculty dean at Moscow's Higher School of Economics, describes the Far East as "a lost opportunity", noting that Russia failed to take advantage of Asia's "skyrocket growth" because it was worried about China and other neighbours encroaching on the sparsely populated territory.

Today there are signs that Moscow is putting such fears aside and focusing on the growth that Asia offers. However, it must now convince Asia that it can be a dynamic trading partner.

"For Russia, it is difficult to open the door [to Asia] and the Apec summit was a way to try to push this door open," says Lilit Gevorgyan, an analyst at IHS Global Insight, the political risk consultancy. Russia, she says, "is trying to shed its image as just a raw materials supplier…The question is what do they have to offer"?

Peter Stonor, global head of infrastructure and transport at VTB Capital, the investment banking arm of state-owned VTB, argues that infrastructure projects could be a good way to attract Asian investors.

The trend got off to a good start last year when South Korea's International Airport Corporation – the owner of Seoul's main airport – bought a 10 per cent stake in the airport of Khabarovsk, the far eastern city 650km northeast of Vladivostok.

Other Asian investors could benefit from the plans of Russian Railways, which is to spend Rb900bn on modernising infrastructure connected to the Far East, or even buy shares in Mechel, the miner valued at $3.5bn, which has operations in the Far East and Siberia, that is looking to sell a 25 per cent stake.

Mr Stonor admits that Russia will be coming from a low starting point in its efforts to build up trade and investment with its neighbours, mostly because it has allowed its Far Eastern infrastructure to fall apart over the past 20 years.

"Part of the issue was the under-investment in the post-Soviet period. More than $200bn will need to be invested in infrastructure alone in the coming years," Mr Stonor says. "At present, only 1.5 per cent of all Asia-Pacific trade goes through Russia."

As Russia looks to alter the image of the Far East abroad, it must also change the perception of the region at home. While the Kremlin can promise to invest as many billions as it likes in the region, the resource it really needs to turn the Far East into a dynamic trade hub is people, says Mr Karaganov.

He says the government should be gearing young, university-educated Russians to look at Vladivostok as a career-ladder destination along the lines of New York or London. The problem is that young Russians of today "have been geared towards the west", he adds, noting that his own internationally educated daughter balked at the idea of a Vladivostok move when he suggested it.

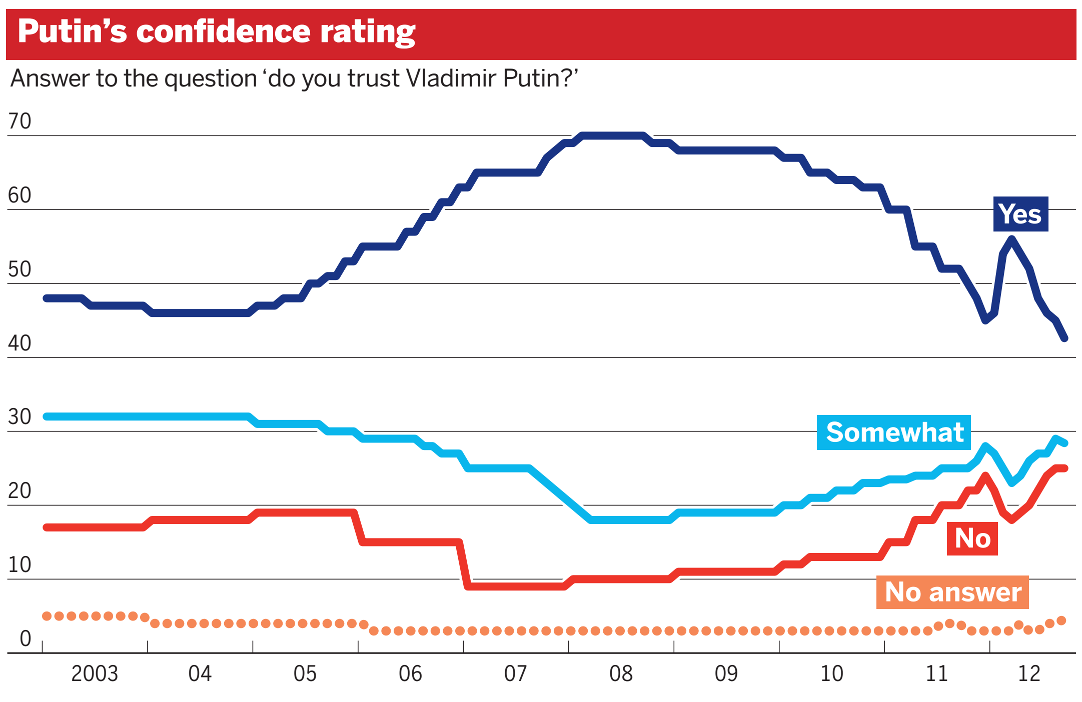
Others say the Far East will not just need better infrastructure within cities such as Vladivostok – with fewer walls falling on roads – but a better road and railway network outside of it so that Far East cities become better connected to the rest of the country.

Just as Asia has long seen the Far East as merely a raw materials supplier so, to some extent, has Moscow. Dmitry Trenin of the Carnegie Centre think-tank says: "For a long time [the Far East] was either a colony or a raw materials base of the empire. What Russia needs to do is to turn it into an actual part of the country and connect it."

While Moscow may have let the region go to waste, it can no longer afford to do so, Mr Trenin says. The Far East "is touching on the most dynamic region in the world where more and more global action is taking place. If Russia wants to have a decent role in the world it has to integrate with the Asia-Pacific."

A ratings game with just one player

Politics Why is the Kremlin such a big consumer of sociological research, asks *Charles Clover*



Source: Public Opinion Foundation

Photo: Reuters

Vladimir Putin, like politicians everywhere, pays no attention to opinion polls. Instead, he relies on his gut instinct, and, rather than some hoity-toity academics, he listens solely to an intuitive connection to the common people. At least, that is the impression he and his advisers are keen to project.

In a television interview broadcast on his 60th birthday on October 7, he sounded unconcerned by the mountains of sociological research produced by the Kremlin and its private contractors every week.

"Of course they are brought to me and I look at them and, in general, some pay attention to them. But not that much," he told NTV, the federal channel.

"The main thing is – it's hard for me to get this across. There is some sort of chemistry, an inner feeling of correctness, the truth of what I do. The feeling of how people will react. Not just some narrow group of respected intellectuals, but the real Russian people."

However one measures it, though, gaining and keeping popularity has been a Kremlin obsession ever since Mr Putin came to power. His two predecessors lost their grip when they lost their popularity: Mikhail Gorbachev lost the state he was entrusted with, while Boris Yeltsin nearly did.

After he came to power in 1999, Mr Putin's popularity skyrocketed with the help of adept handlers. "They took a guy whose rating was equivalent to a statistical error and made him the electoral leader in a few months," says Marat Guelman, a former Kremlin PR consultant. "But how to keep it there? That has been the question ever since"

For more than a decade, they succeeded. The president's approval ratings hovered in the sky-high territory usually reserved for pop stars and sports heroes. But now things are changing.

Since March, when the presidential re-election campaign produced a bump in Mr Putin's popularity, his ratings have fallen badly.

According to the Public Opinion Foundation, the independent polling centre, at the end of September, 42 per cent of Russians polled said "yes" to the question "do you trust Vladimir Putin?". It was a 13 point drop from March, and a level last seen in 2004, according to Mikhail Dmitriev, head of the Centre for Strategic Research. In the past two weeks, however, it has risen by three points to 44 per cent.

While most western politicians would be happy with such a number, it is not directly comparable because, in Russia, there are no alternatives to the president. "You only see one guy on television, and they never say anything bad about him, so you'd expect his confidence level to be [a] bit higher," says one pollster who asked not to be identified.

> 'You only see one guy on TV and they never say anything bad about him'

Daniel Treisman a political scientist at the University of California, Los Angeles, says he sees a "chronic decline" in Mr Putin's rating, adding that approval ratings are not directly comparable with western ratings.

"Ratings in Russia are more volatile," he says. "Putin's current ratings are based on the absence of any credible competitor. If such a competitor were to appear, they could fall very quickly."

Mr Dmitriev, one of the few sociologists to predict the growing protest movement last December, says the thing that came as a surprise was the steepness of the decline.

For a few weeks over the summer, it was falling at 1 per cent a week, he says, three times steeper than at any time during 2011, the last time there were large declines.

Alexander Oslon, head of the Public Opinion Foundation, is less pessimistic. The downward spike in ratings they have measured "is part of the standard volatility of these statistics. They go up, they go down. This is not a crisis," he says.

Other ratings tell a different story. Approval ratings measured by the Levada Centre show Mr Putin with a 68 per cent approval rating in September, up 5 per cent from August, puzzling because Levada's analysis of confidence in the president actually scores below those measured by the Public Opinion Foundation – September saw only a 36 per cent confidence measure.

Lev Gudkov at the Levada Centre, says the downward trend is very real, "though it appears to be braking a bit".

"The reasons are not hard to find," he says. "The same thing generally happens to any leader who stays in power for a long time. People get weary of the same face."

The president's ratings are not anywhere near crisis level, but the Kremlin may have to adjust once again to an era in which popularity is not assured. Mr Dmitriev says that, if the decline continues at the same pace, by next spring Mr Putin will be forced to replace the government of Prime Minister Dmitry Medvedev as a confidence-building measure.

If support were to fall further, Russia's political elite would fracture. "At low levels, the only people who will support Putin are those who are directly dependent on him," says Mr Gudkov.

Mr Gudkov says that surveys are hampered by what he calls "the frontal lobe issue". When there is a single answer to a question, that is considered the "loyal" answer. A poll published in May attempted to get around the issue by asking indirect questions.

"These are questions which do not directly concern politics, and so there are no so-called "correct answers", he says.

The agency found that when people were asked: "What are the strengths and weaknesses of Vladimir Putin?", the president's popularity, as reflected in respondents' answers, "returned to levels last seen in 2000", says Mr Gudkov – the year Mr Putin was just beginning his career in politics.

It is perhaps telling that Mr Putin's highest ratings were scored in 2008 after he stepped down from the presidency voluntarily to take up the post of prime minister.

His confidence score, measured by the foundation, averaged 70 per cent that year.

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Branching out into some far flung regions

Company profile
Magnit

Isabel Gorst looks at a group that opens three stores each day

Most businessmen would be glad to be compared to Sam Walton, the US retail visionary who founded Walmart. Not Sergei Galitsky, the billionaire chairman and chief executive of Magnit, the Russian grocery chain. He thinks the flattery goes too far.

For a start, Magnit, although Russia's biggest food retailer by stores and growing at breakneck speed, will never match Walmart in scope or size, he says. And Mr Galitsky has no plans to follow the US multinational's example and take his company global.

"Why would we when there is so much to be done in Russia?" he told beyondbrics.

'We have got as far as the Urals. It was not easy to do. Russia is very big and varied'

In some ways, Messrs Galitsky and Walton are comparable. Both built their retail empires from scratch, starting in provincial towns – Mr Galitsky in Krasnodar and Mr Walton in Newport, Arkansas. And both, after a difficult start, became fabulously rich by selling discounted goods to the less well off.

It is not difficult to understand why Mr Galitsky, 45, wows investors. Magnit's net profits surged by 142 per cent in the first half of this year, spurred by a rise in consumer spending and a roll-out of new stores. They reached a record $339.9m on revenues of $6.776bn, up 23.85 per cent. The group earned a net profit of $419m in 2011 on revenues of $11.42bn.

Shareholders are gloating over the 30 per cent rise in the stock price this year.

While other listed food retailers, including X5, Dixy and O'Key, have clung to wealthy areas around Moscow and St Petersburg, Magnit has soldiered out into the regions, opening its trademark red and white stores in 1,800 towns and settlements across European Russia.

The company now has more than 5,720 outlets, including hypermarkets, family and convenience stores as well as the new stand-alone Magnit KosmetikaCHECK stores. "We have got as far as the Urals. It was not easy to do. Russia is very big and very varied. People are different in different regions," says Mr Galitsky.

Even though it has been opening three new stores a day this year, Magnit still only accounts for less than 5 per cent of highly fragmented sales. Mr Galitsky is thinking big, however, planning to boost capital spending to $1.8bn-$2bn next year from $1.4bn in 2012. He says he wants changes to anti-monopoly laws that prevent individual companies from controlling more than 25 per cent of the market.

An economist by training, Mr Galitsky went into business in the early 1990s distributing imported household cleaning materials and cosmetics in the chaotic early years of capitalism. He switched to retail in 1998 and opened a food store in Krasnodar, 1,300km from Moscow.

The big question is how long can Magnit continue to deliver meteoric growth? "Probably not more than four or five years," says Mr Galitsky.

If sales growth falters, the company may look at other areas, including online food sales and agriculture.

As a start, it has launched a €300m scheme to grow hothouse vegetables. Mr Galitsky plans to stick with the discounter format, saying that most Russians will always scrimp when spending on food.

With an estimated fortune of more than $6bn, Mr Galitsky is the richest Russian businessman not to have made his money out of natural resources.

He spends his spare cash on a football club and school he has founded in Krasnodar, but is against giving money to charities to fight poverty. "People who don't get rich are lazy or just have other priorities."

Mr Walton, who was renowned for his philanthropic activities, might not agree.

Sergei Galitsky, one of Russia's richest businessmen Bloomberg

A flurry of oil deals with foreigners

Energy Russia is increasingly aware that it needs oil majors' technology, says *Catherine Belton*

Treacherous: fields above the Arctic Circle contain 70 per cent of reserves

When Igor Sechin unveiled the partnership deal for Arctic exploration between ExxonMobil and his Rosneft state oil group earlier this year, the tie-up marked the start of a new bid by Russia to open its vast offshore reserves to foreign investment.

The agreement was the first in a series Rosneft has signed this year as it drafted in Eni and Statoil for exploration deals too. The flurry of activity raised hopes for a new era of co-operation with international oil companies for developing the Arctic shelf, after a decade in which the Russian state had – sometimes arbitrarily – reasserted its hegemony over the energy sector.

While far from giving up control of any of these reserves, the government helped woo the oil majors with a new tax regime for developing offshore deposits hailed as among the most progressive in the world. The regime grants a 5 per cent mineral extraction tax for the most complicated deposits in the Arctic Sea and guarantees no changes for at least 15 years from the start of industrial-scale production.

Its launch was a sign that Russia is increasingly aware it must fast attract the knowhow and technology of the foreign companies to develop the treacherous iceberg-strewn fields above the Arctic Circle that contain 70 per cent of its oil and gas reserves. It must make headway on developing these fields if it is to keep its position as the world's biggest energy producer as existing production in western Siberia starts to peter out.

"There is not so much pressure for the next five years, but there is a growing gap between existing production and projected flows, and the Arctic is the place with the potential to fill the gap," says Chris Weafer, chief strategist at the investment arm of Sberbank, the Russian bank.

"The Exxon deal showed [Vladimir] Putin's determination not to lose any momentum. We expect to see more of these deals and would expect BP to become the next partner in the region as a result of its restructuring of TNK-BP", the Russian joint venture it is attempting to extricate itself from.

Nick Dingemans, a partner at the Moscow office of Norton Rose specialising in energy and infrastructure, says additional legislative changes may be in the pipeline that would further help investments, such as a proposed alteration of the civil code that would ease conditions for project financing. The new tax regime, which must still be passed into law by the Duma, however, is crucial, he says. "If it doesn't work from a tax point of view, it's not going to work," he says. "The tax structure in many ways defines the rest of the structure."

'It would not be the first time in the industry if people walked away disappointed'

The energy ministry is also weighing a policy change that would allow foreign companies to take stakes in the licences to develop the offshore fields. At present, only the two state energy giants, Rosneft and Gazprom, have access to the strategic offshore licences, allowing them to stitch up vast new oil provinces. The agreements Rosneft has signed so far bring in the foreign majors as minority shareholders in operating companies.

The mooted change would not require any amendment to the law, provided a state-controlled company maintained a majority stake and that could do a great deal to encourage investment, says Mr Dingemans. It would also allow the foreign companies to more easily book reserves.

While Rosneft has been forging ahead with foreign partnership agreements, however, Gazprom, the gas export monopoly, has been slow to get off the ground.

In August it shelved its flagship project to develop the vast Shtokman field with partners Total and Statoil after years of debate over costs. The field – 600km off the northern coast in treacherously icy seas where it is dark for almost half the year – highlighted the difficulty in developing the Arctic. But it also shone a spotlight on other problems for Gazprom as it must juggle high-cost projects with rapid change on global gas markets. The project – originally intended as a source for liquefied natural gas to the US – was overtaken by the shale gas boom in the US and weakened demand in Europe.

Its indefinite postponement highlighted the risks for Rosneft's projects too. The deposits Exxon is to develop with Rosneft in the Kara Sea are estimated to contain 85bn barrels of oil equivalent – but it is not yet known whether they contain oil or gas – and the volumes are yet to be confirmed. Rosneft has deployed boats to the region to begin seismic mapping, but drilling will not start before 2014. "Exploration is always risky," says one person close to the project.

"It would not be the first time in the industry if people walked away disappointed. But the Kara Sea is an extension of the west Siberian basin and everyone would be astonished if we didn't find hydrocarbon reserves. The big question is whether it will be oil or gas. This is very important in determining the time and the scale of development. Oil of course would be much faster."

Mr Sechin says he has been picking Rosneft's partners carefully for the technology they can bring to the table, lauding Exxon in particular for its ice-class drilling rigs that "can withstand a crash with a 1m tonne iceberg without needing repairs".

The risks are such that "the problems involved in developing the Arctic are greater in scale than those that had to be solved in sending man into space", says Mr Sechin. "But in comparison to the great competition surrounding the space race, our work is based on international co-operation."

With Rosneft holding licences to develop offshore reserves potentially equivalent to Russia's existing entire reserve base, according to Mr Sechin, the stakes are high.

Massive funds for a 'Silicon Valley' lookalike

Innovation

Isabel Gorst looks at a project that could be a game changer

There is not much to see at the construction site in south-west Moscow where bulldozers are digging the foundations of Russia's new Skolkovo innovation hub.

But the Hypercube that opened its doors last month has set the tone for much of what Skolkovo is about. Billed as the country's first high-tech building, the seven-storey concrete structure is packed with inventive features from solar lighting and waste recycling to a convention hall where the seating disappears at the touch of a button.

Skolkovo was launched by Dmitry Medvedev in 2010 as part of the Kremlin's efforts to transform the oil and gas dependent country into a modern, post industrial economy.

The idea is to bring the best Russian and foreign brains together with big business and venture capital and create an innovative ecosystem that will be Russia's answer to Silicon Valley.

Even in a country with an embedded entrepreneurial culture, it took decades for Silicon Valley to become a driving force for US innovation. Russia is trying to jump start the process with a massive injection of funds. The government has earmarked $4.2bn for investment and pledged millions more in grants and tax privileges.

About three-quarters of the government funds will be spent developing a 390-hectare site on the fringes of south-west Moscow. The area is not yet served by main highways or commuter lines.

A master plan for the project includes a 167m tall glass dome with its own balmy micro-climate inside and a building shaped like a Matroshka doll.

A techno-park for up to 1,000 start ups will be divided into clusters focused on Skolkovo's five target sectors – energy efficiency, biomedicine, nuclear and space technologies and IT.

Among the most prestigious projects is the Skolkovo Institute of Science and Technology, a huge university campus that Switzerland's Herzog & de Meuron is designing in collaboration with the Massachusetts Institute of Technology.

While waiting for a permanent base, Skolkovo's various departments are scattered in offices across central Moscow. Postgraduates enrolled at Skolkovo-Tech have been farmed out to foreign universities.

A small version of the technopark is taking shape at a building a mile from the future innovation hub.

Skolkovo has screened thousands of applications and handed out $260m worth of grants so far. Plans are to allocate between $100m and $200m a year, says Alexander Lupachev, chief investment officer at the Skolkovo Foundation.

"We want to be sure that by 2014 we have a critical mass of energetic people ready to move there."

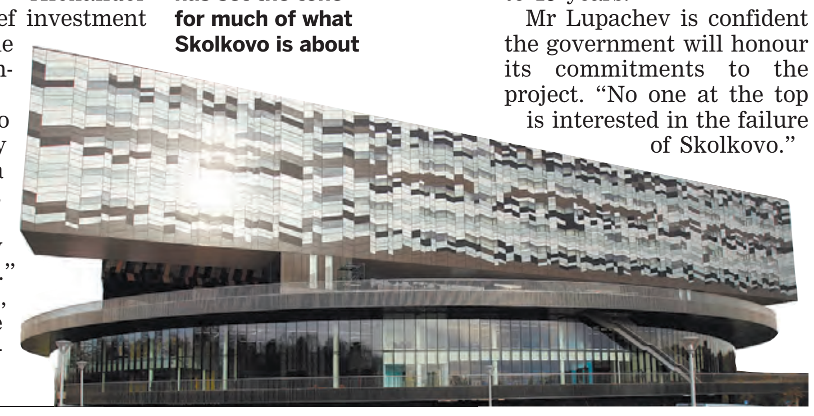
However, even venture capitalists betting on Skolkovo are uncertain about its prospects.

Dmitry Alimov, whose Frontier Ventures fund has pledged to invest $20m, says results will take time to materialise.

"The question is, is Skolkovo going to make a 1 per cent difference to the trajectory of Russian modernisation or be a major game changer. It depends if the government has the patience to sit it out for 10 to 15 years."

Mr Lupachev is confident the government will honour its commitments to the project. "No one at the top is interested in the failure of Skolkovo."

The Hypercube has set the tone for much of what Skolkovo is about



Outsiders capture big share of $11bn railway market

Transport

Isabel Gorst reports on opportunities to be had in modernisation drive

At first glance, the Novocherkassk Electric Locomotive Plant appears to have hardly changed since its launch during Josef Stalin's industrialisation drive.

Banners proclaiming that "hard work is the guarantee of our future" hang above the sprawling grounds where, except for a short break during the second world war, Russia has produced railway technology for more than 75 years.

However, employees glued to computer screens in the engineering department are fast catching up with the times. Until last year, when Alstom Transport arrived on the scene, they were working with pen and paper.

Alstom Transport, a division of France's Alstom engineering group, is one of a growing number of foreign investors establishing ventures in Russia in a bid to capture a larger share of the estimated $11bn-a-year local railway infrastructure market.

Novocherkassk is the starting point for a 50:50 joint venture Alstom has formed with Transmashholding, the railcar producer, to design and produce state-of-the-art rolling stock.

TMH was founded by a group of coal and metals oligarchs 10 years ago to help solve the transport problems of natural resource producers. The company began by buying up Soviet-era rail freight manufacturing facilities and now has a diversified portfolio of 17 plants.

Alstom Transport gained a foothold in 2007, winning a contract to build Allegro high-speed trains for the St Petersburg- Helsinki railway. The company teamed up with TMH last year to design and build modern locomotives, passenger and freight trains as well as metros and trams.

"The deal is broader in scope than straightforward technology transfer," says Bernard Gonnet, senior vice-president of Alstom Transport CIS.

Alstom has invested $425m to acquire a 25 per cent plus one share in TMH, as it sees the company as the key not just to Russia but also to other former Soviet countries where trains and tracks are built to the same specifications. Russian Railways, the state monopoly, also owns 25 per cent of TMH. "It's unusual to have the main customer sitting on the board," says Mr Gonnet. "But we have had to get used to it."

Alstom and TMH's first joint venture is at Novocherkassk in the Rostov region of south-west Russia, where the partners are developing advanced locomotive technology.

There are difficulties, not least the language barrier dividing Russian and expatriate employees. As part of its mission to modernise the plant, Alstom has trained 80 Russian engineers to design and test locomotives using computer.

Alstom's biggest foreign rival is Siemens, the German group, whose experience of Russian manufacturing dates back to Tsarist times. "Since the beginning of the 19th century, Siemens' goal was to be close to the client and be part of the national economy where we were supplying products," says Dietrich Moeller, chief executive of Siemens Russia. "It's a good basis for business development."

Siemens won an order in 2006 to design and build high-speed passenger trains that have set a new benchmark for comfort and efficiency on the busy Moscow-St Petersburg route. Russian Railways has billed the Sapsan train as the flagship of its modernisation drive and rewarded Siemens with billions of dollars worth of new business.

Some of the new orders have been awarded to the joint venture Siemens has with Sinara, the railcar maker controlled by Dmitry Pumpyansky, the billionaire chairman of TMK, Russia's steel pipe company.

As with Transmashholding, Sinara originally set out to fill a gap in Russian Railways' fleet by acquiring plants to build freight railcars for industry. As railway reforms gathered momentum, the group expanded to produce passenger trains as well.

Siemens has helped Sinara design a powerful freight locomotive that will go into production at a plant in the Urals this year. Russian Railways is carving a role for itself as an overland transport corridor between China and Europe and has ordered 221 Granit locomotives from the Siemens-Sinara joint venture to bolster its cargo fleet.

Broadening the partnership with Sinara, Siemens is helping refit the group's Russian assembly lines to produce passenger railcars. Plans are to assemble some of the 38 Lastochka commuter trains Siemens is building for delivery to Russian Railways in 2013 at Sinara's plants.

"This is a typical case of exploiting synergies," says Mr Moeller. "Sinara had an existing factory and we had new technology. If Siemens had built its own plant from scratch, it would have taken two to three years."

Further opportunities lie ahead as Russia takes steps to modernise urban public transport to ease the traffic jams that are clogging its big cities.

Bombardier has signed a pact with Uralvagonzavod, the train and battle tank maker, jointly to develop trams and metro carriages. The Canadian group will transfer technology to the Nizhny Tagil plant in European Russia and train UVZ employees at its European facilities.

While its foreign competitors flock to build technology in Russia, UVZ has moved to localise production in Europe, buying a controlling stake in Sambre et Meuse, one of France's oldest railcar component makers. UVZ plans to modernise Sambre et Meuse plants introducing, among other things, advanced computerised steel cutting equipment.