

2 Tales of Finnish Investment in Russia

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The experiences of two industries where Finland is a major player provide valuable insight into how Russia ticks. I take my examples from Russia's most underdeveloped industrial sector, forestry, and its most-reformed sector, electricity.

At its heart, an EU-Russia dispute over export duties on round timber was a feud over how best to promote investment in Russia. Yet it exposed a lack of understanding on the part of the Russian government as to the nature of the forest industry and its global dynamics. And given that the finish line for Russia's WTO membership is in sight, the round-timber fight must be considered a major faux pas by the Russian government in the field of industrial policy.

It also revealed a serious failure on the part of Finland's industry to think strategically. After all, the Russian taiga covers a 10th of the planet's land surface and is by far the world's largest existing resource of virgin long-fiber coniferous wood. But Russia's forest resources will remain largely unexploited without proper legislation and infrastructure.

The Finnish paper and forest industry took an incremental approach to Russia. It built up a harvesting infrastructure, then saw mills, and eventually planned to start pulp and paper

production in Russia. However, the capital assets remained largely on the Finnish side of the border. Confusion arose when Finnish forest majors began to import large quantities of round timber, mostly birch, for their pulp factories in Finland. Finnish plans to invest in pulp production on the Russian side of the border were always on the drawing board, but a greenfield pulp mill is a big investment. It requires an initial input of about 1 billion euros and, for the sake of synergy, should be followed by a larger integrated investment package that leads to the construction of a paper mill.

These long-range plans by the Finns were not at all clear to the Russian government. Instead, the Russians accused Finnish industry of dragging its feet and exploiting Russia's natural resources with no real intent to invest in added value. When trust was lost, even intervention at the highest political level failed to budge the Russian government from its decision to seek retribution.

The spat appears absurd in hindsight. An exorbitant export duty imposed by the Russians on round timber mostly impacted birch and aspen — for which there is only limited demand in Russian pulp mills. Worse, it upset the natural balance of harvesting. Only 30 percent of birch logs cut in northwest Russia are suitable for local plywood production; the rest is pulpwood. The decision to put high export duties on round timber led to a collapse of the wood harvesting economy of northwest Russia and had dire consequences for the entire region.

The Finnish forest majors went home. They pulled the plug on their harvesting operations, dismantled their infrastructure on the Russian side of the border and shelved long-term investment plans for Russia. Without a steady flow of Russian timber, several mills in Finland had to be closed and there were extensive lay-offs. Finland's forest industry turned to South America for supplies, refocusing its pulp strategy on eucalyptus. Amazingly, Finnish mills today are supplied with eucalyptus pulp shipped across the Atlantic from mills in Uruguay and Brazil.

Could this quarrel have been avoided? My answer is yes. Not by submitting to blackmail and investing under duress, but through "brownfield" investment. In retrospect, it appears that the Finnish forest majors were waiting for "Scandinavian" conditions to emerge before greenlighting large investments in Russia. They looked at the decrepit Russian mills in single-factory towns and saw thousands of workers, many potentially redundant, and administrative expectations of funding for elaborate social infrastructures. What they did not see was that investment in such areas would put them inside the tent, where their negotiating position with the Russian government would be considerably stronger.

Meanwhile, the reform of electrical power generation and distribution stands out as the most comprehensive reform of a Soviet industrial legacy. In many ways, Russia is ahead of the European Union in de-regulating and unbundling its electrical power sector. The underlying logic of the Anatoly Chubais-led reforms for dismantling Unified Energy System, the electricity monopoly, was to create conditions for a market that would attract badly needed investment. Among international investors, three players stand out: Enel of Italy, E.ON of Germany and Fortum of Finland. To date, each has invested as much as 5 billion euros in Russia. Fortum's 4 billion euro investment represents the single largest Finnish investment in Russia ever, and is nearly half of the aggregate stock of Finnish investment in Russia at present.

Fortum's initial investment plan was to increase its 25 percent plus one share in what used to be LenEnergo (now TGK-1), an electrical power company based in St. Petersburg. That deal never materialized, but Fortum was offered the opportunity to invest in the Urals and West Siberia. Today, Fortum controls the former TGK-10 power company, now renamed OAO Fortum.

Even with its position as a world leader in combined heat and power technology, Fortum faces major challenges. It not only has to build new capacity in "the center of Russian oil and gas production" as Prime Minister Vladimir Putin likes to note, but it must modernize the outdated heating networks for several large cities in the region.

Being inside the tent put Fortum in a position to influence both political decisions and the drafting of legislation. This is important, because while the Chubais reforms changed the landscape, they left a lot of landscaping work for future players. Without going into details of the electricity market or a district-heating sector badly in need of reform, these committed investors are well-positioned to influence how Russia's electrical power sector develops. Their presence is also a test for the Russian government; the consistency by which it applies the announced rules of the game in electrical power markets will help determine the overall investment climate in Russia.

The ultimate, and perhaps only, way to influence Russian legislation is from the inside. Major investors must have access, for without it, nothing moves in Russia.

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