



Anatoly Chubais. Photo: Lystseva Marina/ITAR-TASS/Corbis

Liberalisation turns into renationalisation

Russian power play

The liberalisation of the Russian power market has drawn in a number of European electricity companies, including Enel, Eon, RWE, EdF and Fortum. But the way things are going, it looks like the newly liberalised market will be controlled by none other than Gazprom.

| by Jeroen Ketting

The restructuring of the Russian power sector currently taking place is one of the greatest economic reform programmes ever undertaken. The old Russian power monopolist RAO UES has been broken up into a host of smaller power producers, which are being sold piecemeal to private investors, foreign and domestic. The restructuring, to be largely completed this summer, is meant to lead to a nationwide liberalised electricity market – unprecedented in Russia. Foreign investors have been lining up to buy up the OGKs (wholesale generation companies) and TGKs (territorial generation companies), which were formed as part of the restructuring process.

In Russia, however, things are hardly ever that straightforward. The foreign companies might find that they will get a little more – or less – than they bargained for. They will run up against formidable competition from some of Russia's biggest industrial conglomerates – above all from Gazprom. The gas giant, controlled by the state, is rapidly extending its control over the newly liberalised power market. Some even fear that the market will be re-monopolised.

The power sector reform involves the separation and privatisation of the generation, transmission and sales companies. The grids will be brought under regulatory supervision. Although the restructuring should be fully implemented by July 2008, the transition to a fully open competitive market will only happen in 2011. The motivation for the reform programme is to attract investment. More than \$120 billion is needed until 2010 for the upgrading of the aging energy infrastructure and for building additional generating capacity to deal with increasing domestic demand.

Auction |

The first company to move in was Enel. The Italians acquired a 25.03% stake in OGK-5, Russia's largest wholesale generating company, at an auction in June 2007. Enel offered 39.2 billion roubles (\$1.5 billion) for a majority stake against the starting price of 24.7 billion roubles (\$953 million). The sales price amounted to \$690 per kilowatt. Enel beat Eon of Germany, and Russian companies Rusal Energy and Novatek. By now, Italy's biggest utility has increased its stake in OGK-5 up to 59.8% after a

public buyout offer, paying a total of \$4 billion. OGK-5 has its main assets in the Ural region, in the northern Caucasus, and in Central Russia. The aggregate installed capacity is 8,672MW for power and 2,242 gigacalories per hour (Gcal/h) for heat. Enel plans to invest around \$9

Any foreign company will have to dance to Gazprom's tune

billion in the Russian power sector. Enel had earlier, in April 2007, acquired the gas assets of Russia's bankrupt oil company Yukos.

In October 2007, Eon spent \$753 per kilowatt to pay \$6 billion for a 60.75% stake in OGK-4. Subsequently, in February 2008, Eon raised its stake in OGK-4 to an absolute majority of more than 75%. This move made Eon the first foreign company to fully control a major Russian power producer and the biggest foreign investor in Russia's power sector. An absolute majority implies that no other OGK-4 shareholder will be able to block Eon's

decisions on the board of directors. OGC-4, with its headquarters in Moscow, operates five power generation plants throughout Russia, with a total installed generation capacity of 8,630MW that accounts for about 3.9% of Russia's total installed generation capacity and for approximately 5.75% of Russia's total installed thermal generation capacity.

In February 2008, after winning the auction for electricity generator TKG-10, Finnish energy company Fortum agreed to pay \$1.2 billion for a 55% stake. In March 2008 Fortum increased its share to 76%, spending as much as \$3.1 billion for the entire stake, and giving Finland's largest utility its first controlling stake in a Russian power producer. Fortum has stated it is ready to invest up to \$4.1 billion. The deal values TKG-10 at \$767 per kilowatt of capacity, which is a record in Russia. Other companies that expressed

Kostroma regions. In March 2008, RWE paid an additional 9 billion roubles for the purchase of TKG-2's newly issued shares, giving it effective control of the firm for a total of around 19 billion roubles (\$802 million).

EdF of France was poised to acquire OGC-1 at an auction on April 17, along with its Russian partner TransNeftServis-S. Just one day before the auction, however, RAO UES announced that the auction would be delayed and that only one bidder remained: Integrated Energy Systems (IES), a consortium of Russian multi-billionaires, led by the investment vehicle of metals and oil magnate Viktor Vekselberg. The definite outcome of the process was still undecided as this magazine went to press.

Power game |

With the strategic moves of these first five Western energy majors, the game has only started. Companies such as Spain's Endesa, Gaz de France, Czech CEZ, South Korea's KEPCO and America's AES are following the developments in Russia with a keen eye. Yet the outcome of the Russian power game is far from certain. Western companies will have to compete with some of Russia's industrial giants, such as IES, which has managed to buy up some of the choicest UES assets.

Another big Russian player is the Siberian Coal and Energy Company (SUEK), the nation's largest coal producer. The company supplies nearly 31% of steam coal to the domestic market and around 25% of Russian exports. SUEK bought stakes in OGC-2, OGC-6, TKG-12, TKG-13 and in the independent far-Eastern power generation companies, with a total installed generating capacity of about 30,000MW.

Then there is Gazprom, which has secured effective control of four of the twenty large power producers, including the main suppliers of electricity to Moscow and St. Petersburg. But Gazprom wouldn't be Gazprom if it didn't try to dominate the market. Through strategic manoeuvring and tactical alliances, in

particular with IES and SUEK, Gazprom is well on its way to becoming Russia's new power sector monopolist.

Gazprom and IES recently emerged as partners as the two companies set up an investment firm that will enter joint bids for government stakes in Russia's power sector. With both companies together controlling stakes in eight of the twenty large power producers, and with all other players having effective control over not more than one power producer each, it is not hard to imagine what influence IES and Gazprom will hold over the Russian power sector. This influence can already be seen in the price of the stake that was bought jointly by IES and Gazprom in TKG-7. Whereas the Western players paid roughly between \$600 and \$800 per kilowatt of generating capacity, the price per kilowatt of TKG-7's generating capacity will be \$456.

In addition to its joint venture with IES, Gazprom has also announced a merger with SUEK with the aim to join their respective power and coal assets into a holding company. The value of the holding company will be somewhere around \$16 billion. The total generating capacity of the pooled companies will be 30.5 gigawatts, or about 15% of Russia's total. It is estimated that the holding company to be established by Gazprom and SUEK will control more than 40% of the fossil fuel based generation assets being sold off by UES. Perhaps even more importantly, the two partners together will also have a near monopoly on the fossil fuels used to produce power, as SUEK is by far the country's largest producer of coal and Gazprom of gas. Natural gas accounts for about 60% of the fuel used to produce electricity and coal for 25%.

Gazprom will control a 50% plus one share of the venture while SUEK will hold the rest. This will include controlling stakes in four major generating companies: OGC-2, OGC-6, TKG-12 and TKG-13, as well as minority stakes in OGC-5 and TKG-5. This joint venture will create a giant enterprise that will partially re-monopolise the sector and undermine the largely

Some fear that the market will be re-monopolised

interest were Gaz de France, Russian oil major Lukoil and Eon. TKG-10 controls eight power stations in central and northern Russia with 2,785MW of electrical capacity and 10,014Gcal/h of heat. The investments by Fortum are much needed as the utility plans to spend billions of dollars to increase capacity by 2012 to 5,025MW. Fortum also owns about 25% of TKG-1, the main supplier of electricity and heat to St. Petersburg.

Another German company, RWE, recently became the fourth European utility to become a major player in the sector. RWE paid \$568 per kilowatt of TKG-2's generating capacity which is considerably less than Fortum, Eon and Enel paid for their assets. RWE, with junior partner Sintez Group, a Russian utilities investor, paid 9.3 billion roubles (\$392.6 million) for the state's 33.5% stake in TKG-2, which operates in northern and north-western Russia, including the Arkhangelsk, Novgorod, Tver, Vologda, Yaroslavl and

successful liberal reforms started in 2003 that were aimed at making the power sector more open and competitive.

Sector specialists, along with RAO UES chief Anatoly Chubais and former Minister of Economic Affairs German Gref, have expressed fears that Gazprom's acquisition of power and coal assets will undermine Russia's power sector liberalisation and harm competition as Gazprom would control the utilities as well as their supply chains. These fears

seem justified as Gazprom-SUEK would enjoy unparalleled market dominance and lobbying power in Russia.

Gazprom's merger with SUEK must still be approved by the Federal Anti-Monopoly Service, which is widely expected to give the green light this year, perhaps setting some minor conditions. It is also widely expected that the Federal Anti-Monopoly Service will not allow Gazprom to buy any more assets in the electricity sector after this

latest merger. Although a sensible move, it comes too late to prevent the Gazprom-IES-Suek combination. from wielding overwhelming influence on Russia's power sector. As with Russia's gas and oil sectors, Gazprom will be the dominant player. Any foreign company already present in or wanting to enter the Russian power sector will have to be prepared to dance to Gazprom's tune. ■

Gridlock

Russian corporations seize control of the former state owned power sector

| | Asset | Main shareholders | Stake (%) | Price (billion USD) | Capacity (GW) |
|---|------------------|-----------------------|-----------|---------------------|---------------|
| Wholesale Generating Companies (OGK) | OGK-1 | IES | - | - | 9.5 |
| | OGK-2 | Gazprom | Majority | - | 8.7 |
| | OGK-3 | Norilsk Nickel | 53.83 | 3.1 (for 38%) | 8.5 |
| | OGK-4 | E.On Ruhrgaz | >75 | 6 (for 61%) | 8.6 |
| | OGK-5 | Enel | 59.8 | 4 | 8.7 |
| | OGK-6 | Gazprom | Majority | - | 9.1 |
| | Hydro OGK | Russian state | Majority | - | 23.3 |
| Territorial Generating Companies (TGK) | TGK-1 | Gazprom | Majority | - | 6.1 |
| | | Fortum Oy | 25 | - | - |
| | TGK-2 | RWE | 43 | 0.802 | 2.6 |
| | TGK-3 | Gazprom | Majority | - | 10.5 |
| | TGK-4 | Onexim/Norilsk Nickel | 32 | 0.5 | 3.3 |
| | TGK-5 | IES | 46.1 | - | 3.8 |
| | TGK-6 | IES | 65.2 | 1.06 | 3.1 |
| | TGK-7 | IES-Gazprom JV | 32 | - | 6.9 |
| | | IES | 23 | - | - |
| | TGK-8 | Lukoil | 80 | 2.3 | 3.3 |
| | TGK-9 | IES | 67 | - | 4.8 |
| | | EBRD | 8 | 0.14 | - |
| | TGK-10 | Fortum Oy | 76 | 3.2 | 2.6 |
| | TGK-11 | SUEK | 32 | - | 2.0 |
| | UES | 28.9 | - | - | |
| TGK-12 | SUEK | 43.48 | - | 3.6 | |
| TGK-13 | Gazprom -SUEK JV | Majority | - | 2.5 | |
| TGK-14 | UES | 49.66 | - | 0.6 | |

Majority: majority stake

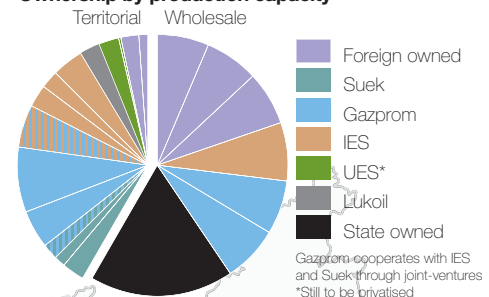
The balance of power

Working together

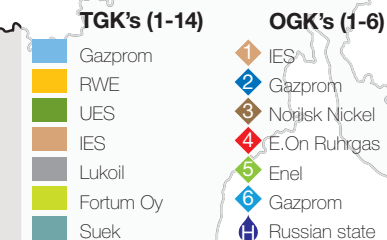


85% of all electricity in Russia comes from gas or coal fired powerstations

Ownership by production capacity



Ownership, geographical distribution



Onexim can raise its stake to between 45% and 50% once TGK-7's minority shareholders exercise their preemptive rights.

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