

The bright lights of downtown Moscow's dazzling nightscape. Will Russian Energy market reforms prove to be a turn on for investors?

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# RUSSIA

## Turning Up the Heat

Moscow is rapidly becoming one of the world's most dynamic and commercially attractive business destinations.

**W**hile the rest of Europe continues to flounder, sustained economic growth in Russia means that the 2008 privatization of the state electricity monopoly, Unified Energy Systems, was a resounding success.

It created an attractive opportunity for international investors, namely the chance to sell heat and light to one of the world's coldest, darkest but fastest-growing countries.

The Kremlin recognized the need for efficient and reliable electricity markets if it was to achieve its aspirations of doubling the Russian gross domestic product in 10 years. As such, the Russian government has pushed through a highly ambitious program of electricity reform. The program has created market structures, market rules, and a regulatory framework that is now much more similar to those operating in the energy markets of Western Europe.

In May 2008 Sergei Shmatko was hand-picked by Prime Minister Putin to head up the newly created Energy Ministry. Minister Shmatko oversaw the final stage of the privatization of the domestic electricity market that raised \$79 billion. The State monopoly was broken down into six wholesale generation companies and 14 territorial generation

companies. The prices and profitability of each of these subsidiaries are now determined by market conditions rather than state regulation. The Russian Government is counting on efficient energy markets to attract new investment in generation. Given that liberalization, Minister Shmatko believes the market offers a clear attraction for potential investors as the demand for electricity in Russia grows.

According to Minister Shmatko, "Electricity production topped 125 TWh last year, which was a 24.5% increase over 2009." And demand is continuing to trend upward: "Electricity consumption in the country has now returned to pre-crisis levels, and demand is expected to grow by 2% in 2011."

With election fever starting to heat up in Russia, Presidential front-runner Vladimir Putin, has made a popular move by announcing a brief reprieve in electricity price hikes. Traditionally tariffs increase in January however Putin has stated that price increases would be delayed by six months until July 2012. So the higher tariffs will begin in summer rather than in the freezing Russian winter when energy demand peaks.

That news will be welcomed by Russian households, which have seen the cost of heating and lighting rise sharply as the government reduced Soviet-era subsidies. In order to compensate electricity companies in those first six months of 2012, Putin has pledged several

billion dollars of government guarantees to support energy investment projects. According to Putin, "In the long term higher electricity prices will be beneficial, encouraging energy saving".

Russia is the fourth-largest electricity market in the world, behind the United States, China, and Japan. While investing in the electricity market can be complex, the potential for big returns in a booming, energy hungry Russia should be lighting up investor's interests. ●



Sergei Shmatko  
Russian Minister of Energy

## THE POWER BEHIND MOSCOW REGION'S BRIGHT FUTURE

The decade-long campaign to reform and restructure the Russian power sector is about to enter a new and challenging stage, one in which the strengths and weaknesses of its key players are sure to be thrown into sharp relief.

**I**N MARCH THIS YEAR — with one eye on December's presidential elections and the other on the need to continue to attract investment and technological know-how from the west — the Government sanctioned a 15% increase in household electricity tariffs and deregulated electricity prices for industrial consumers altogether.

**WHILE THAT 15% IS CONSIDERABLY HIGHER** than the current 9% inflation rate, it nevertheless represents a challenge for the energy sector and its investors. Any cap on electricity prices, some believe, could hamper their chances of raising the estimated \$100 billion needed to modernize generation capacity and meet the country's increasing demand for power. But as President Medvedev was at pains to point out at the time the price hike was announced, rising electricity costs also represent a genuine threat to Russia's economic growth and are also high on the list of consumer concerns across the country.

**THE SUCCESS OF THIS BALANCING ACT WILL LARGELY DEPEND** on the power sector's ability to sustain and increase productivity within the context of fixed tariffs — an environment that is likely to continue for another five years as the Government has also stated it is looking to impose a blanket enforcement

of the Regulatory Asset Base (RAB) tariff system until 2016.

One company that has not just accepted the challenge but is embracing it with enthusiasm is the Moscow United Electric Grid Company (MOESK). Formerly known as the Moscow Region Power Grid Company, MOESK was born out of the radical 2001 restructuring of the state-owned Unified Energy Systems (RAO UES), which saw the creation of a group of energy companies run under the auspices of the umbrella IDGC Holding Company. Its current name was adopted in 2005 to reflect its importance as an electricity carrier for the country's capital as well as the rest of the Moscow region.

**SINCE THEN MOESK HAS IMPLEMENTED** an unprecedented program of investment and repair. In the past five years, MOESK has spent more than \$3.4 billion on infrastructure, technology, and services in efforts to improve the reliability of its existing electricity supply and to connect tens of thousands of Muscovites to the grid for the first time. During this period, more than 7,000 MegaVolt Amperes of transformer capacity and about 5,000 kilometres of electric energy lines have been put into operation. Moscow's freezing winters have traditionally placed a heavy strain on the region's power grid and although power cuts have not as yet been consigned to history, MOESK has now increased its overall capacity consumption by 6%, which means it can



**Andrey Kononov**  
General Director of JSC "MOESK"

guarantee electricity supply in all but the most adverse conditions.

In the process, MOESK has tripled its annual income and reduced its credit portfolio borrowings by around 25%. Although the transition to the new tariff regulation regime means that the top-line growth potential of MOESK and other companies in the electricity sector are by definition limited, its recently appointed Director General Andrey Kononov not only welcomes this Government initiative, but has been positively lobbying for it. "I believe it is perfectly reasonable for the regulators to peg tariff increases to inflation," he says. "And while it leaves us with almost no space to grow our income, it brings some welcome predictability into our business environment. It will also force companies in the sector to concentrate on their efficiencies; it will allow our business customers to grow without imposing extra inflation on them and will have a generally positive impact on the Russian economy."

**KONOVALOV'S PRIORITIES FOR THE COMING YEARS ARE,** consequently, to improve the efficiency of MOESK's capital construction program and to enhance operational efficiencies. The company has already sought the

advice of Western consultants to address issues of labor productivity and its overall production systems, and its Director-General also sees the potential value of teaming up with overseas partners to make the most of their technological experience and expertise. "Their know-how would be invaluable," he says, "as many of them have achieved benchmarks in the standard of the services they provide that we have yet to reach. It's important for us to emulate existing international analogue networks — it's as simple as that."

Kononov has consequently identified the optimization of MOESK's capital investment structure as a key objective for the coming years. By doing so, he intends to both reduce the number of unfinished building projects and to introduce advanced innovative equipment into the company's distribution grid complex — and in the process turn MOESK into the IDGC's flagship company in terms of customer commitment within the space of two years. There is little reason to suggest his confidence is misplaced. ●



Moscow Head office  
Bld.2, 3, 2nd Paveletskiy Pr.  
Tel.: +7(495) 984-5772  
Fax: +7(495) 984-5817  
e-Mail: odou@moesk.ru

## INDUSTRIAL PIONEERS STILL BREAKING NEW GROUND AT NINETY

George Stephenson may have given mankind the steel horse, but it's Russian engineers who created the reins to harness its strength.

**N**IKOLAI EGORENKOV IS GENERAL DIRECTOR of the joint-stock company

MTZ TRANSMASH, Russia's leading developer and producer of brake equipment. With a workforce of just over 1,200 employees and a turnover of €100 million, MTZ TRANSMASH has played a key role in the efficient operations of Russia's rail network since its plant—the Moscow Brake Factory—was established in 1921.

MTZ TRANSMASH became a joint stock company in 1993 and has remained true to its original mission—the supplying of Russia's domestic trains with simple but reliable high-quality products. Its products are integral to the safe and efficient running of virtually every aspect of Russia's vast and vital public rail and road transport system—its freight and passenger carriages, locomotives, motor coach and underground railway rolling-stock, and its high-speed (and extra high-speed) trains. Now Mr. Egorenkov is looking to build on the company's brand and reputation.

**Q: Do you currently only supply the domestic market or do you have an international presence as well?**

**A:** We supply most of our products to Russia and to the countries of the former Soviet Union for the simple reason that they all operate on the same railway standards. But there are also some Asian and African countries that buy our products. In other words,

Russia is MTZ TRANSMASH's sole focus—far from it. We are actively looking to diversify our business through collaboration and joint ventures abroad.

**Q: What kind of strategic partnerships are you looking for?**

**A:** We work in a very narrow sector of the Russian economy and we are trying to diversify our business. Because the sector is so narrow, by the same token the companies we could and would work with are not numerous either. On the one hand, there are the system integrators such as Siemens, Alstom, Bombardier, and Ansaldo—and they are also our potential customers. On the other hand, we've also worked in the past with Knorr-Bremse, the biggest brake company in Germany, which is our competitor—or at least see themselves as such. It may seem strange, but we can co-operate with them nonetheless. When it comes to suppliers, we prefer to work with Russian companies as we can have a clear and open relationship with them.

This strategy has already paid dividends. One of its most recent successful collaborations saw MTZ TRANSMASH enter into an agreement with the French service and railway system provider Faiveley Transport. The agreement, signed at the beginning of 2009, brought the two companies together in a cooperative consortium for the development, manufacture, and sale of brake systems for the rolling stock used in the countries of the CIS, the Baltic States, as well as Russian Railways. In the two



**Nikolai Egorenkov**  
General Director of MTZ TRANSMASH



Lesnaya str., 28  
125190, Moscow, Russia  
Tel: +7 495 780-37-60  
www.mtz-transmash.ru

years since it was established, the consortium has developed a new braking system from scratch. The relationship it has cultivated with Siemens could also bear fruit. In 2010 Russian Railways linked up with the German system integrator to begin the production of 38 state-of-the-art Lastochka—Russian for “swallow”—electric trains, which are scheduled to come into operation in 2013; it is possible that these new trains will also rely on MTZ TRANSMASH brake technology.

**Q: What do you have to offer a strategic partner?**

**A:** Our core strengths are the quality of our products, our willingness to take responsibility for maintaining that quality, and last but not least our commitment to constant innovation and development.

**Q: How does that commitment to innovation and development manifest itself?**

**A:** We are involved in two major initiatives that illustrate our determination. The first is the pilot project we set up last year with the Bauman Moscow State Technical University, which has resulted in the creation of the Laser Technology Centre where we are developing laser materials processing techniques to keep the company in

the vanguard of brake technology. The second, however, can hardly be called a new initiative as it is very much part of our DNA. Our experimental Brake Lab is almost as old as the company itself, which just goes to show that MTZ TRANSMASH is innovative to its very core.

The MTZ TRANSMASH plant houses three group stations—one for 190 cargo wagons, which are used not only in certification tests but also tests for everyday purposes, such as for quality control. A second is for 100 wagons used mainly for testing new equipment, and a third is designed for passenger-train simulation for up to 30 wagons. The complex is accredited as a test center for technical competence and it is now able to undertake certification tests of brake equipment.

**Q: How do you explain MTZ TRANSMASH durability and continued success?**

**A:** In my opinion, the secret of MTZ TRANSMASH's success has been our willingness to invest all our profits back into the future development of the company. We are more than open to entering discussions with financial as well as operation partners as long as they share that philosophy—they must want to develop our company, not conquer it. ●