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A Tailored Country Risk Model for Russia

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Executive summary

This working paper aims to develop a framework for country specific risk analysis for Russia. The aim is to provide a concept for measuring investment risk in Russia that entails factors that are typical for Russia and that will not necessarily be captured by the generic, non-country specific models that exist. The framework established in this paper consists of nine categories with sub-categories, which combined make up a risk matrix specifically designed for Russia.

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1 Introduction

Russia is often described as an attractive country for foreign investments: it is a big market; it has a great potential for productivity increases; until late 2008, it showed substantial positive development of the overall economy and living standards; it has seen a development of a new and consumption-prone middle class etc. Still, the level (stock) and flow of foreign direct investments into Russia has been lower and slower than into other countries in the CIS and Eastern Europe with transitional economies.¹ One of the main reasons for this is obviously that Russia has a well established and strong domestic commercial cluster through the oligarchs, who already own most of the potential assets for investment. These players protect their own economic interest in good Russian tradition, and are particularly careful not to open too much for foreign participation. This attitude coincides with the more general political desire of the Kremlin to protect Russia's national interest against foreign influence, and the collaboration between political and commercial interests in Russia is well known although not easy to observe neither in its detail nor in its full perspective. On this background Russia is perceived as a country with relatively high country specific risk. In essence this means that investment projects that, based on normal economic calculations, would be considered economically feasible, never are realized because the investor fears that non-market factors could interfere with the investment and make it less profitable. This fear may be well founded and rational – but it could as well be founded on ill-conceived interpretations and prejudice.

The main rationale for analyses of political risk are therefore not necessarily to add an extra risk factor to an investment consideration, but equally important to make sure that potentially profitable investments are not shelved due to lack of understanding of the investment environment.

The objective of this paper is twofold: First of all to describe the principle approach to good risk analysis and management for potential investors in real assets in Russia, and second, to establish a framework with broad categories and a set of operational indicators that enable observations of the most relevant country risk factors in Russia over time. The purpose of this exercise is to establish a tailored framework for Russia-specific risk assessments. The rationale for this approach is the belief that generic risk models will not be able to capture the

¹ See i.a. Julia Shevtsova (2006)

particular nature of risk in Russia and therefore will never be able to present an adequate risk assessment for foreign investors in Russia.

In the next section we will present a detailed discussion of the concept of country risk and end up in a definition of country risk suited for the purpose of this paper. In section 3 we engage in a discussion about the relevance of country risk for foreign investors in Russia. We then go on to present some alternative methods for measuring country risk. In section 5 we present our framework for a tailored country risk approach for Russia. The paper concludes in section 6 with a discussion of possible alternatives for application of the framework to specific risk assessments.

2 What is country risk?

This section will first provide an overview of how country risk has been defined in the literature, including the various components of country risk. Second, for the purpose of this paper and given the range of definitions available in the literature, a more clear-cut and precise definition of country risk/political risk will be provided.

2.1 Conceptualization of country risk in the literature

There are many definitions of country risk in the literature, ranging from narrow and precise to broad, general interpretations. Some focus on the effect of country risk on the profitability levels of company operations from an investment perspective. For instance, according to Clark and Marois (1996), country risk refers to “the volatility of returns on international business transactions caused by events associated with a particular country, as opposed to events associated with a particular economic or financial agent”. Another related definition is “non-market events (political, social and economic) causing financial, strategic or personnel losses to a firm following FDI in a specific country market” (Rugman and Collinson, 2006). Other analysts have a quite different interpretation of the concept of country risk, such as for instance Kosmidou et al. (2008), who refer to country risk at a higher macroeconomic level and define country risk as “the probability that a country will fail to generate enough foreign exchange in order to pay its obligation toward foreign creditors.”

There is also not a clear-cut definition in the literature discourse on the components of country risk and how to categorize the key factors. Country risk could include a range of factors, such as for instance technical risks, cultural and environmental risk, regional contamination risk and systemic risks. Clark and Marois (1996) identify four key components

of country risk, namely economic risk, financial risk, currency risk and political risk. These are quite similar to the main risk components of Global Insight: financial, business and political risk.²

The final component, political risk, seems to be the most debated and difficult to define. There does not seem to be any agreement in the literature on what the concept includes and what it excludes. It could also be defined as “the probability that political forces will negatively affect a firm’s profit or impede the attainment of other critical business objectives” (Rugman and Collinson, 2006). Using this definition one can distinguish between direct effects (such as nationalization and expropriation) and indirect effects (such as taxes and monetary policies through for instance the macroeconomic performance and currency fluctuations). Other definitions of political risk are broader, such as “the impact of politics on markets” (Bremmer, 2005), while others are more narrow or precise like “the risk of a strategic, financial, or personnel loss for a firm because of such nonmarket factors as macroeconomic and social policies (fiscal, monetary, trade, investment, industrial, income, labour, and developmental), or events related to political instability (terrorism, riots, coups, civil war, and insurrection)” (Kennedy, 1998).

2.2 An operational approach to country risk

Most people will think of country risk as mainly emerging from political circumstances, and we believe this to be true in most cases. However, in their effects country risk factors may be purely technical or commercial, and to investors the precise classification shouldn’t matter much if only they are able to identify the risks, understand them and manage them in a proper manner. The guiding question that should be addressed by investors as they work out their list of candidates for risk assessment is: Could this have an effect on my future cash flow? In what manner and in what magnitude?

For the purpose of this paper we will assume as a starting point that any risk factor can be classified within three main categories: commercial, technical or political. Seen in relation to Clark and Marois’ (1996) four categories mentioned above, the first three will generally fall into the commercial and possibly technical category, while the last category is identical. We see no need for a very precise delineation between them. It is actually feasible, and from an operational perspective often preferable, to establish a good framework for identifying and

² <http://www.ihsglobalinsight.com/ProductsServices/ProductDetail1121.htm>

handling risk without a very fine-tuned division between the categories. The most important condition for foreign investors to become operational in risk management is to have a good understanding of country risk, and for the purpose of this paper, we have chosen the following relatively broad definition of country risk:

”Country specific conditions, incidents, actions or inactions that might affect cash flows/profitability of a company’s current investments.”

This definition is chosen for its non-exclusiveness, allowing its content be concretized in the description of the model proposed in this paper. In doing so, we hope to provide an operational and manageable definition of country risk. The definition does not explicitly incorporate reputation risk, which also should be taken into consideration before investing in a particular project or country. This is because a company’s business in other countries could potentially suffer from a dubious investment in a country. When it comes to Russia, this risk is more connected with particular projects or strategies than with the country in itself.

We limit our definition of what might be at risk to investments in fixed capital and the accompanying cash flow. Thus the effect of country risk on an investment can be illustrated in the investment’s net present value (NPV) analysis, presented in section 4.2.

The most dramatic example of country specific risk for an investor is the risk of losing the entire investment through disruption of equity participation, i.e. expropriation; either executed by a country’s authorities, or by private players, but with the consent of the authorities or without any possibility to try the expropriation in a fair judicial process.

Obviously, the risk of losing an investment *in toto* is not the only country specific risk an investor may face. The threat may also take the forms of forced renegotiations of contracts, forced contracting procedures, avoidance of agreed commitments, revision of regulations, or any political/cultural change which may impact priorities and disrupt business plans.

3 Why country risk for investors in Russia?

Russia is a transitional economy, meaning that many of the transformation processes from one political and economic system to another is still ongoing. In general, that means less stability and more unpredictability. In terms of country and political risk this means that in Russia, “*politics matters at least as much as economics*”³.

Russia’s business elite would not have been the same without the Yeltsin-era political horse-trading and mutual interdependence. The current day elite have been equally shaped by its ability to support a favourable standing with the Putin-regime. Some of the most prominent oligarchs of the 1990s have fled the country while others have been sentenced to jail. Others have maintained a good standing and enjoy massive political support in times of crisis.

Political ties are important on the regional level as well. Lukoil did not gain access to the PSA part of the Kharyaga-field (where then Norsk Hydro and now Statoil is partner) before coming to an agreement with the legendary Nenets Governor Vladimir Butov in 2002.⁴ License policy has since been exempted from the influence of regional authorities and having friends in the regions is now less crucial though not unimportant.

Large-scale foreign investments have been repeated subjects of conflict with a more or less obvious degree of political overture. On Sakhalin, Shell was accused of disregarding environmental regulations with threats of having their license withdrawn until the company sold a controlling stake to Gazprom. TNK-BP has to reduce its share in the Kovykta field to the benefit of Gazprom after the Federal Subsoil Resource Agency (Rosnedra) threatened to withdraw the license.

Another example of risk exposure that is particularly relevant for the understanding of why we have chosen a wide definition of country risk is found in the experiences of Norsk Hydro on the Uvat field in Western Siberia in 2001–2003. While negotiating for a joint development of the field with TNK, the company studied the functioning of local markets for crude and discovered that local crude prices were extremely volatile and usually far below those at the international market. Exposure to these prices would threaten the profitability of the project. In reality the Russian “domestic market” for crude is not one market but rather a number of parallel markets characterized by monopsony behavior from the single buyers, - the local

³ Bremmer, Ian (2005), *Managing Risk in an unstable world*.

⁴ <http://www.kommersant.ru/doc.aspx?DocsID=348013>

refineries. Hydro also realized that end product prices were far more stable and quite comparable to prices in Europe and the US. The price mechanism seemed to be an obvious result of Russian companies' tax planning through optimum transfer pricing between upstream and downstream entities. Hydro's solution to this problem was to negotiate with TNK for refining capacity for its share of production and thereby avoid putting themselves into a squeeze between different TNK subsidiaries. It can be argued that this is an example of commercial risk, not political, but the fact that Russia covers a huge territory that may put an inexperienced investor into a difficult "land-locked" position stems from the very nature of this country and should therefore be considered a country risk.

Norwegian Telenor's investment in Russian telecom in the 1990s was for many years the company's most successful until a shareholder conflict over market entry to the Ukraine culminated in court ruled seizure of all Telenor's shares in its Russian company Vimpelcom. It seemed at first ridiculous that a microscopic shareholder (Farimex, registered in the British Virgin Islands) could claim the arrest of a major shareholder's interest for the purpose of forced sale. However, it soon became clear that decision made by a regional court in Omsk was taken quite seriously by the Russian judicial system. The case has only come to a seeming end by the 5 October 2009 decision of the two main shareholders Telenor and Altimio (Alfa Group) to put an end to their conflict and merge VimpelCom and the Ukrainian company Kyivstar into one company, VimpelCom Ltd. registered in Bermuda and listed at the New York Stock Exchange.

The Telenor drama is a prime example of Russian country risk. Most likely Farimex acted in the interests of Altimio and most likely Mikhail Fridman, who enjoys close relations to the Kremlin, had received some sort of go-ahead from political circles. This matter is however of secondary importance because Telenor's Russian risk stems from the imperfection of the Russian judicial system. The choice to register the new company in a neutral third country must be seen as recognition of this risk and as a risk mitigation step.

Another example of country specific risk in Russia, not related to the energy sector or big business, is the experience of the Norwegian businessman Sigurd Coates. He got caught in a long-lasting Russian entanglement. The sail ship enthusiast spent 12 years completing a replica of the SS 'Britannia' at an Arkhangelsk shipyard he originally owned. However Coates, who 'had made his life's mistake' of selling the Russian shipyard in 2002, discovered

that the new owner has decided to hold back the boat for ransom.⁵ Only in 2009 could the ship leave Russia after four years of law suits and tug-of-war.⁶

Country risk should be high on the agenda as the Norwegian oil and gas major Statoil is facing the biggest Norwegian investment in Russia ever with the Shtokman project – Phase 1. Uncertain market conditions has led to a postponement of the investment decision for Shtokman Phase 1 but the project has not been shelved altogether. At prevailing cost estimates Statoil will have to stand for 4-5 billion USD investment over the construction period. In addition operating expenses will have to be covered in proportion with Statoil's share in the field operator 'Shtokman Development – AG' (SDAG). Because SDAG does not control the license and does not have marketing rights for the produced gas the SDAG consortium has to negotiate netback prices with Gazprom, the majority SDAG stakeholder. In effect Statoil and Total (the other international partner) may find their interests different from those of Gazprom, which will earn the profit of exports and therefore will profit more on a low netback price at Teriberka. With a track record for hard-handedly renegotiating contracts with foreign investors, whether Russia in the future will abide by agreements made today is subject to risk. Statoil hopes that it will be allowed into the second and third phases of the Shtokman project although Gazprom (and the Russian government for that matter) have stated that these phases will be developed without foreign partners. Participation in phase 1 is therefore an investment into consecutive phases, although this participation is subject to great uncertainty.

On the basis of the examples provided above we argue that investments in Russia are subject to significant risks beyond the economic and technical. Sometimes these risks have their origin in explicit or implicit public policy (as in the Sakhalin-case) other times the risks are closer related to institutional insufficiencies and weaknesses (as in the Telenor-case or in the Coates-case). In all cases being able to monitor country risk factors stands out as important for foreign investors. Had Shell known then what it knows now the company might have been more stringent in following Russian environmental requirements. Had Telenor known how Altimo could take advantage of an immature judicial system, the Norwegian company could have insisted on other corporate models. Had Sigurd Coates correctly assessed the risk to which he was subjecting his project by not controlling the shipyard himself, he would likely not have

⁵ <http://www.moss-avis.no/article/20080809/NYHET/958712489/1003/MRSS>

⁶ http://www.isoon.no/index.php?option=com_content&view=article&id=398:i-historisk-sus-ned-norskekysten-med-britannia&catid=28:maritime-nyheter

sold it. For Statoil, monitoring the development of country risk factors is important in order to correctly assess the expected future value of existing, imminent and future investments.

What is important to keep in mind is that all of these examples, being examples of country risk, are all examples of investments with a positive outcome. Assuming a positive final solution to the Vimpelcom case Telenor would likely not regret having entered the Russian market as this has been one of the more profitable foreign investments for the company. However, if the company had been better prepared and if it had succeeded in establishing mutual interests with its Russian partner it could have saved itself a long and costly quarrel and judicial process and a good portion of nail-biting.

4 Different approaches to measuring country risk

When considering a business case for either an ongoing project or a potential project, a company will have to do a thorough risk assessment of the particular business case in addition to a regular analysis of the profit potential. Prices and costs may deviate from the initial business case assessment. In addition changes to tax regimes, legal framework conditions, political pressures etc. may totally alter the prospects for any business case.

Different rating agencies like Standard and Poor's, Moody's, Merrill Lynch etc. provide credit ratings measuring the credit worthiness of different countries. Such comparisons might be useful for financial investors, who quite easily can switch their investment portfolios from one country to another. These ratings do not however measure the level of country risk relevant to investors in fixed capital. For financial investors, risk is "*judged not by a subjectively formulated probability distribution of possible returns but by the credit rating assigned to the bond by investment agencies*".⁷ Thus risk ratings are more appropriate when considering if a bond is fairly priced.

Several tools for measuring *political* risk are readily available to global investors in fixed capital. Among the more well-known are Eurasia Group's Global Political Risk Index (GPRI) which measures 20 indicators in four main categories (government, society, security and economy)⁸ and IHS Global Insight's Global Risk Service which uses 51 defined risk factors

⁷ Ribeiro (2001:7).

⁸ See www.eurasiagroup.net

distributed over seven main categories (policies – tax, policies – non-tax, outcomes – price, outcomes – non price, domestic political risks, external political risks, economic risks)⁹.

Most generic risk models, however, provide a set of indicators with corresponding values which in turn will end up in a number or a colour code with the purpose of comparing perceived risks between countries. Nonetheless these self-generated political risk reports do not provide investors with sufficiently accurate information. Because the indicators are chosen to fit any country their assessment of particular country does not capture the specific way in which each factor influences risk in each country. Investors who are in the market might therefore have a different view on country risk than provided by generic models. For investors who are already in a market such assessments risk being irrelevant. For Telenor it is of secondary importance whether Russia has a higher country risk than other countries if the company already has a major investment it needs to take care of.

4.1 From generic risk levels to country specific risk dynamics

In this paper we aim to develop a model for of business, involved in trade and/or direct real investments. Most of these business actors do not consider switching their investments from e.g. Russia to Malaysia based on risk assessments. For most actors the question is either to invest in Russia – or not, either to continue their Russia activities – or withdraw, or adjust their activities to new realities. For these actors the main point of importance is not to have a model that is applicable to any country in the world, but rather to have a tool that is sufficiently precise to capture the specific challenges attached to their country of interest. And countries are different. Not only will they score differently on the range of risk indicators, but it is our belief that countries will also have different risk categories and indicators to start with.

We therefore attempt to make a risk model which incorporates factors that are specific to Russia. This will make the model more precise and will enable us to avoid unnecessary noise from a range of categories irrelevant for risk in Russia. Instead of being applicable across countries the tailored country risk model will be applicable to Russia across time, i.e. it will be possible to compare country risk in Russia over time

Our model is non-sector specific. There will be different risks facing an investor in, say upstream oil and gas and an investor in telecom or forest industry. But what we want to

⁹ See <http://www.ihsglobalinsight.com/ProductsServices/ProductDetail874.htm>

capture with our model is the risk typical of Russia, not the risk typical of one sector. Through the model, we aim at constructing a framework that can be of use for any foreign business project in Russia.

4.2 Measuring country risk

In an environment where country risk is assumed not to exist or considered irrelevant, the Net present value (NPV) would be a discounted cash-flow estimate, where the discount factor would be the required rate of return.

$$NPV = \sum_{t=0}^n CF_t (1+r)^{-t}$$

Where: CF_t = expected cash flow in year t , r = required rate of return (discount rate); $r > 0$

One usual way of adding country risk, is to make an adjustment to the discount rate. We

would then get an NPV calculation that would look like: $NPV = \sum_{t=0}^n CF_t (1+r+W)^{-t}$.¹⁰

Here, W represents the country risk factor. This approach may be acceptable to financial investors with a relatively short-term perspective and with the option to mitigate risk by simply withdrawing investments when the political environment gets nasty.

However, for players involved in real asset investments, with the ambition to stay on for the lifetime of the projects, a far more elaborated approach is required. The model should ideally enable investors to take advantage of their own (and others') insights in their own projects and also their insights into all aspects of country risk in Russia and discuss this in a manner that might enforce their preparedness and improve their mitigating abilities. Country risk may be experienced very differently by different players depending on the nature of the project, the solidity of the investor itself and the investor's ability to mitigate in a real situation. The main aim for all investors, however, is to become aware of their own situation in due course and make sure that the entire organisation responsible for project execution is well coordinated in their understanding and approach to country risk.

Keeping our definition of country risk in mind, whatever form the risk takes, it will affect cash flows, and these effects should be identified and preferably measured. Instead of adjusting the discount rate country risk should be added by direct adjustments to expected cash flow elements. The expected risk-adjusted cash flow at time t can be written as:

¹⁰ Clark & Marois (1996:90)

$$E(CF_t) = \sum_{i=0}^n CF_i \times p(CF_i)$$

Where: CF_i are the various cash flows at time t and $p(-)$ the probability of each outcome.

As long as CF_i is a discrete variable $E(CF_i)$ can be written:

$$E(CF_t) = CF_t \times w_t \leftrightarrow w_t = E(CF_t)/CF_t; \quad w_t > 0$$

The country risk factor w measures the effect of country specific risk on future cash flows. If $w=1$ country risk does either not exist ($p=0$ for other outcomes than the expected cash flow calculated based on economic and technical risk) or positive outcomes neutralize the negative. The investor may also expect an improvement in the business climate in which case $w>1$. The risk-adjusted NPV (R-NPV) takes the form:

$$NPV = \sum_{t=0}^n CF_t (1+r)^{-t} w_t$$

The subscript t on w_t denotes that country risk is not static throughout the investment project. First, different stages of the project might be subject to different levels of risk. For example renegotiation of Statoil's Shtokman participation is more probable when net cash flows turn positive than in the net expenditure phase. This situation is referred to as 'obsolescent bargaining'. Secondly, the appropriate values of w may change over time. For example the risk associated with entering into a partnership with a Russian partner may decrease over time if the judicial system improves so that it becomes easier to hold a partner accountable for contract breaches. Conversely if Russia enters a new round of expropriating FDI's then the w associated with the Shtokman project should be decreased.

Answering how each possible event might influence a specific investment is a task of the responsible project organization. The task of our model is to provide a framework within which a structured discussion and analysis of relevant risk factors in the Russian society can be carried out in order to obtain consensus on threats, consequences and mitigating actions.

To give a more practical view on the exercise above we can start with the simple cash flow formula:

$$\Pi = \sum_{t=0}^n [price_t \times production_t - (capex_t + opex_t + taxes_t)]$$

Every identified risk factor should be discussed with respect to which cash flow element is in question, how it could be affected, the size of the effect and of course the probability of each

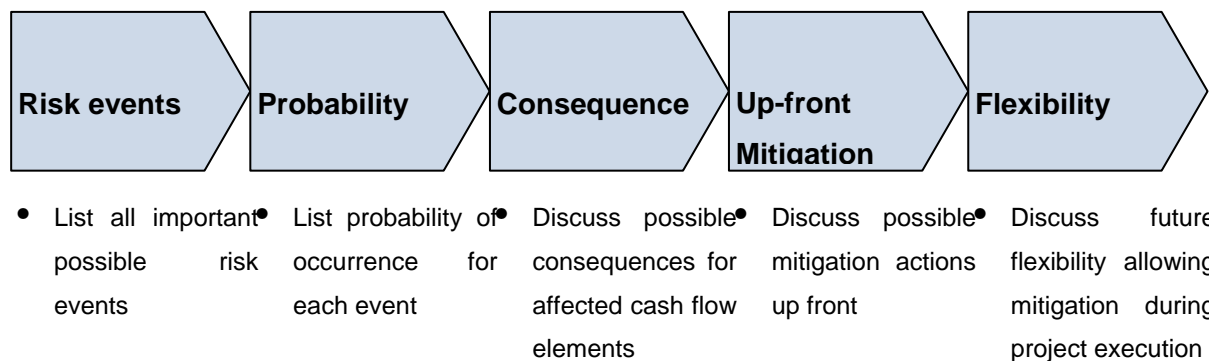
event occurring. Given this approach a relatively limited set of consequences can be identified:

- Lost revenue (price and/or production)
- Changed taxes
- Increased cost (Capex and/or Opex)
- Changes in the timing of cash exposure or collection

These are all consequences relevant to the project under consideration. In addition to this we will have to take into account reputational risk that may be important from a company-wide perspective but not necessarily relevant to the given project.

The practical approach to the above mentioned discussion is as shown in the flow-chart of Figure 4.1:

Figure 4.1 Steps in risk assessment



With this approach the investor will ideally be able to identify and define all potential outcomes and make adjustments to his calculations of expected NPV by running through probability weighted scenarios and thereby establish an economic assessment of the consequences of country risk. This will in turn enable comparison to projects in other parts of the investors' portfolio and improve management's basis for prioritising between projects.

5 Creating a framework for risk assessment in Russia

The country risk framework presented in this paper will in time enable us to observe changes in the risk level of each single sub-category from assessment period to assessment period. We will at this stage not aim for one, single figure for the overall risk picture in Russia. The main

reason is that there will be different risk factors affecting different kinds of investment projects and sectors. The framework may be used as an input factor to calculation of the net present value for a specific investment project, but it is not possible to make a generic model applicable to specific projects with a sufficient degree of accuracy.

Assessing country risk, or any risk at all, is about systematizing and interpreting a complex variety of more and less obvious risk factors. This is not possible without simplifying the reality. The process of performing a risk assessment may be divided into three stages: Firstly, the variables for risk analysis are picked and made operational. Secondly, data on the different variables are collected, and thirdly, the data are processed, analyzed and the results compiled to a total country risk assessment. The analytical job is performed in the first and third stages. Principally, the data collection part should be as objective as possible and not be subject to analysis. Ideally, it could be computerized. In this section, we therefore focus on the first and third stages of the country risk analysis. At this stage, we will not engage in data collection and or analyze data in order to make an assessment of country risk in Russia. We will instead limit ourselves to create a framework for future assessments.

The risks an investor may face could be divided into direct and indirect risks. Direct risks are the risk of losses due to actions (or non-actions) directly aimed at the particular investment or investing company or the particular sector or investors from a particular country. Indirect risks are the risk of losses due to actions (or non-actions) not directly aimed at the specific investment or the company but more arbitrarily or coincidentally striking the investment/investor. This could be policy actions like tax regulations, but also crime, civil disturbances, riots etc. Sometimes it could be difficult to distinguish between the two. Is for example the risk of civil disturbances directed against foreign presence in general a direct threat or an indirect arbitrary threat? In general, mitigating direct threats are easier than mitigating indirect threats. However, one needs to take both into account when assessing the risk of investing. In the following, we have chosen not to explicitly emphasize the distinction between direct and indirect threats as this distinction by nature would differ from one investment project to another.

5.1 The categories

It is not possible to consider all possible risks. What is important is therefore to pick the most relevant risk categories. Furthermore, when categories are found it is of great importance how one goes about to monitor them. We need to identify what type of events will cause a change

in the risk perception of the category under analysis. Such events or bundle of events are called indicators. They should be readily operational, so that the analysis and assessment does not enter into the data collection phase so the collection can be as objective as possible.

This paper presents a matrix consisting of nine main categories, which in turn are divided into three sub-categories each. Each sub-category is finally measured through a set of three operational indicators, leaving us with 90 indicators to monitor and assess.

As the model construction is part of the knowledge integration work of the RussCasp research programme it has been important to test the choice of categories and sub-categories on the researchers and users of the programme. Part of the output has come as a result of the RussCasp Strategic Forum on 21 October 2009. Here, participants were asked to rank a given set of main categories and to suggest sub-categories to be removed and added. The result of this exercise is reflected in the matrix presented below.

The single categories or sub-categories need not be specific to Russia, but the compiled, integrated picture presented by the categories represents a tailored country risk framework for Russia. It will allow us to follow risk development in Russia over time, but will not be applicable to other countries without serious readjustments.

5.1.1 The politics–business nexus

The relationship between the political and economic elites is a category that seems to have big impact on the risk level in Russia. The state in Russia plays an active role in the economy. Through a range of different state-run, state-owned and partially state-controlled companies, it is a noticeable factor. An active state does not in itself enhance the country risk. However, in Russia it does imply that some sectors are non-go for foreign investors. The recently established law on strategic sectors specify a set of limitations for foreign investments in sectors defined as strategic¹¹. If the application of the law is straightforward and predictable, it doesn't in itself increase the risk. If, on the other hand, it is subject for interpretation, readjustments etc., it could increase the political risk to prohibitive levels. Another aspect of politics-business relations that seems extremely important in Russia is the personal connections between the business elite and the top political brass. This was one of the factors

¹¹ These are: Nuclear materials, devices, waste, etc.; coding and cryptographic equipment; weapons and military equipment and technology; aviation and space; television and what may be called large scale radio broadcasting and printed mass media; natural monopolies which are designated as such on the FAS list; telecoms, but not internet providers; and geological survey and exploration and development of subsoil areas of federal significance (Hogan & Hartson 2008).

deciding who were able to accumulate wealth during the privatization of the 1990s. During the Putin reign the relationship has changed markedly, and Russia is said to have gone from *Oligarchic Authoritarianism* to *Bureaucratic Authoritarianism*.¹² The links between politics and business may have been imperative in deciding who has become the target for the re-nationalization of the 2000s.

5.1.2 Administration–bureaucracy

As a country in transition Russia is an example of a country where the administrative system has not yet settled. Putin's administrative reforms from his first presidential term were never really implemented and several were reversed after some time, leaving administrative procedures slow and unpredictable. If, in addition, there is an element of corruption involved in the bureaucracy, the risk may be substantial. In the administration–bureaucracy category, we have also included license policy and practice. In Russia, main examples of risk attached to licences have been the seemingly arbitrary implementation of licence requirements for oil and gas development and production from government institutions like Rosprirodnadzor (the Federal Environmental protection Agency) and other government agencies. The formal licence requirements have been quite strict and clear, but compliance requirements have differed from case to case. The authorities suddenly threatened to revoke TNK-BP's Kovykta licence because the company failed to fulfil the requirements in the licence for gas deliveries to the local market. When Gazprom was given the right to acquire TNK-BP's shares of the license holder, license compliance was no longer an issue. A parallel example seems to be found at Sakhalin II, where Rosprirodnadzor accused the operator Shell of environmental malpractice. Again, after Gazprom acquired a controlling share in the PSA, environmental problems were said to be resolved.

The use of administrative means for political goals could also be an explanation for the pressure against the British TNK-BP management in 2008. UK citizens working on secondment from BP for TNK-BP in Russia were for a period of time not given renewed visas, creating problems for the company. This was also by some seen as a result of a negative development in the overall bilateral relations between Russia and the UK culminating in the closure of two regional branches of the British Council¹³.

¹² Shevtsova (2005)

¹³ Upstreamonline 25 March 2008, at <http://www.upstreamonline.com/live/article151117.ece>, accessed on 17.12.2009

5.1.3 Judicial system

The presence of a reliable, impartial, transparent, incorrupt judiciary is a basis for a good business climate. The Russian judicial system has gone through a wide range of changes and improvements after the unruly 1990s. Still, there are several cases where the general opinion is that the courts have been partial or instructed by political leaders. The Yukos/Khodorkovsky case is one prime example, the Telenor-Vimpelcom case another. As mentioned, the risk mitigating measure of registering joint ventures in neutral third countries may be seen as a sign that confidence in the Russian judicial system and court independence is low. An improvement in the judicial procedures would make a very significant contribution to lowering political risk in Russia. The Coates case mentioned in section 8 may provide an example of a case where the court procedures seem to have worked, but where the enforcement of the court rulings was the problem. Furthermore, corruption is an overarching issue in many of the risk categories, but is probably particularly important in the judicial system.

Another aspect of the judicial system that has been regularly emphasized as a major obstacle to business entry into Russia is property rights.¹⁴ The ability of the legal code and judicial system to defend private property is crucial to any successful direct investment.

5.1.4 Government/Domestic policy

In this category we look at the risk attached to changes in government and political course. Changes in Government do not in itself necessarily represent a significant political risk. A firm, stable political system will have good mechanisms for power transfer from one government/coalition to the next and will have a set of rules of the game that are not likely to change through changing government constellations. However, even in a stable democracy, changes in government may affect the profitability of an investment. In a less stable political regime, a change of regime may more easily lead to changes in the framework conditions for an investor because of a higher degree of politicized business environment. This could e.g. be the risk that a new political regime revokes licenses and contracts agreed by the previous regime. This category does not necessarily imply a measure of the degree of democracy. In principle, an authoritarian government may provide as stable an environment for business as a democracy. However, it may be argued that an authoritarian regime always will have a high

¹⁴ See J. Shevtsova (2006).

risk for instability because the population is deprived of the democratic channels for expressing their ‘voice’¹⁵

5.1.5 Economic policy

The profitability of any investment will depend on the development of the markets. This is to a large degree dependent on factors outside of political control. Those forces are not covered by our country specific risk framework. What are covered are the policy choices and policy changes that affect the markets. Of particular importance to an investment is the tax regime, not only the tax level but also how taxes are collected. The main concern is the predictability and stability of the tax regime. If a political conflict or a business conflict suddenly leads to changes in taxation it could have serious consequences for the investor. One example would be how the Russian government in 2008 suddenly increased the export tax on round timber fivefold to protect its own forest processing industry.

5.1.6 Societal factors

The fate of an investment is not independent of the development of the society in which it operates. The population need channels where they can air their frustrations and views on the actions of economic players. Normally, a free and open variety of NGOs would be regarded a factor lowering the political risk. Through contact with NGOs the investor may receive and provide information thus avoiding risk coming from misunderstandings. Obviously, active NGOs may also increase the costs of a project by requiring extra standards. But again, the main point we are looking for is predictability. Highest risk would possibly be connected with a situation where political or business elites control NGOs (or GONGOs which could be the appropriate term if they are governmentally organized). In such a case an NGO could be used as a proxy for personal business or political interests making it more unpredictable. The Nashi movement in Russia could be an example of such an organization. The conditions for the press would also be a factor affecting the risk level. A concentrated and managed press could be used to direct public opinion in favour or against particular investments, whereas as free and independent press would allow the affected parties of a case to have their views presented and reduce the danger of media being used as a tool for particular interests.

¹⁵ See Hirschman (1970).

5.1.7 Socio-economic development

Socio-economic development may affect the risk situation in several ways. Generally, low living standards, high poverty rates and unemployment create instability in a society. In a country undergoing transformation, this is likely not less of a problem. The population in a society in transit may have expectations about living standard growth far exceeding the real developments. As has been shown before, *inter alia* in the so-called Davie's J-curve, a large gap between a population's expectations and the reality may create a highly unstable situation.¹⁶ It will more easily lead to radicalization of the population. In many societies, not least Russia, radicalization goes hand in hand with nationalization and xenophobia. For a foreign investor this is definitely a factor. In the political risk model for Russia we have thus included nationalization as an important sub-category in this category.

5.1.8 Security policy/Power ministries

Possible interference in business activities from security services is a potential political risk. In Russia, the role of the so-called power ministries have been much discussed, not least due to Prime Minister Putin's past from the KGB and FSB and the seeming strengthening of the power organs. A possible interconnection between high-ranking officers in the power ministries and business elites could create a situation where the power organs are used indirectly to support a certain business. These organs secret nature and lack of accountability add to the risk. There are several possible risks that may fit into this category. One is the risk of direct action from the secret services. In the case of TNK-BP, FSB accused employees of TNK-BP of espionage. This was by some seen in relation with the then ongoing conflict between Russian authorities and the British Council¹⁷. Another potential risk comes from the possibility of a particular business or investment interfering with the interests of the military. The relation between the North Fleet and oil and gas activity in the Barents Sea is one example of this.¹⁸ A different case that could illustrate what this category includes is the dispute between the Russian tax authorities and the US investment fund Hermitage Capital Management. In 2007 police raided offices, took corporate documents for Hermitage's Russian companies. According to Hermitage these documents were then used to take over the companies. Later, a USD 230 million tax refund was paid to companies forcefully taken over

¹⁶ Davies (1962).

¹⁷ <http://nearabroad.wordpress.com/2008/03/21/british-oil-giant-under-fire-after-espionage-arrests/>

¹⁸ See Aatland (2009).

from the Hermitage Fund. Hermitage CEO William Browder calls the tax refund a robbery and claims that it must involve senior tax officers. One of Hermitage's Russian lawyers, Sergey Magnitskiy, was imprisoned in 2008 accused of tax evasion and later died in prison.¹⁹ From this example it is apparent that fitting the indicators into right main category is a demanding task. Here, it is difficult to distinguish between what is organized crime and what are actions from the armed branches of the government apparatus. Police arbitrariness and tax authorities' power game fall naturally into the 'Security policy' category, while organized crime belongs in the socioeconomic category.

In this category we have also included the risk of civil conflict and

5.1.9 Foreign relations

In Russia, there seems to be at least some support in the assumption that Russian foreign policy relations with other countries also may affect the country risk for an investor. Good bilateral relations between Russia and the investor's home country may, at least potentially, affect the ease of doing business in Russia. On the other hand, if bilateral relations suddenly deteriorate there is reason to assess whether this increases the risk of the investment. The pressure against TNK-BP in 2008 coincided with politically tense relations between Russia and the UK, and as mentioned, the two were by some seen as interlinked. The risk of espionage threats and office raids may increase with deteriorating political relations. This possibility increases due to the close relationship between the executive power, the security services and business in Russia.

6 From qualitative to quantitative – the roundtable approach to risk assessment

In the assessment phase of the country risk assessment the target will be to give each indicator a quantifiable value and a particular weight based on the observations. This would imply taking the risk analysis from a qualitative description of the risk factors to a quantifiable description, which could be applied to a specific project representing the risk factor in a calculation of net present value. This process is by nature a subjective exercise. The goal for a risk analyst is anyway to make the disadvantage of subjectivity as small as possible. There are several methods that can be undertaken for this quantification of country risk. Normally, it is

¹⁹ Sources: http://en.wikipedia.org/wiki/Hermitage_Capital_Management#cite_note-nyt-2, <http://www.youtube.com/watch?v=ok6ljV-WfRw>, http://www.youtube.com/watch?v=ZO_joxCkors&NR=1

never a good idea to perform the risk assessment entirely within the company, inter alia in the management committee or board of directors. A company will find it difficult to avoid organizational biases, cultural and ideological biases or cognitive biases (wishful thinking, mirror imaging).²⁰

The concept of risk assessment thus works better when independent experts are consulted in the process. Normally, there is a trade-off between simplicity/cost on the one hand and objectivity on the other hand. One expert could, with the right monitoring system, perform the risk assessment single-handedly. This could be the chosen solution in a case where resources are scant and probably where the country risk initially is seen as small. However, in order to make a more broad-based and balanced assessment, there is need to bring in several experts. The challenge of this, however, is that experts tend to be strongly opinionated and more often than not in disagreement with other experts. One possible approach out of this challenge, used among others by Credit Risk International is the 'Delphi technique'.²¹ This technique involves sending questions to a group of experts, continuously receiving feedback. The goal of the exercise is to reach a group position/consensus on an issue. Depending on the size, flexibility and initial positions of the expert group, the Delphi technique may be overly time and resource consuming.

A less time-consuming approach, but therefore also possibly more prone to strong personal biases, would be to assemble a fairly broad panel of experts physically in a workshop/roundtable and allow them to discuss the risk factors but without the aim of consensus. Then it could be up to one country risk manager to extract the risk factor based on the discussion. If the panel is the same from assessment period to assessment period, this process could give useful and sufficient insights for a risk assessment. A third possibility is to collect expert opinion through a regular survey to a fixed group of experts leaving the collection and possibly the final interpretation to the country risk manager. In addition to the obvious advantage of resource efficiency, this technique has the advantage of avoiding negative group dynamics, socialization and group dominance by strong personalities.

Having conducted the expert group risk assessment it is crucial for the investor to incorporate the assessment and possible risk mitigation strategies in the entire organization. It needs not only to be taken into the profitability calculations as shown in 4.2. All parties involved in the

²⁰ See Bremmer and Keat (2009).

²¹ Clark & Marois (1996:71-72)

company's business in the relevant country – here Russia – must be aware of the different risk factors and have an independent responsibility for assessing the risk and mitigating it. The final decision to invest is, after all, the company's decision.

Table 6.1 The risk matrix

Main Category	Sub-category	Operational indicator
Administration/ bureaucracy	Administrative processes	Transparency in administrative processes Ease of doing business Centre-region relations
	Institutional weaknesses	TI/CPI, other corruption indicators Frequency of admin changes
	License policy and practice	Predictability in licensing License practise
Politics – business relations	State interference in business	State share in business Top politicians in boards Balance between statist and liberal politicians Strategic sectors
	Business culture	Oligarchs position vis a vis government/administratio Counterparts' track records Partners' track records
	Favouritism	Regional variations
Judicial System	Legislation predictability	Change of laws, rules
	Courts' independence and integrity	Appointment of judges Corruption
	Court procedures	Jury system Transparency in judicial processes Appeal possibilities
Economic policy	Fiscal policy (taxes)	Tax changes Tax collection Budgets
	Economic development	Economic growth Trade balance, Inflation, purchasing power

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Societal factors	Civil Society	Role of independent NGOs
	Media	Crime Press freedom Attacks on journalists
	Social Unrest	Living standards
Socio-economic development	Nationalism	Attacks on foreigners
	Radicalization of population	
	Crime	General crime level
	Living standards	HDI, wages, poverty Income distribution
Government/Domestic policy	Power vertical	Election results Attacks on opposition politicians State party/Party memberships Government approval rate
	Political opposition	
	Regional independence	
Security Policy	Role of power ministries	Military and para-military budgets FSB/police attacks on business
	Military-business relations	Property Exercises close to areas of business opportunities
	State security/Internal conflict	
Foreign Relations	Attitude to outside world	Political statements Agreements and negotiations
	Attitude to foreign investors	FDI and trade
	Perception and role of foreign actors	

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