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## The High North and Russo-Norwegian bilateral economic relations

Russo-Norwegian bilateral relations have been high on the Norwegian political agenda for nearly two decades. Several success stories can be noted, but there seems to be a pattern that success is easier to achieve on "soft" issues such as environment and culture than on "hard" issues like foreign policy and economic relations. But also in sectors such as environmental cooperation it has been difficult to realize the full potential of the Norwegian efforts, which often have included an element of aid<sup>13</sup>.

The current Norwegian government<sup>14</sup> has been very explicit in placing the High North high on its political agenda. In December 2006 the Ministry of Foreign Affairs launched the Government's High North Strategy, a 70 page document describing the main features of the Arctic's position in Norwegian foreign policy<sup>15</sup>. Bilateral relations with Russia are given a prominent position in the strategy. On the economic field the strategy states that "The Norwegian authorities will facilitate business development in the High North and promote Norwegian business interests in Russia". So far, it is difficult to see any concrete results from the strategy manifested in bilateral trade or Norwegian investments in Russia.

This article will primarily look at the bilateral *economic* relations between Norway and Russia and will not discuss other fields of bilateral cooperation. The main focus of the article will be the significance of the Shtokman gas and condensate field development for Russo-Norwegian bilateral relations including some of the main risks.

The article will start out by presenting some key statistical features of the bilateral relations as a backdrop to the article's main topic. Then the opportunities and possible risks of the Shtokman adventure for Norwegian companies and authorities will be discussed. The main message of the article will be that the Shtokman development when it comes will provide ample opportunity for Norwegian companies, both for the developer StatoilHydro and for the Norwegian oil supply cluster, but that the opportunity also comes with a high degree political risk attached both for StatoilHydro and for the Norwegian government.

### Economic Relations

The last few years Russia's relative positions as a trade partner for Norwegian companies has remained stable<sup>16</sup>. In 2008 Russia was only the 21<sup>st</sup> most important export destination for Norwegian goods and services and the 12<sup>th</sup> most important source of imports to Norway. As can be seen from Figure 1, Norwegian exports to Russia as a share of total Norwegian exports have varied between 0.6 and 0.8 percent the last six years from 2003 to 2008, with a peak in 2005. The corresponding numbers for Norwegian imports from Russia are between 2.1 and 2.5 percent of total

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<sup>13</sup> Rowe, Hønneland and Moe (2007): Evaluering av miljøvernssamarbeidet mellom Norge og Russland, FNI Rapport 7/2007.

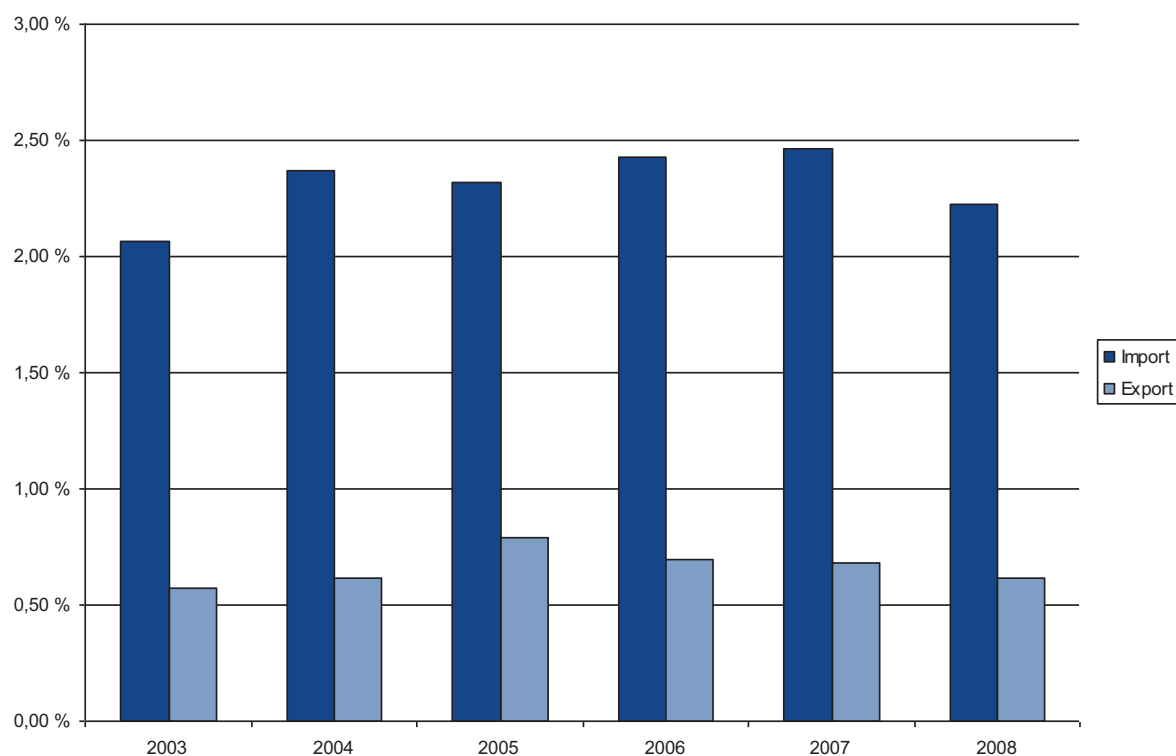
<sup>14</sup> At the time of writing, the new government platform after the parliamentary elections in September 2009 has not been finalized. Therefore we consider the Soria Moria I government the 'current government'.

<sup>15</sup> The Government's High North Strategy, accessed at <http://www.regjeringen.no/upload/UD/Vedlegg/strategien.pdf>

<sup>16</sup> All numbers in this section are from Statistics Norway, accessed at [www.ssb.no](http://www.ssb.no)

imports. In absolute numbers, exports as well as imports have grown considerably; exports to Russia measured in NOK have more than doubled since 2003 while imports have all but doubled.

Figure 1 Bilateral trade Russia – Norway as share of total Norwegian trade



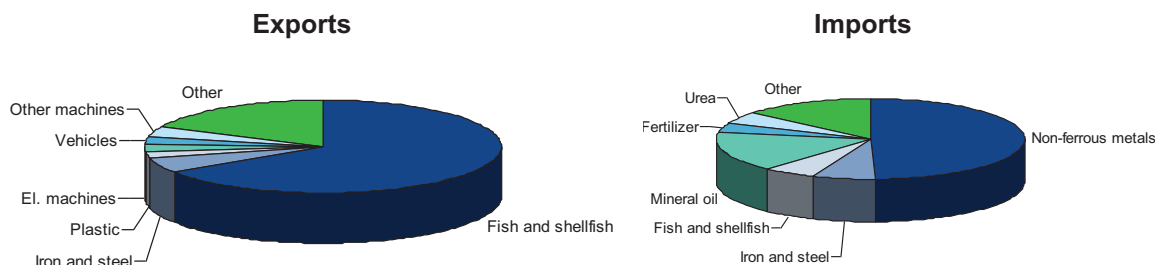
Source: Statistics Norway

The low Russian share of overall Norwegian exports could in part be explained by the fact that Russia does not import Norwegian oil and gas. With oil and gas prices sky-rocketing up to mid-2008, so did Norwegian export revenues. An increasing share of exports to a non-petroleum importing country would, in this time period, have implied a serious increase in the trade of other goods and services. Russia's share in Norwegian exports subtracting exports of oil and gas, ships and platforms is still low, 1.7 percent, making it the 17<sup>th</sup> most important export destination. The growth trend is also less positive for Russia than for Norwegian non-oil exports in total. While the value of exports to Russia has grown by 12 percent since 2005, the corresponding number for total non-oil exports from Norway is 42 percent.

Even though Russia does not stand out as a very important trade partner for Norway in general, it is a vital partner for a few sectors and companies. Norway's trade with Russia is highly concentrated. Most notably, Russia has grown to become one of the main markets for Norwegian seafood. Despite trouble due to the Russian import ban on Norwegian salmon in 2006, the Russian market has grown again and in 2008 Russia was export market number one for Norwegian fish (marginally ahead of France) with a total value of more than NOK 4 billion (EUR 490 million). This corresponds to 66 percent of all Norwegian exports of goods and services to Russia. Throughout 2009 Russia has maintained the position as a main destination for Norwegian fish despite the economic crisis' negative impact on Russian consumption. Eight months into the crisis year of 2009, Russia is the second most important market for Norwegian fish, now only just surpassed by France.

Imports to Norway from Russia are concentrated to metals, which constitute 56 percent of all imports from Russia. This import is important for the Norwegian metallurgy industry.

Figure 2 Composition of Norwegian trade with Russia in 2008



Source: Statistics Norway

## The main Norwegian investment in Russia has been plagued with trouble

Norwegian companies have in general been reluctant to invest in Russia. Still, it seems to be a clear trend that Russia is increasing its share of Norwegian FDI (see 3). In 2007, according to statistics from Norwegian national accounts, the stock of direct investments in Russia from Norwegian companies totalled NOK 12.6 billion (EUR 1.6 billion). This indicates that the Russian share of total Norwegian FDI is around 1.8 percent. Now, it must be noted that national account numbers are a very imprecise way of measuring the actual investment activity. Because of the practice of registering daughter companies and affiliates abroad due, among other things, to tax regulations some of the major investments may slip under the radar of the official statistics.

Contrary to what could be expected, Norway and Norwegian companies have not been active investors in the oil and gas sector in Russia. To some extent this could be explained by the fact that the oil and gas sector in Russia is relatively closed and that the last five years has seen a Russian policy aimed at increasing control over the sector.

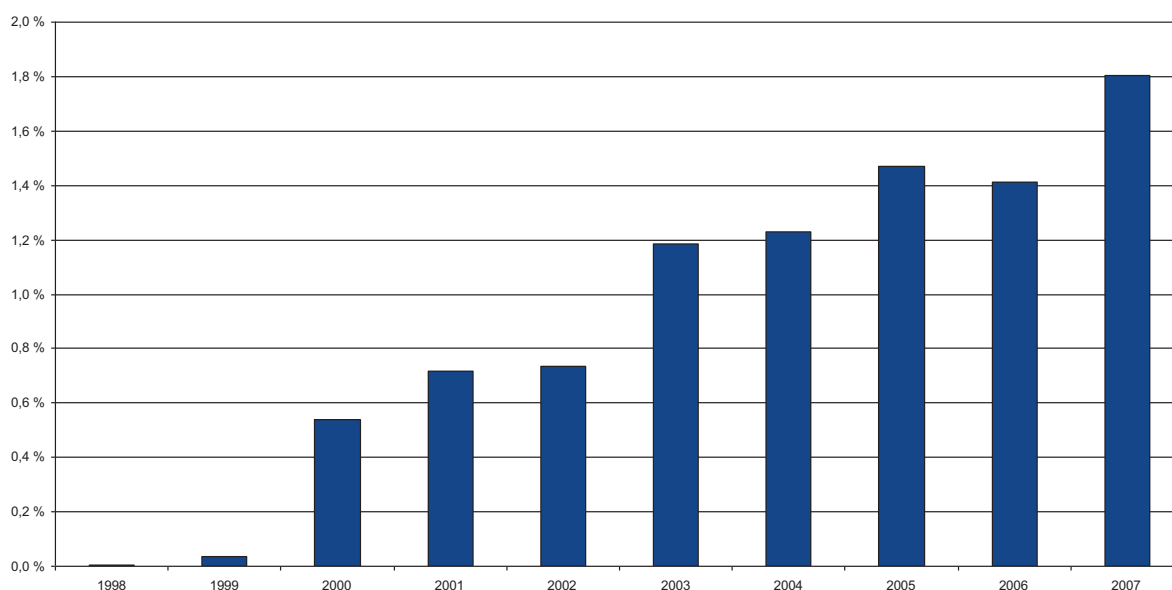
The main Norwegian investment in this sector in Russia stems from StatoilHydro's 40 percent share in the Kharyaga oil field in the Nenets Autonomous Okrug (Timan-Pechora basin) acquired in 1996, with the formal Production Sharing Agreement (PSA) approved in 1999. The StatoilHydro investment at Kharyaga is said to have reached approximately NOK 1.5 billion (EUR 190 million)<sup>17</sup>. In addition, two small oil companies, Saga Oil and Aladdin Oil beginning in 2005 and 2006 have acquired small Russian companies with production and licences in the Orenburg region in south Russia and licences in Timan-Pechora. These investments are relatively modest compared to the Kharyaga investments of StatoilHydro. Saga oil is currently threatened by bankruptcy and as of 30 September 2009 the shares had fallen by 98.57 percent the last 12 months<sup>18</sup>.

<sup>17</sup> Grünfeld, Leo A. (2007): Norske handelsinteresser overfor landene Kina, Japan, India og Russland, MENON-publikasjon nr. 1 / 2007

<sup>18</sup> Netf

onds, at <http://hopey.netfonds.no/ppaper.php?paper=SAGA.OTC>, accessed 30 September

Figure 3 Norwegian direct investments in Russia as share of total Norwegian FDI (stock figures)



Source: Statistics Norway

The biggest Norwegian investment in Russia up to now is the investments made by Telenor in the Russian telecom market, more specifically in the Russian mobile phone company VimpelCom. Telenor's total accumulated investments amount to several billion NOK<sup>19</sup>, probably around EUR 500 million<sup>20</sup>.

The Telenor investment has been plagued with problems the last five years, basically due to a conflict between Telenor and the VimpelCom's other main shareholder Altimo, part of the Alfa Group controlled by Mikhail Friedman. Telenor's problems in Russia culminated in April 2009 when a court in Omsk held Telenor liable for USD 1.7 billion in damages for obstructing VimpelCom's expansion in Ukraine. Subsequently all of Telenor's shares in VimpelCom were taken in arrest and threatened with forced sale.

The background for the court ruling was a lawsuit in 2008 by a minority shareholder Farimex with a 0.002 percent share in VimpelCom called Farimex. Telenor claimed that Farimex had connections with Friedman and Alfa Group. A court in Khanty-Mansiysk supported Farimex and held Telenor liable for USD 2.8 billion in damages. An appeal from Telenor resulted in a reduction of the sum.<sup>21</sup> On 5 October Telenor and Altimo agreed to put an end to their conflict and merge VimpelCom and the Ukrainian company Kyivstar into one company, VimpelCom Ltd. registered at Bermuda and listed at the New York Stock Exchange. As part of the agreement all ongoing disputes, including the Farimex case, are to be ended.<sup>22</sup> However, there is at the time of writing no guarantee that Farimex will withdraw its lawsuit and that the Russian judicial system will drop the liability ruling.<sup>23</sup> Even though the parties for now seem to have put an end to their conflicts and thereby to the trouble surrounding Telenor's Russian investments, it is likely that the Telenor experience has affected the attractiveness of Russia as a market for Norwegian investments. The

<sup>19</sup> Grünfeld (2007)

<sup>20</sup> Calculations based on statistics from Statistics Norway

<sup>21</sup> See [www.telenor.com](http://www.telenor.com), [http://www.economist.com/businessfinance/displaystory.cfm?story\\_id=13962526](http://www.economist.com/businessfinance/displaystory.cfm?story_id=13962526)

<sup>22</sup> <http://www.dagensit.no/article1754971.ece#>

<sup>23</sup> Dagens Næringsliv 07.10.2009

case serves as a prime example of the high political risk perceived to be associated with investments in Russia.

The Telenor experience, together with a number of other negative experiences with investments in Russia<sup>24</sup> makes Norwegian companies in general reluctant to go into Russia with capital. In interviews the author of this article has conducted with Norwegian company representatives in 2007 and 2008, they express that the main obstacles to investments in Russia are: Lack of transparent and efficient bureaucratic procedures, problems with finding a reliable Russian partner, tax regime and corruption. These factors provide a substantial part of the explanation why Norwegian companies seem to be reluctant to make investments in Russia. These considerations are not, however, unique to Norwegian companies. Russia receives low scores on important indicators for business environment assessments such as corruption, where Russia ranks 147 out of 180 countries on Transparency International's corruption perception index (CPI)<sup>25</sup>, and ease of doing business, where Russia ranks 120 out of 183<sup>26</sup>.

## The Shtokman opportunity

With the situation described above as a backdrop, it is easy to see why the Norwegian government and the Norwegian oil and gas cluster see the Shtokman field development as a golden opportunity. When Gazprom in October 2007 announced that StatoilHydro was to get a 24 percent share in the Shtokman development, a decision that was formalized in 2008 through the establishment of the Swiss registered company Shtokman Development Company AG (SD AG), the news was received not without a certain amount of euphoria in the Norwegian press. And it is no doubt that the Shtokman development may provide ample opportunity for Norway and Norwegian companies.

For the Norwegian government it could give a boost to the bilateral relations, taking economic cooperation to a completely different level. It will in reality be the first joint development by a Norwegian and Russian company of a Russian field (disregarding the Kharyaga field where the Russian partner Nenets Oil acquired its 10 percent share at a later stage of the development). And it is big.

Estimated total investments for the phase 1 development, not including the pipeline from Teriberka on the Kola Peninsula to Volkhov near St. Petersburg, are in the range of USD 15-20 billion. This means that the Norwegian share will be some USD 4-5 billion, planned to be invested over a period of four years. The official timeline for the Shtokman development, however, seems quite unconvincing. Gazprom and the two other partners have for a long time upheld the initial time schedule saying start-up of dry gas production in 2013 and LNG in 2014. This has been the official policy even after the investment decision was postponed from late 2009 to early 2010. Lately, however, sources in Gazprom have suggested that start-up may be postponed beyond 2014 due to the market situation in Europe<sup>27</sup>. Compared to the experience of other difficult offshore developments a timeline of only three-four years from investment decision to first gas production seems overly optimistic.

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<sup>24</sup> See *inter alia* "Evaluering av fondene for Øst- Europa og Nordvest- Russland", Econ rapport 2007-103

<sup>25</sup> [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi/2008](http://www.transparency.org/policy_research/surveys_indices/cpi/2008)

<sup>26</sup> [http://www.doingbusiness.org/Documents/DB10\\_Overview.pdf](http://www.doingbusiness.org/Documents/DB10_Overview.pdf)

<sup>27</sup> <http://www.barentsobserver.com/index.php?id=4631507&xxforcedir=1&noredir=1>



Source: Gazprom

For StatoilHydro and the supply industry Shtokman represents a huge commercial opportunity. Due to the sheer size of the field, it will potentially be a revenue bearing project for Russia for a century. The first phase of the development, which is the phase StatoilHydro and Total are part of, will according to plan produce 27.5 bcm of gas annually for 25 years. The two partners, of course, hope that they will be part also of phase two and three, taking plateau production up to 70 bcm annually (2.5 times Troll production in 2009). For StatoilHydro it surely is a project with high commercial risk, and the profit potential of the first phase of the Shtokman is uncertain. The Shtokman agreement, as it is publicly communicated does not give StatoilHydro and Total ownership rights to the gas reserves, but to the infrastructure and the right to sell the gas to Gazprom when it reaches Teriberka on the Kola Peninsula. This means that their revenue depends entirely on the price they can get at Teriberka. These prices will be based on netback calculations where transportation and other costs as well as taxes are subtracted from the end-user price in Europe.

For the Norwegian supply industry the commercial risk is lower and the upside is high. There are high hopes that the Shtokman development will lead to major contracts for Norwegian companies, and in the northern part of Norway there are hopes for a petroleum boom from the Shtokman development<sup>28</sup>. Aker Solutions has, in partnership with Technip and SBM offshore, already won the contract for the front end engineering design (FEED) for the floating production unit (FPU) at Shtokman, a contract estimated at approximately €25 million (USD 31.8 million). Aker Solutions has also announced that it will tender for the full Engineering, Procurement Supply Construction and Commissioning (EPSCC) for the FPU worth around USD 1 billion<sup>29</sup>.

<sup>28</sup> Øverland, Indra (2008): "Natural Gas Projects in the Russian North", in Aalto, Blakkisrud and Smith (eds.), *The New Northern Dimension of the European Neighbourhood*, Brussels: CEPS.

<sup>29</sup> <http://www.oilinfo.co.uk/index.cfm?event=doLink&famId=78203>

Other companies are lining up for the bidding rounds for large and smaller contracts. At a meeting between the Norwegian supply industry network INTSOK and SD AG in late September 2009 more than 70 Norwegian companies were expected to participate<sup>30</sup>.

In general Norwegian companies believe that they are in a good position to land several of the Shtokman contracts due to several factors:

- First of all, it is considered a huge advantage for the Norwegian industry that a Norwegian company is one of the three consortium partners in SD AG. StatoilHydro knows the Norwegian oil and gas cluster very well and has several decades of experience of working with Norwegian companies.
- Secondly, the Norwegian offshore experience has been stated as one of the reasons why StatoilHydro was taken in on the project in the first place. The Snøhvit development and Ormen Lange have given parts of the Norwegian industry valuable experience with offshore solutions in Arctic waters and high depths as well as LNG production under extreme conditions.
- Thirdly, several Norwegian companies have experience from Russian projects. Aker Solutions and Acergy have participated in the Sakhalin developments, and Norwegian companies are said to have delivered 25 percent of technical deliveries and services to the development of the Prirazlomnoye oil field in the Pechora Sea<sup>31</sup>.

## Towards a hold-up threat?

Even though Shtokman may represent a huge opportunity both for StatoilHydro and for the Norwegian oil and gas supply industry, it does not come without a certain amount of risk. The commercial risk for StatoilHydro has been mentioned. However, there is also a high political risk potential. In the following, we will therefore consider the political risk for StatoilHydro of the Shtokman investments. This is not meant to be a probability assessment; the intention is merely to point to certain risk factors that may arise after the field development phase is completed. Certainly, StatoilHydro and Total have duly considered the potential political risk associated with investing in the Shtokman development and taken measures to reduce the risk. Still, there is a question whether it is possible to hedge all political risk and consider all possible scenarios. For StatoilHydro and Total it is also a question of a fine balancing act between efforts to control for risk and efforts to build trust. If too much weight is put on control for risk, Gazprom is likely to respond negatively. On the other hand, if more weight is put on building trust, StatoilHydro and Total may increase the chance of achieving a favourable agreement and a fast development but at the same time they may have to live with uncovered risk of unforeseen factors jeopardising the entire project and investments.

The road to the 2007 inclusion of Total and StatoilHydro in Shtokman phase 1 has been a bumpy ride and a long beauty contest with changing rules and conclusions. Only one year before the 2007-decision Gazprom disappointed the five companies that were on the short-list to be included in the development by stating that it would develop the Shtokman field alone. With the financial position of Gazprom becoming increasingly strained due to increasing costs and falling revenues (see article by Daniel B. Fjærtøft in this publication) it now seems clear that the company is not able to lift the Shtokman project alone and needs other co-investors for the Shtokman

<sup>30</sup> <http://www.oilinfo.co.uk/index.cfm?event=doLink&famId=97098>

<sup>31</sup> INTSOK, [http://www.nortrade.com/index.php?cmd=show\\_article&id=255](http://www.nortrade.com/index.php?cmd=show_article&id=255)

development to become a reality. All other things being equal, and the proposition that Russia and Gazprom need the project, this strengthens the negotiating position of the two non-Russian partners.

After the main investments are made and the main technological transfers have been implemented, however, the bargaining position is likely to change again in Gazprom's favour. This increases the chance of a hold-up situation, i.e. a situation where one party to a contract uses its new bargaining power to reduce or deprive the other party's rent. In contract theory it is assumed that the risk of a hold-up will lead the investing party to underinvest at the first stage to hedge the possible losses at the second stage<sup>32</sup>. However, in a situation where the future rent depends on a certain level of investment, underinvestment would not be an option. Thus, the risk premium will likely have to be included in the setup for future revenue.

The question is whether it is possible at stage two for one party (Gazprom or the Russian state) to use its new bargaining position to alter the terms of the contract. In the following we will suggest two possible bargaining chips that could be used by Gazprom or the Russian government.

The most extreme scenario would be that Gazprom or another Russian company forcefully takes over StatoilHydro and Total's assets, i.e. ownership rights to the infrastructure, before the agreed 25 years, leaving the companies with sunk CAPEX but no revenues (apart from possible reimbursements). It is difficult to make assumptions of the plausibility of such an extreme scenario, but it could be detrimental to Gazprom's reputation and it would surely be taken to court. However, experiences from Sakhalin-II (Shell, Mitsui and Mitsubishi) and Kovykta (TNK-BP) show that consortia with foreign partners are not immune to pressure from the Russian government. In both these cases Gazprom finally was given the possibility to acquire a majority position in the consortia after threats from government agencies of revoking production licenses. Gazprom now holds a 50 percent plus one share in the Sakhalin Energy Investment Company, while for Kovykta the asset transfer has not yet been made<sup>33</sup>

This expropriation scenario is probably one of the main reasons why the Shtokman Development Company is registered in a neutral third country. Illustratively, Telenor and Alfa Group have chosen the same solution for their new company.

Other, less dramatic, but still extremely important factors that can be subject to renegotiation attempts by the Russian side are the netback price received by the consortium partners for gas delivered at Teriberka and the tax scheme. The netback price will likely have to be renegotiated from time to time resulting from changes in export and transport tariffs. This could be exploited by the Russian side to put pressure on the two non-Russian partners from its new bargaining position.

## Could politics become hostage to business?

In addition to the risk of Gazprom changing the rules of the game for the commercial players, bilateral political relations may find themselves held hostage to the commercial interests of Norwegian companies.

There are some factors that need to be considered when discussing this political risk for politics: Firstly, it is important to remember that the Shtokman investment if or when it is made will be the largest Norwegian investment in Russia ever<sup>34</sup>. For a government that emphasizes bilateral relations with Russia, including the expansion of economic cooperation, Shtokman will become a

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<sup>32</sup> Schmitz, Patric W. (2001): "The Hold-Up Problem and Incomplete Contracts: A Survey of Recent Topics in Contract Theory", *Bulletin of Economic Research*, Volume 53: Issue 1, January 2001, 1-17

<sup>33</sup> <http://www.upstreamonline.com/live/article186045.ece>

<sup>34</sup> It may not show up in the national accounts as the procedure will be StatoilHydro investing in a Swiss company and the Swiss company investing in Russia. But this is only a technicality and does not influence the following argument.

show-case for this strategy's success and it is not inconceivable that it will feel a pressure to go some lengths to avoid a negative outcome of the project.

Furthermore, a substantial amount of political capital has been put into the project from the Norwegian government. StatoilHydro's part in the beauty contest before the 2007 decision received high-level political backing. The symbolism in the fact that the decision to invite StatoilHydro into the Shtokman project was first publicly announced in a telephone call from President Putin to Prime Minister Stoltenberg and not from Gazprom CEO Miller to StatoilHydro CEO Lund suggests the political aspect of the matter. If one also keeps in mind that StatoilHydro is a partly state-owned company and that Putin earlier has mentioned the company as an example of a national oil company, it is not unlikely that the Russian side believes that it could be possible to couple political and commercial issues.

Thus, a situation may arise where the Norwegian state feels subject to pressure to make political concessions to support the commercial interests of StatoilHydro. This article does not imply that Norwegian authorities will actually give in to such pressure, only suggests the possibility of such a risk. Covert, or more overt, political pressure could be linked to sensitive unresolved foreign political issues like the negotiations over the sea border between the two countries and the disputed area in the Barents Sea or an ease of Norwegian administration of the Spitsbergen archipelago. However, these are issues so high on the political agenda that concessions will be regarded as high cost.

Other, less obvious concessions could relate to how Norway considers Russian positions on the international arena. Will Norway more easily support Russia's positions in international issues, does Norway criticize Russia less over human rights violations than would otherwise be the case? These are questions that this article does not aim to answer. Here it is merely suggested that a Norwegian company's involvement a Russian mega-project may have strings attached. An even more subtle result could be that the Norwegian government, conscious or not, shifts its policy towards Russia in order to avoid a pressure where StatoilHydro's position in Shtokman could be at stake – as a preventive action. Norway has stood on Russia's side in the dispute over the US missile defence shield. Whether or not Norwegian politicians relate this to Shtokman, it is plausible that Russian policy makers do.

Seen from a company perspective, the interest of StatoilHydro is dependent on the general bilateral relations between Norway and Russia. Should governmental level bilateral relations worsen significantly, it could cause problems for the company and their position at Shtokman. This dependency is mutual. If the big oil players do well, that can strengthen the bilateral ties between their home country and Russia. This proposition seems particularly relevant in the case of state controlled and national oil companies. Success at Shtokman can therefore have some impact on state relations between Norway and Russia. A failure at Shtokman could, on the other hand, represent a blow to the bilateral ties between Norwegian and Russian political authorities<sup>35</sup>.

## Concluding remarks: Ample opportunity – High Risk

After the Russian decision in October 2007 to invite StatoilHydro as a partner in the Shtokman Development Company there has been something of a euphoric sentiment in the Norwegian public discourse. And the opportunity is clearly present. For StatoilHydro, Shtokman could become an important revenue source and, not less importantly, could pave the way for new projects further east in Russia, both onshore and offshore. Already, StatoilHydro CEO Helge Lund has announced that

<sup>35</sup> See Anker and Brunstad (2008): "Foreign Involvement in the Russian Energy Sector", in Aalto, Blakkisrud and Smith (eds.), *The New Northern Dimension of the European Neighbourhood*, Brussels: CEPS.

the company might be interested in taking part in upstream projects at the Yamal Peninsula. Furthermore, success at Shtokman could give a boost to bilateral political relations between Norway and Russia. In that case, all talk about friendly and mutually beneficial relations would be given far more substance.

On the other hand, the risk of failure is clearly present. In a worst case scenario the Russian party alters the premises of the cooperation after the main investments have been made. This could have seriously negative consequences not only for StatoilHydro but also for the Norwegian government and the overall bilateral relations with Russia. One question is how far the government is willing to go either in terms of political concessions or in terms of pressure on StatoilHydro to prevent Shtokman from becoming a liability instead of a success story.