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RUSSIAN FEDERATION'S INVESTMENTS IN ROMANIA: THE CASE OF LUKOIL

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Abstract

The unusual magnitude of the ongoing economic and financial crisis raises major concerns about the propensity and capability of transnational corporations to continue investing and expanding abroad. This study investigates the Russian Federation's investments in Romania, with an eye to reveal the reasons to invest in Romania, and the case of Lukoil, as the first private company from the Russian Federation that opened the way for investments in Romania. The findings of this study disclose that Romania is an attractive country for foreign direct investment, and moreover, the oil industry has developed due to Lukoil's investment in Petrotel refinery. The study was carried out by combining a wide variety of sources, such as statistics, data books, fact books, reports and articles. The results reported in this study may be used as a starting point for further research in the area of foreign direct investment endorsement.

Keywords: Investment, Romania, Russian Federation, Lukoil, Petrotel Lukoil refinery.

1. INTRODUCTION

This study explores how Russian Federation's foreign direct investment in Romania has been developed throughout the years, based on a case study of Lukoil's investments. In order to achieve this aim, firstly this study briefly discloses the Russian Federation's role in the international oil industry. Secodly, the study reveals some of the reasons to invest in Romania, and presents an analysis of foreign direct investment net flows and foreign direct investment stock in Romania. Thirdly, the study investigates Lukoil's investments in Romania, by presenting the company's activities in the world oil industry, and the investments made in Lukoil's Petrotel refinery from Ploiesti. The study was conducted using evidence provided by as statistics, data book, fact book, reports and articles. The research question was answered by analyzing published sources, evaluating and interpreting evidence.

2. RUSSIAN FEDERATION'S ROLE IN THE INTERNATIONAL OIL INDUSTRY

Global foreign direct investment flows have been severely affected worldwide by the economic and financial crisis. However, outward foreign direct investment from the Russian Federation reached a new high in 2008 (USD 52 billion in 2008 from USD 46 billion in 2007), making this country again the second leading source of foreign direct investment among developing and transition economies, after Hong Kong (China). With a

slowdown in foreign demand for their products, Russian transnational corporations shifted their strategies from expanding markets for their products abroad (through securing access to downstream activities along value chains) to gaining access to technological innovations and advanced marketing and management know-how (UNCTAD, 2009: 74).

The international oil and natural gas industry is among the most vital markets in the world, because it serves as a source of energy, and also provides the basic raw materials that form the basis of an immense multitude of industries including manufacturing, agricultural and services industries. Holding the world's largest natural gas reserve and the eighth largest oil reserve in the world, the Russian Federation is the largest exporter of natural gas and has recently become the largest oil exporter. Thus, the Russian Federation is an ever-growing major player in the international energy market (Katsioloudes and Isichenko, 2007: 133).

In the first half of 2008, Russian oil and gas transnational corporations continued market-seeking acquisitions of processing entities, distribution networks and storage and transportation facilities across Europe and the United States. For example, Gazprom concluded an agreement with Austrian OMV for the purchase of 50% of the largest Central European gas distribution terminal and storage facility in January 2008, and Lukoil acquired a 49% stake in the Priolo oil refinery of ERG (Italy) for USD 2.1 billion, this being the first ever deal of a firm from the Russian Federation in such activities in Western Europe (UNCTAD, 2009: 74).

3. WHY TO INVEST IN ROMANIA?

In general terms, investment is the outlay made at a certain time to produce capital goods (such as machines, buildings, factories, etc.) or to increase stocks of raw materials, consumer goods, etc. (Delitheou, Vinieratou and Touri, 2010: 167).

When considering Romania as a possible location for developing their businesses, foreign investors may take a close look to the advantages provided by our country:

- a. **Market and location advantage:** (1) Romania is one of the largest markets in Central and Eastern Europe (ranking 7th, with over 21 million inhabitants); (2) European Union unique market gateway (access to approximately 500 million consumers); (3) attractive location, because Romania is situated at the turning point between EU, the Balkans and CIS countries, thus is crossed by three important pan-European transportation corridors: corridor no. IV linking Western and Eastern Europe, corridor no. IX connecting Northern and Southern Europe and corridor no. VII – Danube River, facilitating inland water transportation, at the same time connecting the Romanian Port of Constanta (the biggest Port to the Black Sea) to Northern Europe, through the Rhine.

- b. **Resource Advantage:** (1) highly skilled labour force at competitive prices (solid knowledge in foreign languages, technology, IT, engineering, etc); (2) rich natural resources, including surface and underground waters, fertile agricultural land, oil and gas; and (3) high potential for tourism.
- c. **Political advantage:** (1) stability factor in the Area - NATO membership; (2) stability guarantee in South Eastern Europe; and (3) EU membership.
- d. **International relations advantage:** (1) bilateral agreements between Romania and other countries on investments promotion and protection; (2) bilateral diplomatic relations with 177 out of the 191 United Nations member states, plus the Holy See, the Sovereign Military Order of Malta and the Palestinian National Authority; (3) member of the United Nations and other international organizations, like: OSCE, Council of Europe and International Organization of La Francophonie; (4) free trade agreements with EU, EFTA countries, CEFTA countries; and (5) WTO member since January 1995.
- e. **Economic advantage:** (1) increasing interest on behalf of Foreign Investors – leader destination for FDI in the region; (2) sound fiscal policy (16% flat tax).
- f. **Social advantage:** (1) agreement between Government and major unions; (2) no major union movements; and (3) labour relations regulated by the Romanian Labour Code.
- g. **Legislative advantage:** (1) similar legal provisions as in UE (Acquis Communautaire implementation); and (2) fiscal policy regulated by the Fiscal Code.
- h. **Other advantages:** (1) commitment to improve the highway infrastructure to EU standards; (2) well-developed networks of mobile telecommunications in GSM systems; (3) highly developed industrial infrastructure, including oil and petrochemicals; (4) presence of branch offices and representatives of various well-known international banks; and (5) extensive maritime and river navigation facilities (Romanian Agency for Foreign Investment, 2010).
- i. Given all these advantages, it is not surprising that foreign direct investment in Romania has grown during the past years before the actual global financial crisis (Figure 1).

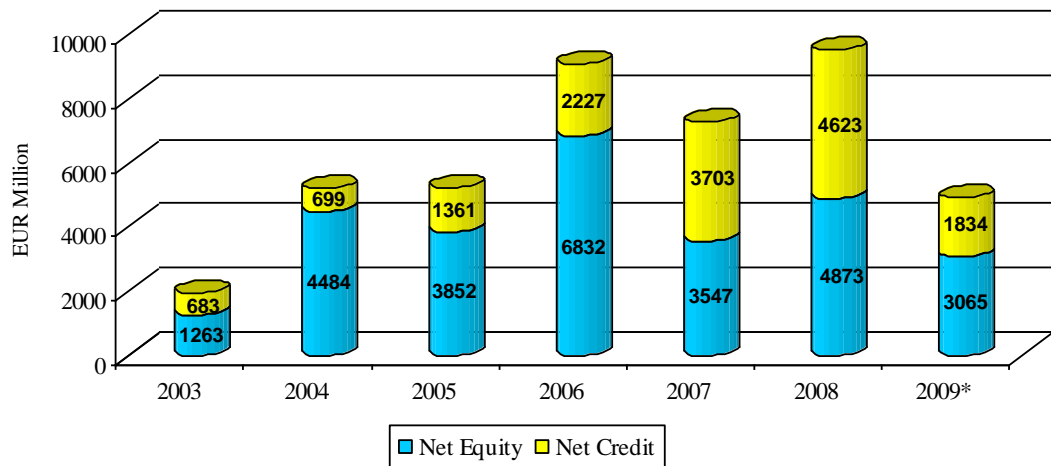


FIGURE 1 - FOREIGN DIRECT INVESTMENT NET FLOW IN ROMANIA
 (* Provisional data)

(Sources: National Bank of Romania, 2010a; National Bank of Romania and National Institute of Statistics, 2010)

Romania is increasingly a welcoming and potentially profitable destination for foreign investment. While certain challenges remain and require continuing attention, measurable progress is being made in many areas and it is internationally acknowledged.

The National Bank of Romania's data from the Balance of Payments for 2009 (provisional data) indicate an inward foreign direct investment value of Euro 4899 million, meaning a reduction with 48.4% as compared to 2008. During 2009, equity stakes (including reinvested earnings) stood at EUR 3065 million (as compared with EUR 4873 million in 2008) and intra-group loans (meaning loans between the foreign investor and the resident company) at EUR 1834 million (compared with EUR 4623 million in 2008). This evolution (-37% for net equity in 2009 as compared to 2008, and -60% for net credit in 2009 as compared to 2008) is due to the economic crisis.

The foreign direct investment stock in Romania during 2003-2008 is illustrated in Figure 2.

The foreign direct investment stock at end-2008 reached EUR 48,798 million, 14% higher than the 2007 final stock, the amount including revaluations due to the exchange rate or price developments and also accounting restatements. Equity stakes (reinvested earnings included) of direct investment enterprises at end-2008 increased 10% versus end-2007, standing at EUR 34,892 million (71.5% of net foreign direct investment final stock). Total net credit received by direct investment enterprises from foreign direct investors, intra-group included, reached EUR 13,906 million, up 23% year on year (28.5 percent of net foreign direct investment final stock). Net credit includes both the medium-term and long-term loans and the short-term loans granted by foreign investors to their direct investment enterprises in Romania, either directly or through other nonresident members of the group (National Bank of Romania and National Institute of Statistics, 2010: 2).

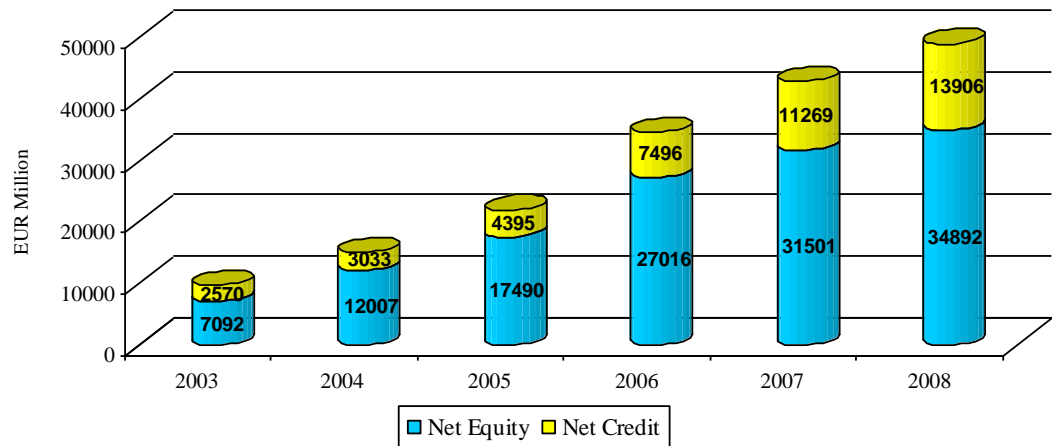


FIGURE 2 - FOREIGN DIRECT INVESTMENT STOCK IN ROMANIA
 Source: National Bank of Romania, 2010b

According to the National Bank of Romania and the National Institute of Statistics (2010: 2-3), by economic activity (NACE Rev. 2), the bulk of foreign direct investment in Romania as of 31 December 2008 (Figure 3) went to manufacturing (31.3% of total), out of which the largest recipients were: metallurgy (6.9%), food, beverages and tobacco (4.6%), oil processing, chemicals, rubber and plastic products (4.3%), transport equipment (4.0%) and cement, glassware, ceramics (3.6%). Despite their large potential, certain sectors (such as textiles, wearing apparel and leather goods) still hold a rather small share, i.e. 1.6% of total foreign direct investment.

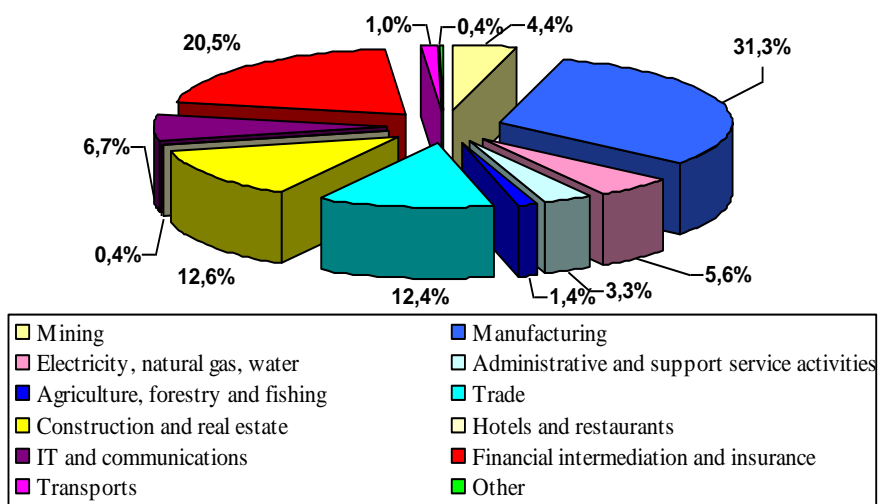


FIGURE 3 - FOREIGN DIRECT INVESTMENT STOCK IN ROMANIA BY MAIN ECONOMIC ACTIVITY
 Source: National Bank of Romania, 2010b

Other activities that have attracted significant foreign direct investment are financial intermediation and insurance, which include banks, non-banks and insurance companies and account for 20.5% of total foreign direct investment stock, construction and real estate (12.6%), trade (12.4%), IT and communications (6.7%).

4. LUKOIL'S INVESTMENT IN ROMANIA

4.1. Lukoil's Activities

On November 25th 1991, the state owned company LangepasUraiKogalymneft was founded in the Russian Federation, which included the associated companies Langepasneftgas, Uraineftgas, Kogalymneftgas, having also crude oil processing capabilities. The acronym LUK was created from the company name LangepasUraiKogalymneft. LUKOIL Company was registered on April 22nd 1993 with the Moscow Trade Register (Lukoil Romania, 2010).

Since its foundation, Lukoil Company has undergone a dynamic development, and nowadays Lukoil is one of the world's leading vertically integrated oil and gas companies. Main activities of the Company are exploration and production of oil and gas, production of petroleum products and petrochemicals, and marketing of these outputs (Lukoil Company, 2010a). In 1994 the first Lukoil shares were made private property and were listed with the secondary stock exchange. In accordance with a Governmental Decree of the Russian Federation issued in 1995, numerous companies acting in the field of oil production, distribution and related services were merged with Lukoil. This resulted in a growth of the oil volume produced from the fields and processed in the refineries owned by Lukoil. ARCO (Atlantic Richfield Company) became one of the major shareholders and strategic partners. In 1996 LUKOIL entered a partnership exploring potentially profitable oil fields in Azerbaijan and Kazakhstan. Also in 1996 an ambitious program was started with a view to create the company's own fleet for petroleum product transport (Lukoil Romania, 2010).

Most of the Company's exploration and production activity is located in Russia, and its main resource base is in Western Siberia (Figure 4). Lukoil owns modern refineries, gas processing and petrochemical plants located in Russia, Eastern and Western Europe, near-abroad countries. Most of the Company's production is sold on the international market. Lukoil petroleum products are sold in Russia, Eastern and Western Europe, near-abroad countries and the USA (Lukoil Company, 2010a).

According to Lukoil Romania (2010), simultaneously with consolidating its existing activities, Lukoil made a number of acquisitions in various sectors of the oil industry. In 1998, the major stock of Petrotel refinery (Romania) and polymer plant Stavropolpolymer (Russian Federation) was purchased. In 1999, the refineries in Odessa (Ukraine) and Neftochim-Burgas (Bulgaria), the petrochemical plant in Saratov (Russian Federation) and the oil company KomiTEK (Russian Federation) were acquired. In 2000 another important

acquisition was made by Lukoil. The American motor fuel distribution company Getty Petroleum Marketing Inc. (about 1260 filling stations in 13 states of the north-eastern US) was taken over by Lukoil.

As mentioned before, Lukoil owns significant oil refining capacity both in Russia and abroad (Figure 5). In Russia the company owns four large refineries at Perm, Volgograd, Ukhta and Nizhny Novgorod. Total capacity of Lukoil facilities in Russia is 44.7 mln tons of oil per year. Lukoil also has refineries in Ukraine, Bulgaria, Romania, and a 49% stake in ISAB refining complex (island of Sicily, Italy), with total capacity of 21.8 mln tons per year. In 2008 Lukoil refined 56.28 mln tons of oil at its own refineries and ISAB complex, including 44.18 mln tons at its Russian refineries (Lukoil Company, 2010a).



FIGURE 4 - LUKOIL IN RUSSIA AND THE WORLD

Source: Lukoil Company, 2009a: 2

A number of projects in the Caspian Sea region lead to strengthening Lukoil's position within the oil industry of this area. In 2000 production began in a new oil field (Severnai) in the northern part of the Caspian Sea. Lukoil takes part in the construction of an oil pipeline in the Caspian Sea area within a consortium. In October 2001, in the processing sector, Lukoil acquired 85.36% of NORSI-Oil stock, which includes one of the largest refineries in Russia. During this period the company's positions were strengthened with a number of acquisitions in the oil production sector. Starting from 2002, Lukoil has been listed with the London Stock Exchange (Lukoil Romania, 2010).

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FIGURE 5 - LUKOIL GROUP REFINERIES
 Source: Lukoil Company, 2009a: 33

Lukoil operates distribution networks in the United States, Poland, Bulgaria, Romania, Turkey, Baltic States, Czech Republic, Ukraine, Belarus, Republic of Moldova, Azerbaijan, Kazakhstan and Kyrgyzstan. The retail petroleum products network includes about 4076 filling stations in Russia and other countries, of which 1691 stations are in Russia and 2385 are located in Europe and the USA (Figure 6). Thus, one can say that Lukoil is the Russian oil company with the widest international diversification and its development rate is among the highest in the world.

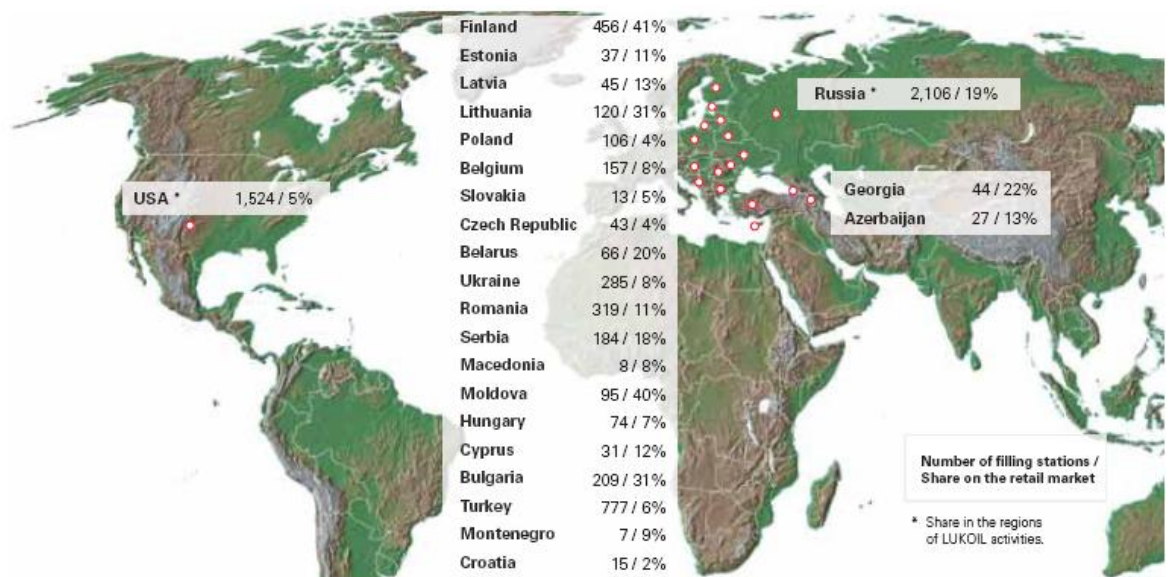


FIGURE 6 - LUKOIL RETAIL NETWORK
 Source: Lukoil Company, 2009b: 63

4.2. Lukoil's Petrotel Refinery

Lukoil Oil Company is the first private company from the Russian Federation that opened the way for investments in Romania by purchasing, in 1998, the majority of shares of Petrotel Refinery from Ploiesti (Figures 7 and 8), one of the Romanian refineries having the longest tradition (founded in 1904). Thus, on the 12th of June 1998 the refinery changed its name to "S.C. PETROTEL-LUKOIL S.A.". Lukoil's management had a proactive attitude towards Romanian oil industry' tradition and expertise, approving a complex program of investment in the oil processing and petroleum products distribution sectors. Lukoil invested over USD 283 million for a wide program of modernization and restructuring of the Petrotel Refinery in Ploiesti. Direct investments in Petrotel Refinery crude oil processing units and equipment represented over USD 230 million, and USD 53 million represented the equivalent value of the shares paid by Lukoil to the Romanian Government when it purchased the Petrotel Refinery. The reconstruction plan included the modernization in parallel of 18 technological and auxiliary units, the construction of 3 new technological units, as well as the automation of the production process management system. The refinery units use the technologies of the most well-known licensing companies like UOP (UK), Exxon-Mobil (USA), Linde (USA), Haldor Topse (Denmark), NPV Himtex and Energo-Service (Russia), etc. (Lukoil Romania, 2010). Therefore, Petrotel-Lukoil can be referred to as one of the pioneers among Romanian refineries for implementing a number of state-of-the-art technologies.



FIGURE 7 - MAP LOCALIZATION OF LUKOIL'S PLOIESTI REFINERY

Source: Lukoil Company, 2009b: 51

During 2002-2004 the first stage of a complex modernization and reconstruction process was completed. The goal of this process was to carry out a technological upgrade in order to ensure refined products that meet the EURO 3 and EURO 4 quality standards now in effect in Romania. The refinery reconstruction plan also

provided for modernization of 18 technological units including their auxiliary structures, building 3 technological plants and automation of the technological process control system (Lukoil Romania, 2010).

In compliance with the Romanian Government's decisions and the European Union's recommendations, starting from the 1st of July 2007, the company sells biofuels (biodiesel), their share being of minimum 2% from the total motor fuel sales.

Lukoil's investment and business activity creates an impressive impact on the Romanian economy. More than 5000 people are employed by Lukoil in Romania, of which more than 1200 in the Petrotel-Lukoil refinery. Other 2500 persons work within the construction and service providing companies directly involved in the investment programs. The companies of the Lukoil Group that operate in Romania obtained the audit certification regarding the standardization of the quality management systems, environment protection, industrial and labour safety, in accordance with the ISO 9001, ISO 14001 and OHSAS 18001 international standards. The total investment volume achieved by Lukoil in the Romanian oil sector amounts to over half a billion USD (Lukoil Romania, 2010).



FIGURE 8 - PETROTEL-LUKOIL PLOIESTI REFINERY

Regarding the retail, Lukoil Romania implements an investment programme meant to build corporate retail stations along the pan European transport corridors, guaranteeing European standards for products and services to the customers. In this respect, the amount of about USD 20 million has been invested in 2007, including the modernization and efficiency increasing of the existing stations (Figure 9). The integrated system of crude oil processing and petroleum products distribution allows the company to obtain motor fuels of very good quality. It is easy to recognize "LUKOIL" brand, as Romanian drivers associate it to a high quality of the petroleum products and with reasonable prices (Lukoil Romania, 2010).



FIGURE 9 - LUKOIL'S RETAIL NETWORK IN ROMANIA
 Source: Lukoil Romania, 2010

Petrotel-Lukoil produces and markets, both in Romania and for export destinations, products that meet the EURO 5 standards, namely: (1) SUPER EUROLUK COR 98; (2) EUROLUK COR 95; (3) Diesel EURO 5 with a sulphur content of maximum 10 ppm; (4) LPG; and (5) PROPYLENE (Figures 10 and 11).

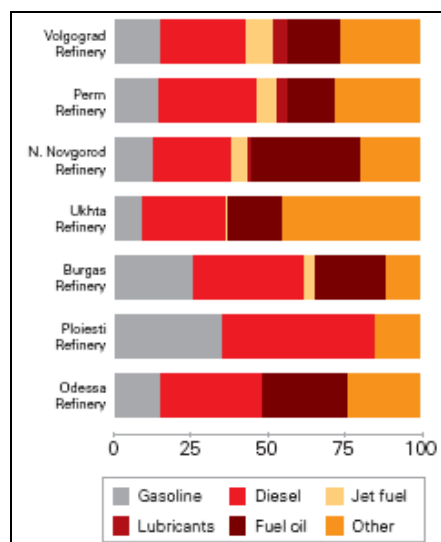


FIGURE 10 - OUTPUT OF MAIN PETROLEUM PRODUCTS AT LUKOIL REFINERIES (2008), %
 Source: Lukoil Company, 2009a: 34

In 2007, Power supply unit No. 4 with the capacity of 25 megawatt (MW) was commissioned at the refinery, increasing the total power capacity of the heat electric generating station up to 61 MW. It provided the refinery with a complete supply of electric and thermal power, and helped arrange thermal power supplies to Ploiesti's municipal facilities. Project investments amounted to over USD 24 million. In addition to that, an Integrated Control Room was commissioned at Petrotel refinery which helped introduce a new approach to refinery management system and optimize production processes. Petrotel-Lukoil is the first Lukoil's refinery which has implemented a pilot project titled *Integrated Control Room*. The Integrated Control Room is an automated complex which helps promptly manage technological processes at separate units, and to provide online response to any changes in production cycle of the whole plant. Operating model of the Integrated Control Room is based on modern software and hardware solutions. The Integrated Control Room Project helped align all management systems of the refinery in a blast-resistant area. Project investments came to about USD 3 million (Lukoil Company, 2007).

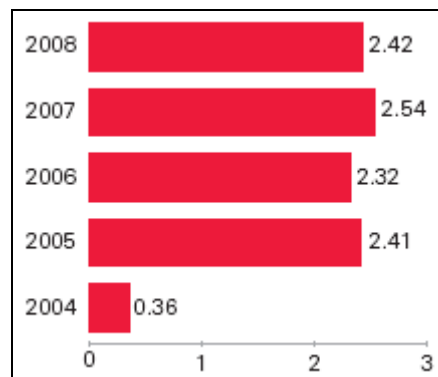


FIGURE 11 - PLOIESTI REFINERY THROUGHPUT, MLN TONS
 Source: Lukoil Company, 2009b: 51

The reconstruction process made possible for Petrotel – Lukoil to become one of the leading companies in the petroleum industry, the depth of crude oil processing being significantly increased, which resulted in a higher quality of the finished products, and a considerable reduction of the atmospheric emissions (Figure 12). However, according to Alpogi and Colesca (2010) the level of the atmospheric pollution is high in many areas in Romania, including Ploiesti, exceeding the maximum permitted concentration for many hazards discharged into the environment, such as suspensive and settled dusts.

The Petrotel-Lukoil refinery completed the bulk of required work to enable production of fuels to Euro-5 standards from 2009 and to improve levels of environmental safety at the refinery. Upgrading work was completed in 2008 on units for FCC gasoline hydrotreatment, the catalytic cracking unit, and also on the vacuum block of distillation unit No.1 (Lukoil Company, 2009c: 45).

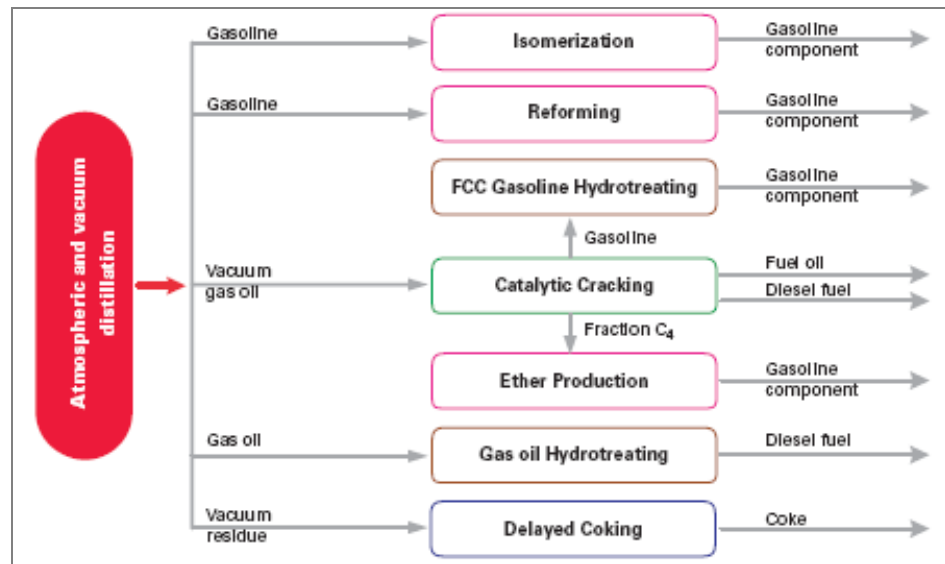


FIGURE 12 - CONVERSION PROCESSES WITHIN PLOIESTI REFINERY

Source: Lukoil Company, 2009b: 51

In 2009, the production at Petrotel-Lukoil refinery was 7.4% lower compared to 2008, due to overhaul performed at the refinery in January-February 2009 (Lukoil Company, 2010b: 8). As a result of Romania joining the European Union in 2007, Petrotel-Lukoil S.A. is required to upgrade its refining plants to comply with the requirements of the European Union legislation in relation to the quality of produced petroleum products and environmental protection. These requirements are stricter than those which previously existed under the Romanian legislation. Therefore, Lukoil Company estimates the amount of future capital commitment required to upgrade Petrotel-LUKOIL S.A. to be approximately \$44 million in 2010 (Lukoil Company, 2009c: 142; Lukoil Company, 2010b: 31).

5. CONCLUSIONS

This study has shown that the first private company from the Russian Federation that opened the way for investments in Romania, that is Lukoil, has plenty invested in developing Petrotel-Lukoil refinery and despite the actual economic and financial crisis the company has plans for new investments. Another conclusion of this study is that Romania is an attractive country for foreign direct investment, and moreover, the oil industry has developed due to Lukoil's investment in Petrotel refinery. However, we suggest that further research should be done in order to find solutions to improve the Romanian business environment. The results reported in this study may be used as a starting point for further research in the area of foreign direct investment endorsement.

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