CENTER FOR THE STUDY OF DEMOCRACY

ASSESSING RUSSIA'S ECONOMIC FOOTPRINT IN SERBIA

Policy Brief No. 72, January 2018

Overview

Russia's economic footprint has been growing in the Western Balkans for at least a decade. The gradual takeover of the Serbian energy sector by Russian state-owned and -affiliated firms is the most visible manifestation of this trend. Russian firms and their Serbian domestic intermediaries have targeted in particular large companies with weak corporate governance. Because these companies typically have only a handful of capable managers, Russian and associated Serbian entities have been able to win largely uncontested and in many cases unilaterally enriching contracts. Among the four countries under this study, the Russian economic footprint in Serbia is the largest in terms of Russian companies' revenue as a share of the total turnover of all Serbian businesses. Russian entities, directly or indirectly, affect as much as 10 % of the Serbian economy. Notably, Russia's corporate presence, measured by volume of revenue and assets controlled by Russian companies in Serbia, is even larger than in Montenegro, where Russian foreign direct investment (FDI) is a third of the country's gross domestic product (GDP).

There are two main, interconnected factors in Russo-Serbian relations that have laid the foundations

KEY POINTS

- There are two main factors that have laid the foundations for Russia's expanded presence in Serbia: Russian support for Serbia's non-recognition of Kosovo and the 2008 energy agreement.
- Russian-owned or indirectly linked firms in Serbia control revenues of close to EUR 5 billion, or 13 percent of the total revenues generated by the local economy.
- The indirect Russian footprint has different forms, including: 1) local companies' dependence on Russian raw material imports, i.e. natural gas; 2) debts accumulated for gas supply; and 3) domestic companies' dependence on exports to Russia and/or Russian-controlled bank loans, for example Agrokor's subsidiaries.
- In addition to the corporate investments, Russia has used direct government-to-government loan schemes to expand its footprint in the Serbian economy.
- The Russian economic footprint is most visible in the energy sector, where Gazprom and Lukoil dominate the oil and fuels markets; Serbia is almost fully dependent on natural gas imports from Russia; and local politically-connected intermediaries prevent supply diversification and market liberalization.
- Russia has compounded its political ties with Serbia and its economic presence in the country by leveraging traditional pro-Russian, pan-Slavic, and pan-Orthodox attitudes via a series of Russia-inspired soft power initiatives.

This report was compiled using publicly available sources and databases. CSD would like to thank Dr. Igor Novakovic, Research Director at the International and Security Affairs Centre – ISAC Fund and Nemanja Todorović Štiplija, Editor-in-Chief, European Western Balkans who contributed to the analysis, as well as Dr. Dimitar Bechev, Research Fellow, Center for Slavic, Eurasian, and East European Studies, University of North Carolina at Chapel Hill and Ilya Zaslavsky, Research Expert, Free Russia Foundation and Academy Associate at Chatham House, for providing valuable comments.

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This publication is supported by a grant from the Center for International Private Enterprise (CIPE) in Washington D.C. The document does not reflect CIPE's opinions or any employee thereof. CIPE is not responsible for the accuracy of any of the information included.

for Russia's expanded power in the country. One is Russian support for Serbia's non-recognition of Kosovo's unilateral declaration of independence, and the second is a 2008 energy agreement that included Gazprom's takeover of Serbia's largest Serbian company, the oil and gas firm Naftna Industrija Srbije (NIS). The agreement sold NIS at a below-market price and approved a new long-term contract with the Yugorosgaz intermediary company, which, in effect, appears to be a shell company majority-owned by Gazprom. The 2008 agreement also included provisions for Serbia to join the South Stream project. Although work on the project ended in December 2014, South Stream's dominance over the Serbian energy agenda for the past decade slowed key diversification projects, market liberalization efforts, and the implementation of critical EU energy commitments. Moreover, Russia has effectively reincarnated the South Stream project as Turkish Stream, which could be read as a continued attempt to lock Serbia into an asymmetrical energy relationship.

Gazprom's terms in the 2008 natural gas agreement have weakened the financial solvency of the state-owned wholesale gas supplier, Srbijagas, and have ballooned the debt of other petrochemical and large industrial companies. High import prices dictated by Gazprom and the limited liberalization of the domestic market have caused a large accumulation of debt in the energy sector (primarily in the state-owned gas supplier, Srbijagas). The gas debt accumulated in the energy sector has, over time, translated into state debt, which severely limits the country's financial firepower.

Moreover, the far-reaching energy agreement appears to have energized Russian involvement in other sectors of the Serbian economy. For example, Russia has sought economic cooperation in railway infrastructure projects and the banking industry. Although in comparison with Serbia's total trade with the EU and the EU's investments in Serbia, Russia's economic presence is comparatively small, the Russian footprint is concentrated in several strategic sectors that affect the whole economy.

Over the past decade, Russia has compounded its political ties with Serbia and its economic presence in the country by leveraging traditional pro-Russian, pan-Slavic, and pan-Orthodox attitudes via a series of soft power initiatives. Sputnik, a Russian state-owned media company, has worked with some Serbian media owners to provide content directly through their local branches. Whether directly or indirectly, the promotion of ideas sympathetic to Russia provides a narrative to the Serbian population that appeals to anti-NATO and anti-EU sentiments.

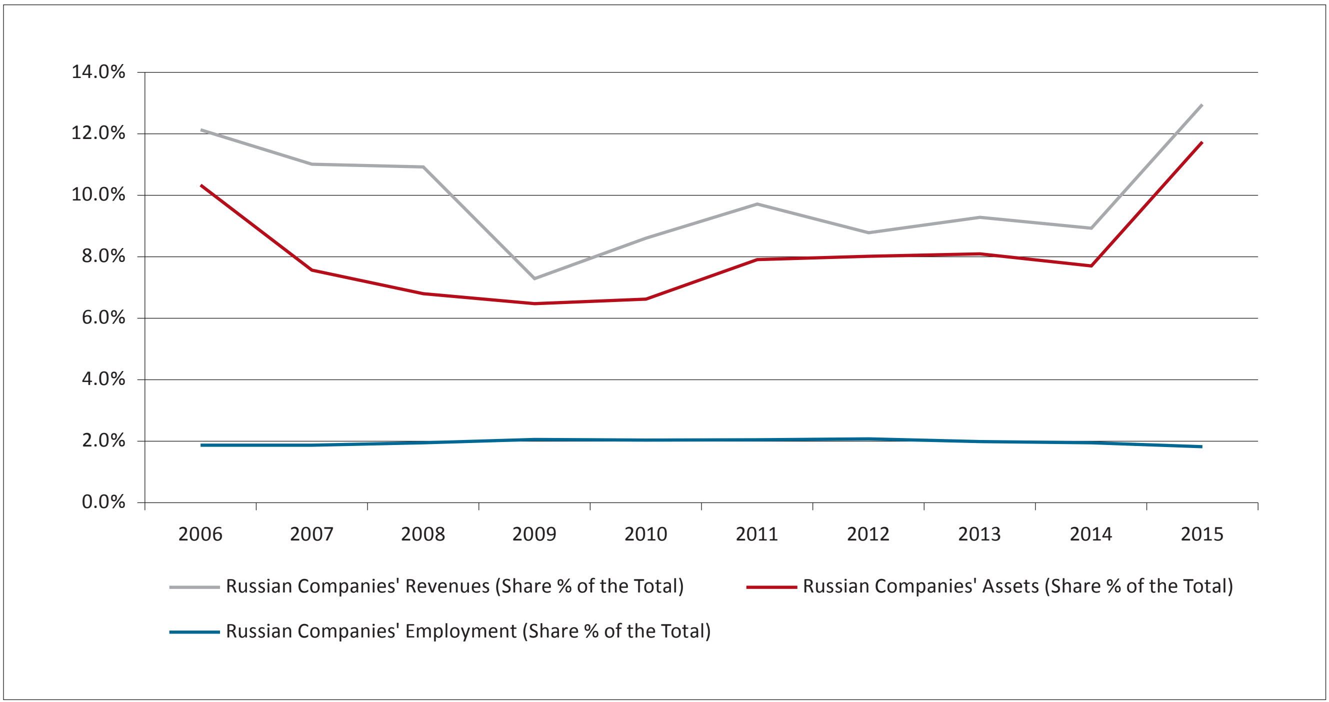
Moreover, Russia has used high-level political visits to strengthen political ties and impress upon ordinary Serbians that Russia is a strong foreign policy actor and ally. In the background, Russian companies and Russian officials have built networks that take advantage of Serbian governance deficits, such as opacity in economic decision-making, the lack of accountability among the management of state-owned companies and a lack of regulatory independence.

Russia's Economic Footprint in Serbia

Russia's effort to increase its political and economic leverage in Serbia dates back to 2008, when Russia sided with Serbia's position against Kosovo's declaration of independence. Russia's support for Serbia's stance coincided with the takeover of NIS and the commitment by Serbia to join Russia's South Stream pipeline initiative, which defined the energy policy thinking of Southeastern European policy-makers for ten years.[1] Gazprom also gained control over the wholesale gas supplier, Srbijagas, via a long-term gas import contract that utilizes a politically-connected intermediary company, Yugorosgaz. This intermediary is controlled by Gazprom and managed by a board of directors, one member of which is Srbijagas' CEO who

[1] Polterman, Andreas. "Serbia Caught between Two Chairs? Does Serbia Want to be Part of the Russian Sphere of Influence or Join the European Union?" Heinrich Böll Stiftung in Serbia, Montenegro and Kosovo, 10 December, 2014.

Figure 1. Russia's Corporate Footprint in Serbia



Source: *CSD calculations based on a commercial corporate database survey using ultimate beneficial ownership as criteria.*

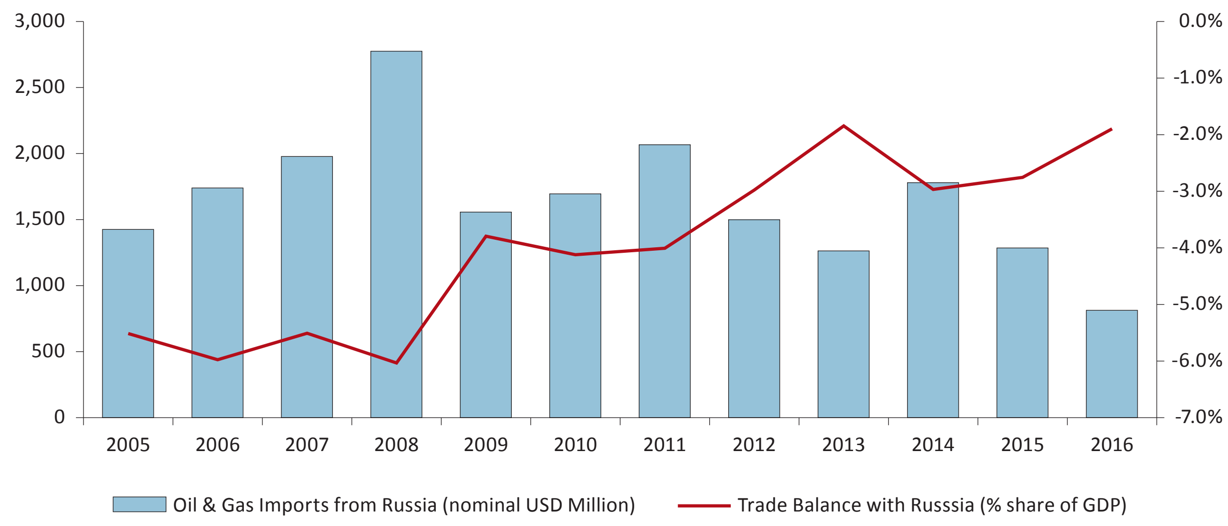
is a Vice President in the government's junior coalition partner, the Socialist Party.

Russia has firmly entrenched itself in the Serbian oil and gas sector. Serbia imports close to 65 percent of its natural gas needs and more than 70 percent of its crude oil consumption from Russia. However, the fall of energy prices since 2014 pushed down Serbia's oil and gas import costs from USD 2.06 billion in 2011 to just USD 812 million in 2016, or from 5.4 percent to 1.8 percent of Serbian GDP (see Fig. 2). Correspondingly, as energy resource imports make up most of the bilateral trade between the two countries, the Serbian trade deficit with Russia has also dropped significantly. Although these factors have decreased the financial burden from excessive dependence on one supplier, Russia remains the country's most important energy partner. Critically, Russia still dominates Serbia's domestic oil and gas production via ownership stakes in NIS, and controls the wholesale and retail fuel market through Gazprom Neft and Lukoil.

Apart from the energy sector, Russian FDI in Serbia has remained small. From 2005 to 2016, Russian investment amounted to 4 percent on average annually of all FDI in Serbia. Russia invested a total of around USD 1.1 billion, or a bit less than 3 percent of Serbian GDP over this period. However, this figure underestimates the true value of Russian investment in the country; for example, our research shows that NIS, Lukoil and Sberbank, among others, have invested in Serbia through intermediary states such as Austria and Netherlands. NIS has invested at least USD 1 billion since Gazprom's purchase of it in 2008, and Lukoil has invested additional USD 250 million. Hence, a more realistic estimate of total Russian FDI (including indirect investments) would be around USD 2 billion, or 6 percent of the country's GDP.

In addition to corporate investments, Russia has used direct government-to-government loan schemes to expand its footprint in the Serbian economy. During the Serbian fiscal crisis in 2012 – 2013, Serbia asked Moscow for a loan to buttress the Serbian budget. This could be read as an effort to avoid asking for assistance from the International Monetary Fund (IMF), which would require structural reforms. Russia agreed to lend Serbia USD 500 million and disbursed USD 300 million immediately

Figure 2. Oil and Gas Imports and Trade Balance with Russia



Source: *CSD calculations based on data from the National Statistical Agency of Serbia.*

to keep the country afloat. At the same time, Serbia borrowed additional USD 800 million from Moscow to modernize the country's outdated railway infrastructure. At an annual interest rate of 4.1 percent, the Russia loan had less favorable conditions than typical loans from European development financial institutions such as the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB). Moreover, the second loan granted preferential status to Russian state-owned contractors for the infrastructure modernization projects.[2] This loan was not debated publically, and it seems that Serbia agreed to the terms of exclusive access for Russian contractors in violation of EU norms on competition and transparency in public procurement. Moreover, the loan negotiations happened concurrently with negotiations between Gazprom and Srbijagas for the 10-year gas supply contract.

The result was a long-term contract to deliver up to 5 billion cubic meters (bcm) per year of natural gas, twice the amount of gas supplied by Gazprom from 2001 to 2011 and 40 percent more than Serbia's average annual gas demand. However, Gazprom set a 1.5 bcm minimum threshold for the annual volume of Serbian gas purchases, somewhat alleviating the initial worries that Serbia would be paying for much more gas than it actually needs.[3] On December 19, 2017, Yugorosgaz and Gazprom signed an addendum to the Russian gas supply contract to increase the volume of gas supplies to Serbia from 1.5 bcm to 2 bcm, starting from 2018, although Serbia imported only 1.75 bcm in 2016.[4] The contract's amendment came on the tail of two preliminary agreements between Gazprom and Serbia to expand transmission and storage facilities, including that of Banatski Dvor, an underground gas storage facility from 450 to 750 million cubic meters (mcm).[5]

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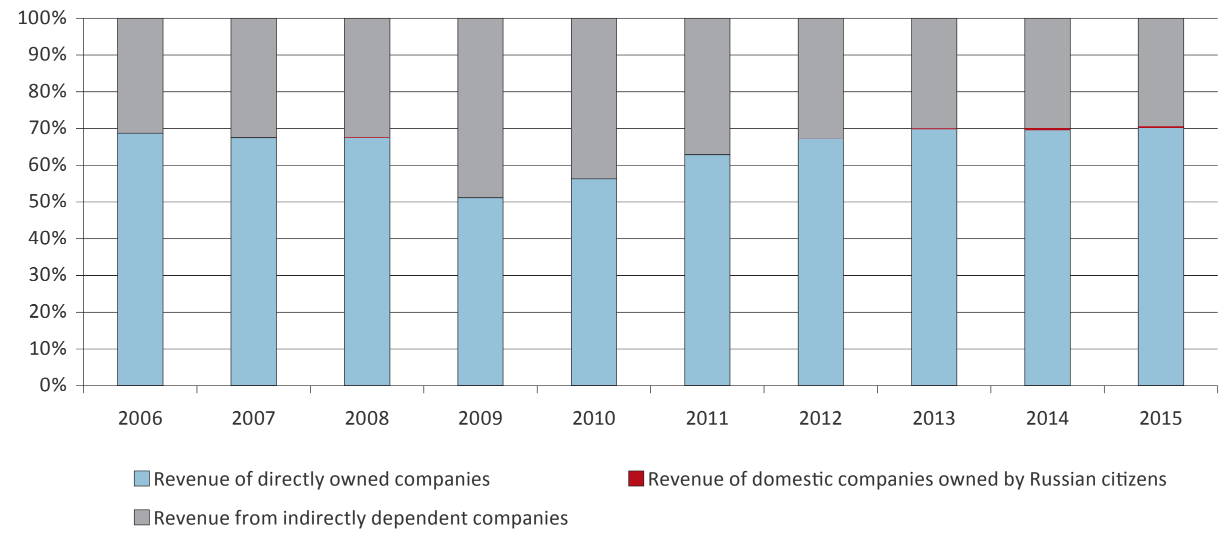
[2] For example in June 2017, the German development bank, KfW, lent Serbia EUR 17 million for new water supply infrastructure. See https://seenews.com/news/serbia-gets-17-mln-euro-loan-from-kfw-for-water-supply-projects-571661

[3] Reuters (2011). "Srbijagas agrees 10-yr gas import deal with Gazprom," 21 December, 2011, accessed on 24 November at http://www.reuters.com/article/serbia-gazprom-gas/srbijagas-agrees-10-yr-gas-import-deal-with-gazprom-idUSL6E7NL4H320111221

[4] Gazprom Export webpage dedicated to the relations with Serbia, accessed on 2 January, 2018 at http://www.gazpromexport.ru/en/partners/serbia/

[5] Ibid.

Figure 3. Structure of Russia's Corporate Presence in Serbia



Source: *CSD calculations based on data from a commercial corporate database.*

During Serbia's fiscal crisis, Russia further deepened its presence in the Serbian economy through loans, contracts, and investments. In our view, Russian state-administered and -controlled companies have won favorable repayment terms, gained preferential treatment to work in country, and forced unnecessary energy purchases on the country's balance sheet. The renegotiation of the natural gas contract has significantly changed the Serbian energy import scheme and has gone largely unnoticed by the public. A Russian-owned company effectively took control of the Serbian natural gas sector without much public discussion.

Russia's economic presence is most salient in the corporate arena. In Serbia, approximately 1,000 companies are entirely or partly Russian-owned.[6] Russian-owned or -connected firms in Serbia control revenues of close to EUR 5 billion, or 13 percent of the total revenues generated by the local economy. As will be described below, the indirect footprint of Russian companies takes different forms, including: 1) local companies' dependence on Russian raw material imports, i.e. natural gas; 2) debts accumulated for gas supply; and 3) domestic companies' dependence on exports to Russia or Russian-controlled bank loans, for example Agrokor's subsidiaries.

Meanwhile, Russian entities directly or indirectly control between 8 percent and 10 percent of all assets in the Serbian economy. This is despite the lower-than-market valuation of NIS' oil and gas reserves and the decapitalization of some petrochemical plants, the gas debt of which has been transformed into equity for Gazprom. Russian state-owned and private oil and gas companies own almost all domestic oil and gas reserves, control over half of the wholesale and retail fuels markets, and indirectly affect the financial management and corporate governance of state-owned gas supplier Srbijagas, as well as that of its important industrial clients. Russian companies are also major employers in the country, directly employing approximately 2 percent of the total labor force and indirectly employing around 5 percent (roughly 70,000 people in total). Such employment is concentrated in just a few industrial enterprises.

Two of the biggest Russian-led mergers and acquisitions in the energy sector are Lukoil's takeover of Be-

6 According to an analysis of company data in a commercial corporate database.

opetrol in 2003, and NIS and Lukoil's buy-up of shares in petrochemical plant Petrohemija. After the latest conversion of Petrohemija's debt into its ownership in 2017, NIS and Lukoil own around 23 percent of its shares, while the rest is in the hands of state-owned companies including Srbijagas (32 percent). Srbijagas has been involved in the partial takeover of several of its gas clients, including Azotara and MSK, and even companies in other industries such as Srpska Fabrika Stakla, Toza Marković, and Agroživ. All these companies accumulated large gas debts with the national supplier.

Russian presence in the finance, banking, and insurance sectors is limited but has expanded significantly in the past years, as three Russian-owned banks, Sberbank,VTB (state-owned) and Expobank entered the market. However, their market share is minimal, as they are not among the top 10 biggest banks in the country. There is the possibility that the 2017 Agrokor crisis could increase Sberbank's footprint via an expanded share in Agrokor's debt-ridden subsidiaries in Serbia, including Merkator-S, the biggest retail chain in Serbia.

Furthermore, exports to Russia have become an important aspect of the economic relationships between Russia and Serbia, following the expansion of the free trade agreement signed in 2000. A Russian embargo on the import of EU agricultural and food products has provided a boost to exports from non-EU countries in the Western Balkans. Since 2011, Russia has ranked consistently among the top five export destinations for Serbian goods, with more than 5 percent of all Serbian exports ending up in the Russian market, which contributes to about 2 percent of the Serbian economy. Between 2005 and 2015, Serbian exports to Russia rose four-fold to more than USD 1 billion, the largest amount by volume for the Southeastern European region after Greece.

Even though Serbian officials continue to emphasize that the free trade agreement is a unique instrument that will enable more rapid economic development in Serbia, the true effects of this agreement on Serbian exports have been humble at most.[7] Several obstacles persist; in particular, Russia maintains strict import criteria, and Serbia has only modest production capacity. Some of Serbia's most valuable manufactured goods are not on the list of duty-free products in Russia. For example, Russian officials on several occasions did not grant Serbian-produced Fiat cars duty-free status, while Serbia's exports to Russia are predominantly machinery and transport equipment, medical and pharmaceutical products, and agricultural products. In 2016, 815 Serbian companies exported goods to the Russian market. A quarter of all Serbian exports to Russia have been in agricultural goods because of the Russian embargo on EU-produced agricultural goods. In June 2017, Mlekara Sabac, one of the largest dairy companies in Serbia, which exports 75 percent of its white cheese to Russia, announced that it would build a factory in Russia with a production capacity of 450 tons of milk, equivalent to the output of some of the biggest dairy farms in the Western Balkans.[8]

Vulnerable Sectors

Energy

Serbia is an energy-poor country that imports much of its energy resources, with the exception of coal. The country has limited oil and gas reserves, with 77.4 million barrels and around 4.8 bcm in storage, respectively. Currently, the only two gas supplies in Serbia are from local gas fields in Vojvodina, and Russian imports via Hungary and Ukraine (the Beregovo metering station).[9] Local gas production currently satisfies only 16 percent of Serbia's needs and, despite some exploration activity since 2010, it is difficult to imagine a significant increase in pro-

7 Xinhua (2017). *"Russia wishes to further strengthen ties with Serbia: Russian official,"* 6 June, 2017, accessed on 24 November, 2017 at http://news.xinhuanet.com/english/2017-06/06/c_136342229.htm

8 Ralev, Radomir (2017). "Serbian dairy group Mlekara Sabac to build factory in Russia," SeeNews, 2 June, 2017, accessed on 2 January at https://seenews.com/news/serbian-dairy-group-mlekara-sabac-to-build-factory-in-russia-570858#sthash.t2ujHIjr.dpuf

9 Energy Community. (2017). Serbia Gas Chapter in the 2017 Annual Implementation Report. October 15, 2017.

duction. The share of imports in crude oil dropped from approximately 80 percent in 2006 to about 60 percent in 2015, because of renewed exploration activity by NIS.[10] Due to the high share of coal and hydropower in overall electricity production, Serbia is one of the least electricity-dependent countries in Southeastern Europe. Coal, mainly domestic lignite, represents 53 percent of gross inland energy consumption.[11] Nonetheless, 47 percent of Serbian energy consumption is imported from Russia.

It is through the energy sector that Russia truly exerts its economic leverage in Serbia – one of the hardest hit countries in the wake of the 2009 gas supply crisis. The country's gas imports are fully dependent on Russia and the supply pipeline route through Ukraine, Slovakia, and Hungary. Instead of seeking to diversify its gas supply through strategic pipeline interconnectors with Bulgaria and Croatia, Serbia has remained an energy island that has devoted considerable effort to promoting Gazprom-controlled pipelines. Not surprisingly, Serbia pays one of the highest gas import prices in Europe, which has dissuaded local residents from pursuing domestic gasification and has pushed them out of the district heating systems that use natural gas in large urban centers, and into burning coal and wood, as well as using electricity for heating purposes.

In 2016, Serbia's oil and gas imports (mainly from Russia) accounted for less than 2 percent of the country's GDP, down from over 5 percent in 2005. Yet Russia has firmly occupied a crucial decision-making position in the energy sector in Serbia for the past decade. In 2008, Serbia concluded a wide range of intergovernmental 30-year agreements, including the sale of 51 percent of then-state-owned NIS to Gazprom, as well as a majority stake in the country's only gas storage facility, Banatski Dvor, for a total of USD 400 million. Russia bolstered the agreement with a firm pledge to build the 63-bcm gas pipeline, South Stream, which would cross the Black Sea before crossing Bulgaria, Serbia, and Hungary, ending at Austria's Baumgarten hub. Although the project has since been shelved, South Stream captivated the imagination of Serbian energy policy-makers for the six years it was active. For example, at the outset, Srbijagas founded a joint project company with Gazprom to build Serbia's portion of the South Stream pipeline. According to an investigative report by *Insider,* the national gas supplier spent roughly USD 35 million for the project's preparatory activities.[12] However, in reality there has been no visible progress in the completion of the pipeline in both the feasibility and engineering parts of the project.

If Serbia wanted access to the windfall of benefits that South Stream could provide, it would have had to accept other unsatisfactory conditions, including not completing alternative projects providing for potential future gas diversification. For example, by focusing entirely on South Stream, Serbia did little to advance the strategic gas interconnector with Bulgaria, which could establish an alternative gas supply route from Azerbaijan via the Greece-Bulgaria interconnector and the Trans-Adriatic Pipeline. Despite a Bulgarian-Serbian intergovernmental agreement on the construction of the interconnector in 2017, no concrete steps have been taken to complete the project; funding has not yet been sourced and a project management company has not been set up.

When the South Stream project fell apart in 2014 due to the objections of the European Commission to the pipeline project's violation of EU energy and competition law, the Russian president replaced South Stream with Turkish Stream in December 2014, and proposed the hastily-designed extension TESLA. TESLA is supposed to link to the proposed Turkish Stream project and bring Russian gas to Europe through Greece, Macedonia, Serbia, Hungary, and end in Austria. Turkish Stream has a proposed

[10] According to the Serbian energy balance statistics of the International Energy Agency accessed on January 2, 2018 at https://www.iea.org/statistics/statisticssearch/report/?country=SERBIA&product=oil&year=2006

[11] Data from the European Energy Community, 2012.

[12] In 2016, a team of investigative journalists tried to uncover where the amount of 30 million EUR was invested and why. They were however left without any answer. See "Plaćamo i za ugašeni projekat Južni tok?" Insider, 11 March, 2016, https://insajder.net/sr/sajt/tema/454/

Table 1. Gas Import Prices in Serbia (USD/1,000 cubic meters)

Year	January-March	April-June	July-September	October-December	Average
2004	118	121	124	134	**125**
2005	147	157	177	207	**167**
2006	228	224	255	166	**248**
2007	265	248	252	283	**271**
2008	339	382	447	496	**416**
2009	440	334	245	273	**323**
2010	327	357	372	374	**357**
2011	384	420	478	483	**441**
2012	477	491	491	497	**489**
2013	419	410	397	396	**405**
2014	390	395	398	390	**394**
2015	350	286	235	199	**267**

Source: *Presentation "Пословање ЈП Србијагаса у 2015 и очекивања у 2016 години," Srbijagas, March. 2016, p. 9.*

capacity of 31.5 bcm,[13] of which Turkey expects to consume about 16 bcm.

Kosovo's unilateral declaration of independence in February 2008 appears to have catalyzed the 2008 energy agreement between Russia and Serbia. It appeared that the Serbian leadership at the time sought to bring Russia into the Western Balkans as a counterbalance to the West. Since the early 1990s, the success of Russian energy policy in Serbia typically relied on close connections to the senior leadership of the Serbian Socialist Party (SPS). The links established between SPS and Gazprom were revived in the second half of the 2000s, when senior SPS members rose to high management positions in many state-owned energy companies. With the 2008 agreement, Gazprom gained a bigger-than-ever say in the financial management and governance of Srbijagas. For instance, Dusan Bajatovic serves as both a CEO of the national gas supplier and a Vice President in the SPS. The Serbian media considers him the principal pro-Gazprom player in Serbia. Bajatovic has kept his position for almost a decade with alleged support from Moscow.[14] Additionally, Serbia's Anti-Corruption Agency claimed in 2014 that his corporate positions could be a source of conflicts of interest,[15] but he has so far defied the criticism.[16] Bajatovic has openly opposed gas supply diversification, an otherwise widely popular concept that would lower gas prices for Serbia. Strikingly, on a number of occasions, he has even expressed on-the-record viewpoints that directly conflict with some of the government's and energy ministry's proposals.

The asymmetrical relationship between Gazprom and Serbia has indirectly affected the financial health of a range of gas-dependent companies. State-owned firms accumulated EUR 200 million in debt to Srbijagas between 2006 and 2013, due to Gazprom's price

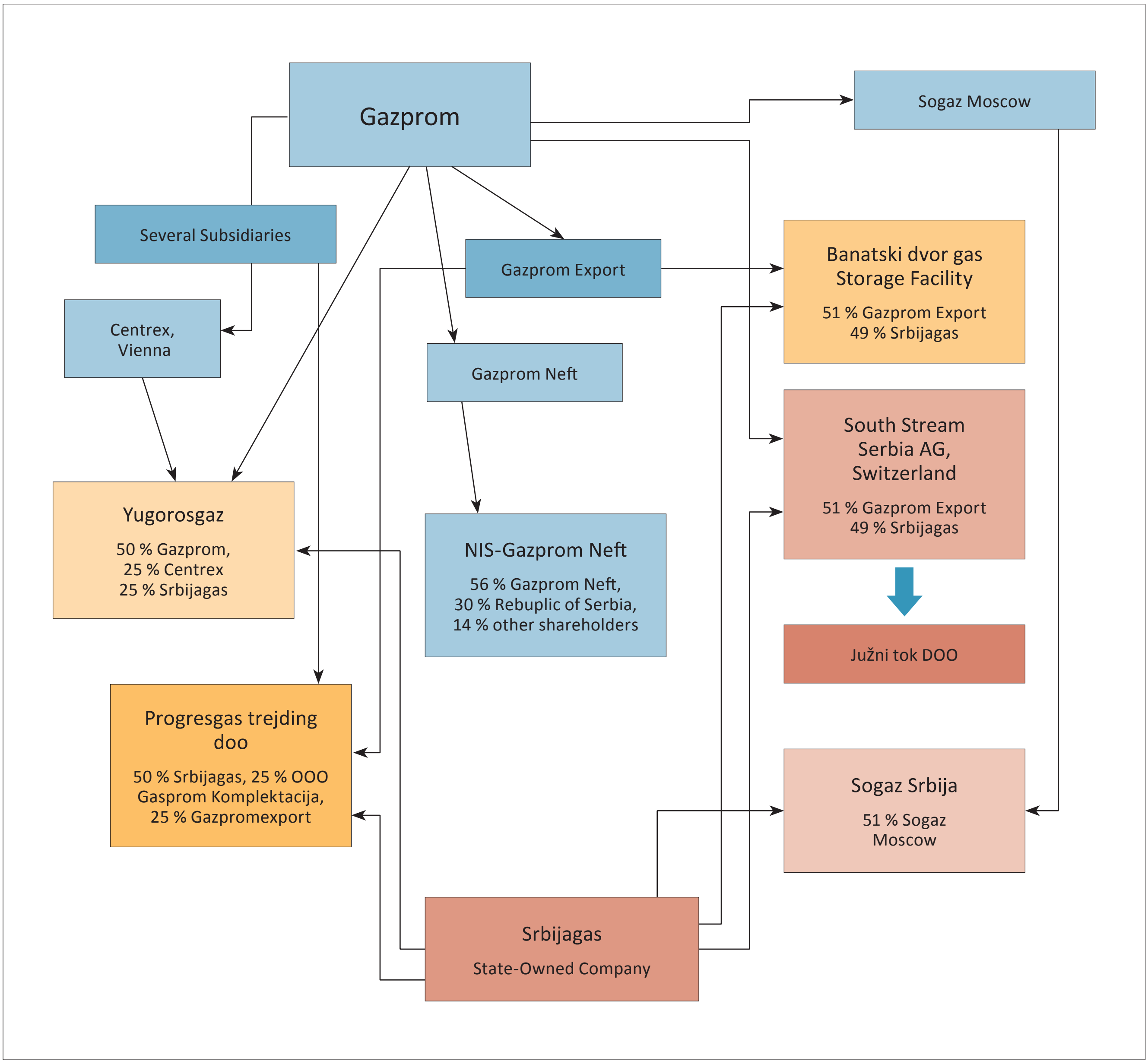
13 "Perspective for 'Turkish Stream' Project: Possible Scenarios and Challenges," Natural Gas World Website, 27 January, 2017, https://www.naturalgasworld.com/perspective-for-turkish-stream-project-possible-scenarios-and-challenges-35401

14 For example see G.V, "Ruska drugarska podrška Bajatoviću," Danas, 1 April, 2016 http://www.danas.rs/danasrs/ekonomija/ruska_drugarska_podrska_bajatovicu.4.html?news_id=258344 and "Rusi ne daju Bajatovića", Novi Sad news portal 021, May 17, 2016, http://www.021.rs/story/Info/Srbija/135604/Rusi-ne-daju-Bajatovica.html

15 "Case – Dušan Bajatović", Anti-Corruption Agency of the Republic of Serbia, 18 September 2014, accessed on January 18, 2018 at http://www.acas.rs/wp-content/uploads/2015/09/Dusan-Bajatovic-slucaj.pdf?pismo=lat

16 Biljana Baković, "Kako je Bajatović zadržao sve funkcije," Politika Online, 10 April, 2016. http://www.politika.rs/sr/clanak/352864/Politika/Kako-je-Bajatovic-zadrzao-sve-funkcije

Figure 4. Gazprom Ownership Tree in Serbia



Source: *CSD description based on a commercial corporate database analysis.*

policies and its inflexible long-term gas import contract. These financial losses are a result of the mismatch between the high price of gas imports and the low domestic price paid by consumers. It appears that domestic consumer prices are heavily subsidized, in part to prevent social unrest. Moreover, Srbijagas has been unable to pursue its claims on the debts accumulated by several large state-owned enterprises (SOEs), such as Azotara Fertilizer Plant, Petrohemija, Smederevo Steel Mill, and some municipal district heating companies, as this could make the companies insolvent, endangering thousands of jobs or even the heating supply to big cities. Ultimately, a considerable part of Serbian heavy industry has depended on the supply of cheap natural gas both from NIS' domestic sources and from Srbijagas's imports. The global economic crisis in 2009 however prompted some significant takeovers by Srbijagas or the state.[17] For exam-

[17] "Srbijagas: Gas, staklo, pilići...", B92, December 14, 2010, accessed on January 18, 2018 at https://www.b92.net/biz/vesti/srbija.php?yyyy=2010&mm=12&dd=14&nav_id=479101

ple, Azotara Fertilizer Plant, Petrohemija and Smederevo Steel Mill, which are not owned by Srbijagas or the state, amassed huge losses from 2008 to 2014 despite receiving cheaper natural gas from Srbijagas.[18] It is in the strategic interest of Gazprom for all three companies to survive since they constitute almost one third of Serbia's gas market. Gazprom may avoids purchasing these companies outright, and instead leverage their debt to pressure Serbia since the indebted companies' potential collapse could leave thousands of workers on the street protesting.

By participating in the Serbian energy sector through buy-ups, it appears that Gazprom has positioned itself to potentially benefit from Serbia's gas debt vulnerability by cutting gas deliveries to Serbia. The most significant reduction in gas supply – by 30 percent – occurred just days before a visit by Russian president Vladimir Putin to Belgrade in 2014. At the time, Gazprom stated that the official reason for the gas cut was Srbijagas' debt to the Russian company.[19] In March 2016, Srbijagas began talks on restructuring its total debt of around EUR 1 billion – close to half of which is owed to Russian state-owned banks. Ultimately, the Serbian state took over the majority of the debt owed directly to Gazprom, which has contributed to the country's worsening fiscal position. In June 2017, the Serbian energy minister reported that state-owned companies have fully repaid all gas debt worth USD 450 million to Gazprom.[20]

Russia's footprint in the gas sector extends through intermediary channels as well, such as Yugorosgaz, a joint venture between Srbijagas and Gazprom in which the Russian side controls 75 percent of the shares (see Fig. 4 above). The venture originally was set up to construct the gas interconnector with Bulgaria and to gasify southern Serbia, but in 2007, the company became the main intermediary in Srbijagas's gas trade with Russia. Yugorosgaz receives around a 4 percent premium on the gas it resells to Srbijagas, contributing to profits of approximately EUR 15 million in 2013 alone.[21]

Gazprom has designed the gas supply structure to its benefit – and apparently at the expense of Srbijagas. Gazprom sells the contracted volume to Yugorosgaz in Ukraine, then Srbijagas buys the same gas but at a 4 percent premium and pays the additional shipping costs through Hungary. For years, the paradox has been such that after Yugorosgaz sells the Russian gas to Srbijagas, the national gas supplier resells it at a low, regulated price back to Yugorosgaz for its own distribution in southern Serbia, which contributes to persistent large losses on Srbijagas' financial statements.

Although many elements of the gas trade between Serbia and Russia remain unknown due to the confidentiality of the contracts, investigative reports from leading Serbian media outlets[22] show that Srbijagas bears significant losses due to its gas trade arrangements. Eventually, the Serbian taxpayer will have to foot the bill, most likely through the issue of more public debt to be covered by higher taxes or a cut in social expenditures. Yugorosgaz, on the other hand, does not reinvest its proceeds into developing its gas pipeline system in Serbia or constructing the interconnector with Bulgaria as negotiated by the Russian and Serbian governments, but instead divides the funds between the company's owners.[23]

18 Republic of Serbia – Fiscal Council. Assessment of State-Owned Enterprises in Serbia: Fiscal Aspects. Belgrade: July 31, 2014, accessed on 22 January, 2018 at http://www.fiskalnisavet.rs/doc/eng/analysis_of_state-owned_enterprises-fiscal_aspect.pdf

19 "Russia Reduces Gas Flow to Serbia over Unpaid Debt," *Novinite.com*, November 1, 2014, http://www.novinite.com/articles/164467/Russia+Reduces+Gas+Flow+to+Serbia+over+Unpaid+Debt

20 Ralev, Radomir (2017). "Serbia owes no gas debt to Russia – energy min Antic," SeeNews, June 5, 2017, accessed on January 2, 2018 at https://seenews.com/news/serbia-owes-no-gas-debt-to-russia-energy-min-antic-571092#sthash.Oamnx7Hb.dpuf

21 Originally, the Bulgarian-Serbian interconnector was believed to be a pipeline to transport Russian gas in the future.

22 E.g. Insider, TV B92.

23 Apart from 100 km of pipeline built down to Nis before 2000, there has been very little progress in construction of the gas pipeline Nis-Dimitrovgrad (Bulgaria). In 2014, when Russia's Gazprom said it would abandon South Stream, Bulgaria and Serbia, which had signed a memorandum for the construction of the gas interconnector in 2012, were forced to look for alternative gas supply options.

Srbijagas receives 25 percent of all proceeds, while the other 75 percent are transferred abroad, including 50 percent to Gazprom in Russia and 25 percent to another company, Centrex, which research shows is ultimately owned by Gazprom.

In response to criticism from the European Commission and amid the freezing of the South Stream project, Serbia began to restructure the gas sector at the end of 2014. According to the Energy Community Secretariat, the two transmission system operators (TSOs) licensed in the country – the state-owned Srbijagas and Yugorosgaz (distributing gas to the southern part of Serbia) – did not fulfil their obligation to effectively separate energy transmission from production and supply, as EU energy rules required. The respective reasoned opinion stated that although Yugorosgaz's ownership arranged the company into a separate pipeline subsidiary in fall 2012, it did not do enough to ensure discretionary independence from political interference within the company.[24] The Secretariat also found the failure to unbundle the two TSOs a key obstacle to the proper development of a competitive gas market in Serbia.

The Bulgaria-Serbia interconnector project (IBS) however lagged behind, due to constant opposition from Srbijagas's management to implementing the restructuring of this company. After strong pressure from the Energy Community and the EU, Srbijagas formally established two new companies, one tasked with gas transportation and the other with gas distribution. Through a government special decision in January 2017, these new companies were to receive a functional permit from the Ministry of the Economy, despite the fact that Serbia's energy regulator denied the license request since the whole process happened only on paper. Both companies had neither property nor employees. In its latest Implementation Report, the Energy Community reiterated its observation that Serbia has persistently failed to unbundle Srbijagas and noted that the gas market remains closed and highly concentrated.[25] In any case, the functional permit approval opens the door to the EBRD's financing of the Bulgaria-Serbia Interconnector, which was conditional on the restructuring of Srbijagas. Overall, Serbia has been dragging its feet in implementing changes to the energy regulation framework in accordance with the EU and Community, especially in the areas directly affecting the current Gazprom-controlled gas supply structure. The result has been a decade-long delay of a key interconnector with neighboring countries that could improve the diversity and security of supply.

In many cases, corporate governance issues plague these downstream companies and actively contradict the declared long-term interests of Serbia. The mismanagement of the price-setting formula – in which Russian-controlled companies sell expensive natural gas to the wholesale supplier, which then resells the fuel to final clients at subsidized tariffs ensured by the regulator – is the most critical example of such failure. Moreover, the gas intermediary has successfully lobbied to stymie the liberalization of the gas market and halt the unbundling of Srbijagas, ultimately delaying EU alignment. There are also indications that the Serbian government continues to meddle in Srbijagas' corporate governance, failing to separate its high-level management from involvement in the Russian-controlled gas supply intermediary, Yugorosgaz.

In the fuel market, the Russian-owned NIS-Gazprom Neft and Lukoil dominate the upstream, refining, wholesale and retail sectors. According to 2015 data, NIS owns 325 gas stations (24 percent of all gas stations in Serbia), while Lukoil has 148 (ten percent), making them the two biggest retailers in Serbia. In addition, NIS supplies 78 percent of the fuels sold by other competitive retail gas stations. This data suggests that Russian-owned firms have almost full control and monopoly over the fuels market, with more

24 Energy Community (2014). "Secretariat submits a Reasoned Opinion against Serbia on its failure to comply with gas unbundling rules." Press Release of the Legal Department, February 24, 2014, accessed on January 2, 2018 at https://www.energy-community.org/news/Energy-Community-News/2014/02/24.html

25 Energy Community (2017). Serbia Gas Chapter in the 2017 Annual Implementation Report. October 15, 2017.

than a third of the retail market, all upstream production, and most wholesale storage facilities. While crude oil prices fell by more than half in 2014, retail gasoline and diesel prices fell between 4.4 percent and 10.4 percent, far below the decline registered in European oil trading indices such as the Platt's Mediterranean Quote.[26]

Railways

Russia, as opposed to the EU, has not provided any development aid grants to Serbia. However, Moscow has leveraged other types of macroeconomic loans to accelerate large-scale infrastructure projects that potentially serve Russian strategic interests. For example, a 2008 agreement between the two countries allocated USD 800 million towards modernizing the country's railway infrastructure. Despite the conclusion of the agreement nearly a decade ago, the government only began utilizing the loan in 2014. The original intention was for full implementation by 2016. In 2016, Russia extended the deadline for the loan's full implementation to 2021. Meanwhile, Zorana Mihajlovic, now Serbia's Minister of Transportation and a government Vice President, claimed in early 2016 that the government had implemented about USD 700 million of the total 800 million from the loan. Russia included a condition in the agreement that the Russian state-owned railway company would be the primary contractor for the modernization project.[27] The loan's repayment period is 20 years at a 4.1 percent per annum interest rate. This is less favorable than the EU financial institutions' terms, which have been providing infrastructure loans in the region at an interest rate between 1 and 3 percent. Serbia decided to contract the Russian Railways International subsidiary "Zarubezhstroitekhnologiya" (Зарубежстройтехнология) as a main contractor for the coordination aspects of the project as well.

There are two main possible reasons for Russia's interest in the modernization of Serbian railway infrastructure. First, it would grant Russia an opportunity to provide state-owned companies with procurements abroad, and second, it would improve strategic connections between Belgrade and Montenegro's port of Bar, where Russia was interested in building a naval base. Montenegro however officially rejected this project at the end of 2013, due to its NATO aspirations. Interestingly, another major railway modernization project involved a stretch between Belgrade and Nis. Improving this infrastructure would better connect the Serbian capital with a Russian humanitarian center in the country's second-largest city, Nis. The U.S. has perceived the Russian humanitarian center as a potential pretext for the deployment of a strategic Russian military facility, which could be used, for example, for espionage activities in the Western Balkans.[28] Despite repeated Russian calls urging the Serbian authorities to grant the humanitarian center diplomatic status, Serbia has so far refrained from doing so.[29]

Finance

Although Russian presence in the financial, banking, and insurance sectors is quite limited, in the past ten years, two Russian state-owned banks opened branches in Serbia: Moskovska Banka, now part of the VTB group, which opened its first branch in 2008 as a greenfield investment, and the Russian state-owned Sberbank, which entered the market in 2012, by purchasing the banking arm of Volksbank

[26] *Извештај о секторској анализи тржишта трговине на велико и трговине на мало дериватима нафте у 2015. години*, Commission for the Protection of Competition of the Republic of Serbia, December 2016, p. 35, http://www.kzk.gov.rs/kzk/wp-content/uploads/2017/01/Izvestaj-o-sektorskoj-analizi-trzista-trgovine-na-veliko-i-trgovine-na-malo-derivatima-nafte-u-2015-godini.pdf

[27] It is planned that participation of Russian companies in the reconstruction of the railway infrastructure in Serbia will be 70 %, while participation of Serbian companies is supposed to be 30 %.

[28] Tanjug (2017). "US "concerned" by Russian humanitarian center in Serbia." 15 June, 2017 as reprinted by B92, accessed on 4 December, 2017 at http://www.b92.net/eng/news/world.php?yyyy=2017&mm=06&dd=15&nav_id=101553

[29] Tanjug (2017). "No need to give Russian Center diplomatic status." 17 July, 2017 as reprinted by B92, accessed on 4 December, 2017 at http://www.b92.net/eng/news/politics.php?yyyy=2017&mm=07&dd=17&nav_id=101829

International in Central and Eastern Europe. Another small domestic institution, the Marfin bank, was recently taken over by the Czech Expobank, owned by a Russian businessman, Igor Vladimirovich Kim; there is some anecdotal evidence of Kim's links with President Putin.[30] However, none of these banks is on the list of 10 major banks that hold more than 77 percent of the banking market in Serbia. The three Russian-owned banks jointly hold 4.7 percent of Serbia's market, and only Sberbank is visibly trying to establish itself in the marketplace. In addition, there is only one Russian-owned insurance company, Sogaz, founded jointly by Srbijagas and Sogaz Insurance from Russia. Nevertheless, Agrokor's recent default on a Sberbank loan could provide Russia with an opportunity to expand its political footprint in the region. The potential failure of Agrokor's subsidiaries in Serbia could also trigger larger unrest, given that hundreds of businesses serve and are dependent on Agrokor's supply chain.

In 2012, when Sberbank took over Volksbank's business in the region, the Russian financial institution expressed its readiness to invest EUR 100 million in Serbian export companies tied to the Russian market, as well as to help attract a strategic partner to purchase the Smederevo Steel Plant.[31] To date, Sberbank has not significantly increased its market share in Serbia, and maintains the relatively low profitability of its previous owner. In addition, the bank's initial plans to finance the acquisition of the Smederevo steel plant did not go beyond a formal agreement, and cooperation with companies exporting to Russia did not materialize in large numbers.[32] Sberbank has preserved the investment policy of its Austrian predecessor and has not gotten involved in developing business cooperation with the largest privately-owned companies in Serbia, since local businessmen own many of them.[33] Sberbank considers these businesses risky, as several banks in Serbia collapsed in the period 2008 – 2015, due supposedly to political meddling into their business. Sberbank, however, was interested in purchasing the Komercijalna Banka or Banka Intesa (a Serbian subsidiary of Italy's Banca Intesa) in late 2013, as the latter has been the biggest creditor of Srbijagas.[34] No agreement was reached though, and there have been no new developments in the past four years.

One notable exception has been Sberbank's aggressive investment in the retail sector, including the largest retailer in the Western Balkan region, the Croatian holding company Agrokor. The company, whose owner, Ivica Todoric, has been reported to have close ties to Croatia's government over the years, has functioned as a highly centralized and in many respects unreformed business. Relying heavily on bank loans, the company has expanded into almost all countries of the Western Balkan. In early 2017, Agrokor employed some 60,000 people throughout the region and had an income equal to roughly 15 percent of Croatian GDP. The company simultaneously accumulated large debts, totaling around USD 6.4 billion or six times its equity.[35] It owes around 18 percent of its debt to Sberbank, while VTB has provided around EUR 300 million in loans (5.4 percent of the total) (See Fig. 5). Sberbank also supported Agrokor's acquisition of a Slovenian retailer, Merkator, in 2014, which in turn owned the Serbian chain Roda. At the time of the Merkator buy-out by Agrokor, Western creditors were skeptical of the company's ability to finance the purchase. Sberbank was the only institution that backed the Croatian holding, providing it with a EUR 600 million loan, followed by a second EUR 400 million loan to improve the company's financial

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30 Bjelotomic, Snezana. "Marfin Bank: Putin's man Igor Kim gets green light for takeover." Serbianmonitor.com. 30 November, 2016.

31 "Sberbanka traži partnera za Železaru Smederevo," RT Vojvodina website, August 23, 2012, http://rtv.rs/sr_ci/ekonomija/sberbanka-trazi-partnera-za-zelezaru-smederevo_338100.html

32 Interview with the source close to Sberbank Serbia August 7, 2017.

33 Ibid.

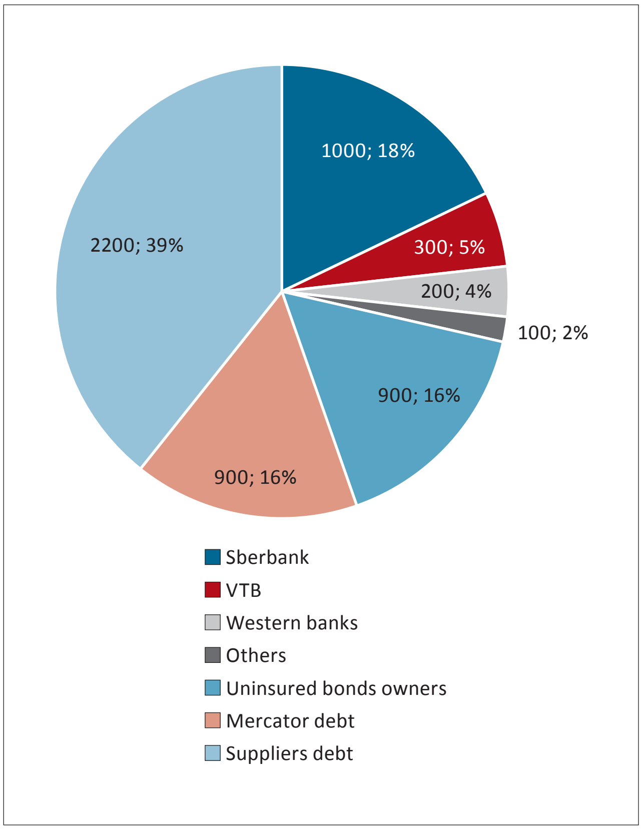
34 "Rusi žele Komercijalnu banku?," B92, November 25, 2013, http://www.b92.net/biz/vesti/srbija.php?yyyy=2013&mm=11&dd=25&nav_id=781821

35 Ilic, Igor. "Croatia passes law to protect economy from Agrokor-like crisis," Reuters, April 6, 2017.

health. Agrokor used the shares of some of its major subsidiaries to secure the second loan, including the Croatia-based PIK Vinkovci, Ledo, Zvijezda, and Jamnica.

Despite ballooning debt and unsustainable growth, Agrokor remained relatively stable until February 2017, when Russian Ambassador to Croatia Anvar Azimov threatened that Agrokor "will have to repay the loans from Russia and Russian banks or will face the consequences."[36] He added that the company had financial problems and that this time Russian banks would not come to its rescue. The statement sent shockwaves through the market. In the following days, credit agencies downgraded Agrokor's long-term debt rating, which led to a stampede of creditors asking for the repayment of their loans. Sberbank later clarified that the bank was not interested in acquiring the Agrokor businesses but only in improving the holding's management.[37]

Figure 5. Structure of Agrokor's Debt by Source (EUR million and share %)



Source: *CSD calculations based on an analysis by Bloomberg.*

In an attempt to consolidate Agrokor, in March 2017, Sberbank gathered four other creditors (Privredna banka Zagreb, Reifeisen banka Austrija, VTB Banka Austrija AG, and Zagrebacka banka) and issued one large syndicated loan with the condition that Agrokor appoint new management, consisting of independent experts. At the same time, Croatia adopted a special law that would restructure the management of companies with systemic importance for the economy (later dubbed "Lex Agrokor"), with the immediate purpose of stabilizing Agrokor. This law effectively prevented a potential Sberbank takeover of Agrokor. The law imposes compulsory state administration for companies with more than 5,000 employees and debt levels higher than EUR 1 billion, depending on the company's loan agreement. The Slovenian parliament similarly introduced "Lex Mercator" to protect the use of the Slovenian subsidiary of Agrokor to cover Agrokor's debt. Croatia installed a special administration in early 2017 to run the company for the following 15 months. The new management succeeded in persuading a American Knighthead Capital Management (AKCM) fund specializing in distressed companies to secure a EUR 480 million loan to Agrokor. Sberbank rejected the deal and proceeded to claim its Serbian and Bosnian assets that had been used as securities for its loan to Agrokor. However, the Serbian Commercial Court did not allow Lex Agrokor to apply to the subsidiaries in Serbia. Consequently, Sberbank was able to begin a lawsuit claiming its Serbian assets as loan guarantees in July/August 2017. The Serbian court decided to rule against Lex Agrokor in order to protect Serbian companies from potential bankruptcy during a resale.

[36] "Rusija više neće davati kredite Agrokoru – Hrvatski koncern moraće da vrati pozajmljeni novac," E-Kapija, February 11, 2017, http://www.ekapija.com/news/1669550/rusija-vise-nece-davati-kredite-agrokoru-hrvatski-koncern-morace-da-vrati-pozajmljeni

[37] "Vučić pred susret s Putinom: Sberbank preuzima 52 % udjela u Agrokoru," SEEbiz, March 26, 2017, http://www.seebiz.eu/vucic-pred-susret-s-putinom-sberbank-preuzima-52-udjela-u-agrokoru/ar-153125/

Clearly, the Agrokor's crisis has the potential to critically affect the Serbian economy. In Serbia, Agrokor owns a supermarket chain (made up of three brands), a retail credit card company, pastry and ice cream companies, a mineral water and sunflower oil producer, real estate management companies, and various consultancies. Agrokor directly employs 11,200 workers, or 16 percent of all employees of Russian-controlled or –related companies in the country.[38] Merkator-S, which is the second biggest retailer in Serbia with around EUR 867 million in revenues in 2016, has 350 diverse supermarkets under its purview, making it one of the largest companies in Serbia in terms of turnover and employees. The company works with at least 660 domestic suppliers with enormous significance for small-town economies.

Not surprisingly, Serbia pledged to prevent companies under Agrokor's ownership from suffering any direct damage and announced, in April 2017, that it would introduce temporary measures in commercial courts to protect these companies.[39] Following this statement, Sberbank filed multiple requests in Serbian commercial courts to block the disposition of companies' property related to Agrokor. Serbian law prevents a foreign-owned parent company from guaranteeing loans with the property of subsidiaries in Serbia. This effectively supported the Sberbank request. The courts introduced additional temporary measures that the forbid creditors of Agrokor companies from expatriating affected Serbian property.

During the Agrokor crisis, the Serbian mainstream media however reported that several businesspeople who could be connected to Russia were interested in taking over the ailing subsidiaries in Serbia.[40] Rodoljub Draskovic, who is a brother-in-law of Danica Draskovic, a current member of the Board of Directors of NIS, is one of the most prominent among them. Because Sberbank has indicated that it would not like to run the Agrokor subsidiary businesses itself, it is possible that the Russian financial institution will sell them to private owners. So far, the Serbian government and the courts have assisted Sberbank in its fight for control of Agrokor's assets. By allowing asset transfers into the hands of companies with ties to Russia, Moscow could potentially penetrate deeper into the Serbian economy. The extensive reach of Mercator-S into the Serbian economy could represent a future vulnerability.

Political Amplifiers

Dating back to at least the 19th century, Serbia has traditionally perceived Russia as a strong ally in its political ambitions. The Kremlin's support for Serbia's cause in Kosovo and Russia's rejection of Kosovo's independence have strengthened the image of Russia as a guardian of Serbia's interests. While domestic Russian media outlets have promoted a shared vision of international relations in the Western Balkans, a network of dedicated Russian institutions in Serbia has fostered feelings of proximity. The network has been expanding in recent years to provide support (including financial aid) to organizations and groups that promote Russian interests. Branches of Russkiy Mir (Russian World) and a representative office of the International Fund for the Unity of Orthodox Nations have operated in Novi Sad and Belgrade since 2005. Attempts to strengthen mutual ties between Serbia and Russia have further intensified since 2013, the same year that the Council of the EU announced Serbia's readiness to start accession talks. At the same time, the Russian Institute of Strategic Research (RISI) established a local branch in Belgrade, its only one in the Western Balkans. RISI's website states that the institute is a major scientific, research and analytical center

38 "Seratlić poručio Ljajiću: Mercator S plaća sve na vreme," SEEbiz, 23 March, 2017, http://rs.seebiz.eu/seratlic-porucio-ljajicu-mercator-s-placa-sve-na-vreme/ar-152959/

39 "Vučić o Agrokoru: Evo šta možemo da uradimo," Mondo, 19 April, 2017, http://mondo.rs/a1000962/Info/Ekonomija/Agrokor-Vucic-i-ministri-iz-regiona-zasedaju.html

40 BIZLife (2017). "Rodoljub Draskovic offering Todoric to take over Agrokor's operations in Serbia." Reprinted in online media portal Ekapija on 27 April, 2017, accessed on 2 January, 2017 at https://www.ekapija.com/en/news/1742166/rodoljub-draskovic-offering-todoric-to-take-over-agrokors-operations-in-serbia

founded by Russia's President, with the primary goal of providing information to the presidential administration and other state institutions. There are also several other Russian foundations, including the Gorchakov Public Diplomacy Fund, the Strategic Culture Foundation, the Center of National Glory, and the Foundation of St. Andrew, which have promoted Russian interests through various activities: financing projects on Serbia's neutrality,[41] organizing roundtables and conferences on Russian soft power,[42] and helping to establish Russian centers in Serbia's academic institutions.[43] Several Serbian political parties, including parties that participate in the current government, claimed cooperation with Russia's ruling party, United Russia.[44]

Russia has promoted the creation of several Serbian-language branches of major Russian media outlets, often with a comprehensive section devoted to political affairs. Since 2012, a considerable number of online news outlets that openly promote Russian interests in Serbia, by focusing on Russian military strength[45] and spreading fear of U.S. influence, have appeared.[46] The first among them was the web portal Vostok (www.vostok.rs). There is a considerable number of web news portals that have appeared since 2012 that openly advocate Russian interests in Serbia. Among the most influential are Novi Standard (www.standard.rs), Srbin.info (www.srbin.info), Vaseljenska TV (www.vaseljenska.com), but also smaller portals such as Gazeta (www.vesti-gazeta.com), Fakti (www.fakti.org) Kremlin (www.kremlin.rs), Glas Moskve (www.glasmoskve.rs) etc. Additionally, the state-owned news agency Sputnik opened a regional editorial office in Belgrade in 2015. In Serbia, Sputnik operates in the Serbian language through its internet portal and radio program, providing to local radio stations free content, which is widely used. One of the major Serbian weeklies, Nedeljnik, contains the R Magazin supplement, published by Rossiyskaya Gazeta as part of a project "Russia Beyond the Headlines." Public perception is that the promotion of Russian interests is visible even in the most prominent daily tabloids, such as Informer[47] and Srpski telegraf. Efforts to penetrate almost all areas of public life are also obvious from Gazprom's donation of USD 5 million to the Serbian Orthodox Church, which was spent on drawing mosaics in the St. Sava Church. This project is part of Gazprom's comprehensive program for projects in the fields of culture and the preservation of the historical heritage of Serbia.[48]

The activities of Russian organizations and their Serbian media counterparts fall into several thematic areas. First, these outlets promote a Russian perspective on international affairs, for example, saying that the current crisis in Ukraine will be more dramatic because of U.S. involvement,[49] or they interpret history through a Russian lens in the spirit of support for the long-term Russian-Serbian alliance. Secondly,

41 NSP (2015). News about project on Serbia's military neutrality. October 17, 2017, accessed on December 25, 2017 at http://slobodarski.rs/2015/10/17/fondacija-dostojanstvo-i-fond-gorcakov-dogovorili-zajednicku-konferenciju-o-aktivnoj-neutralnosti/

42 NSPM (2014). Round table on Russian soft power. November 15, 2017, accessed on December 25, 2017 at http://www.nspm.rs/politicki-zivot/meka-moc-rusije-u-srbiji-mogucnosti-i-perspektive.html?alphabet=l

43 Sputnik (2017). Opening of the Russian centre on the Faculty of Political science in Belgrade. December 16, 2016, accessed on December 26, 2017 at https://rs.sputniknews.com/drustvo/201612161109269463-Centar-za-ruske-studije-FPN1/

44 Danas (2016). Who are the allies of Putin's party in Serbia?. December 26, 2017, http://www.danas.rs/danasrs/politika/ko_su_saveznici_putinove_partije_u_srbiji.56.html?news_id=321319

45 Sputnik (2017). Recent news about new Russian basis in Syria. December 26, 2017, https://rs.sputniknews.com/rusija/201712261113946517-rusija-stalna-grupa-sirija-baze/

46 Sputnik (2017). Recent news about US influence in Serbia 2018. December 26, 2017, https://rs.sputniknews.com/komentari/201712251113943563-na-nisanu-lazanskog/

47 Informer (2017). News about new weapons for Serbia as a gift from Russia. December 21, 2017, accessed on December 26, 2017 at http://informer.rs/vesti/srbija/361738/samo-u-informeru-putin-se-dogovorio-sa-vucicem-vi-cutite-a-mi-saljemo-oruzje

48 Blic (2017). Company "Gasprom Neft" with 4 million euros finances a mosaic in the Temple of Saint Sava. April 22, 2016, accessed on December 6, 2017 at http://www.blic.rs/vesti/drustvo/poceli-radovi-kompanija-gasprom-njeft-sa-4-miliona-evra-finansira-mozaik-u-hramu/ltwy1yz

49 Sputnik (2017). Recent news, allegedly, about US military activities in Ukraine. December 26, 2017, https://rs.sputniknews.com/rusija/201712261113945545-karasin-ukrajina-isporuka-oruzje-donbas/

they attempt to discredit Western structures (NATO, the EU) by claiming that these institutions counter Serbia's interests (for example, EU support for Vojvodina's "separatist groups")[50] and that they pose a threat to global peace and stability. Thirdly, they present Russia as Serbia's closest ally, whose actions are always consistent with the interests of Serbia.[51] They emphasize common aspects of Serbian and Russian history, in particular the tradition of fighting shoulder-to-shoulder in the two world wars. Next, they criticize the pro-European actions and present Serbia as a country repeatedly humiliated by the EU, as well as by the U.S., yet still "determined" to become a part of the Union to the detriment of the Serbian society.[52] Finally, Russian media constantly remind of past disputes and conflicts between Serbia and its Balkan neighbors, which seems to aims to deter Serbia's EU integration and the process of reconciliation in the region.[53]

Governance Vulnerabilities

To bolster its foothold in the Serbian economy, Russia appears to systematically target Serbia's governance deficits. Russia strategically invests in the energy sector, often with the effect of reducing competition, reinforcing its position, and locking in supply. These investments promote Russia's economic and political interests and foster interdependence. To achieve these ends, Russia seems to identify and use weaknesses in Serbia's regulatory regimes and corporate governance. Gazprom has successfully struck deals in secrecy and without transparent cost/benefit analyses, which has locked Srbijagas into a number of long-term contracts, as in the case of the South Stream project. The management of the South Stream project did not comply with the principles of competitive and transparent public procurement, and involved unaccountable spending. A joint-venture company, in which Gazprom controlled 51 percent of shares, was to oversee the management of the project. This venture company was also in violation of the Third Energy Package, part of the energy obligations that Serbia has committed to implement. Seven years later, Srbijagas still has not fully restructured to comply with European energy rules. Domestic opposition to the restructuring is most likely related to the high likelihood that unless the contract with Gazprom changes significantly to the benefit of Serbia, if Srbijagas loses its transmission and gas storage operations and becomes just a distribution company, it might go bankrupt. Moreover, Gazprom might have opposed the restructuring, since it would bring more competition to a highly concentrated and closed market, potentially endangering its market share in Serbia.

Similarly, Gazprom has opposed indirectly the construction of the Serbia-Bulgaria Interconnector, which could bring down gas prices by diversifying the source and type of gas imported into the country. Yugorosgaz, the Gazprom-Srbijagas joint venture, was mandated to implement the project, but did not have an interest in actually constructing the interconnector. Constructing it would have directly challenged Gazprom's dominant supply position on the Serbian market. In addition, the key condition for EBRD to finance the construction was the requirement for Srbijagas to restructure its company. Ultimately, its failure to restructure, largely hindered by Serbian officials close to Gazprom, was the final blow to any hope for construction of the interconnector.

It also appears that preserving Bajatovic as the CEO of Srbijagas coincides with Gazprom's interest

[50] Vesti.rs (2015). Allegedly, EU and NATO are planing to make new state – Vojvodina. February 16, 2015, accessed on December 25, 2017 at https://www.vesti.rs/Evropska-Unija/DA-LI-JE-VOJVODINA-NOVA-INSTANT-DRZAVA-NA-BALKANU.html

[51] Srbin info (2017). News on strengthing ties between Russia and Serbia through military cooperation. December 16, 2017, accessed on December 25, 2017 at http://srbin.info/2017/12/17/putin-definitivno-salje-srbiji-s-300/?lang=lat

[52] Sputnik (2017). News about US blackmail on Serbia. December 23, 2017, accessed on December 26, 2017 at https://rs.sputniknews.com/politika/201712231113918663-Hojt-Ji-nova-ucena/

[53] Srbin info (2017). News about possibility for Dayton 2 which allegedly means disappaerence for Republika Srpska (as a part of Bosna and Herzegovina). December 23, 2017, accessed on December 26, 2017 at http://srbin.info/2017/12/26/sta-se-krije-iza-projekta-dejton-2-pandorina-kutija/

in ensuring that the Serbian gas supplier remains a state-owned entity. Bajatovic's party, SPS, holds an important position in Serbia's government, as one of the partners in the ruling coalition. Such close proximity between business, particularly related to state-owned enterprises, and politics creates the potential for conflict of interest. Since the state has acted as the guarantor of the company's gas debts (which other Srbijagas-supplied companies have further exacerbated with their debts), Gazprom's ties to Bajatovic have secured, in essence, a guaranteed stream of revenues from the Serbian state.[54]

Moreover, Gazprom has installed an enormously profitable intermediary between itself and Srbijagas. This intermediary, Yugorosgaz, makes a commission on the resale of Gazprom gas to Srbijagas. Bajatovic, CEO of Srbijagas and a member of the Board of Directors of the Gazprom-controlled intermediary, Yugorosgaz, has also been the Serbian representative in most joint ventures with Gazprom, including South Stream, Sogaz, and Banatski Dvor, the underground gas storage facility. His appointments to the senior management of these companies would appear to contradict the OECD's best practices in corporate governance, which recommend clear separation between politics and the management of national companies, in order to prevent conflicts of interest, clientelism, and unprofessionalism.[55] From his positions, Bajatovic receives around EUR 20,000 per month,[56] which is 20 times more than his baseline reported income from Srbijagas. Because of Srbijagas' sponsorship, he is also the President of the Board of Directors of the Sport Society Vojvodina, an association of sport clubs from Novi Sad, and was a member of the Board of Directors of one of two biggest football clubs in Serbia, Crvena Zvezda, whose main sponsor is Gazprom.

The Anti-Corruption Agency recommended in 2014 that Bajatovic resign from the post of CEO, but he managed to defy the recommendation.[57] In the media, he often promotes cooperation with Russia in the energy sector and criticizes all other energy diversification options, including the interconnector with Bulgaria and any potential supply from a liquefied natural gas terminal on Krk in Croatia.[58] By objecting to the restructuring of Srbijagas, he has thwarted progress on the interconnector project, because the EBRD demanded Serbia's alignment with the Third Energy Package, which requires that the ownership of supply and transmission activities be legally and functionally separated. He has also readily defended Gazprom's interests in the media, and has publically opposed, among other issues, an attempt to increase the mining tax.

Concerning oil and fuels, Gazprom and Lukoil have completely taken over the wholesale market. They currently control also more than a third of the retail segment. The result has been higher fuel prices, lack of competition, and significant influence over the country's economy through the indirect control of a large share of value-added tax and excise tax revenues.[59] Gazprom's below-market-price purchase of the controlling stake in NIS has raised serious ques-

54 SHADOW GOVERNANCE INTEL. (2017). "Can New Blood Shake Up Serbia's Power Industry?" OilPrice.com, August 5, 2017, accessed on January 2, 2018 at https://oilprice.com/Energy/Energy-General/Can-New-Blood-Shake-Up-Serbias-Power-Industry.html

55 OECD. (2015). OECD Guidelines on Corporate Governance of State-Owned Enterprises. Edition 2015, accessible and downloadable at http://www.oecd.org/corporate/guidelines-corporate-governance-SOEs.html

56 Nataša Latković "Srbijagas" u sve većoj dubiozi, a Bajatoviću VEĆA PLATA za čak 1.400 evra," February 2, 2017, *Blic*, accessed on November 29, 2017 at http://www.blic.rs/vesti/politika/srbijagas-u-sve-vecoj-dubiozi-a-bajatovicu-veca-plata-za-cak-1400-evra/s2brymd

57 "Agencija: Bajatović će moći usmeno da se izjasni o predloženoj smeni," November 25, 2015, *Blic*, accessed on December 21, 2017 at http://www.blic.rs/vesti/politika/agencija-bajatovic-ce-moci-usmeno-da-se-izjasni-o-predlozenoj-smeni/2fqzqbb

58 "Srbija u problemu – nema alternative za ruski gas," March 26, 2015, *Sputnik Srbija*, accessed on December 21, 2017 at https://rs-lat.sputniknews.com/ekonomija/20150326893419/

59 Serbia's then Prime Minister Vucic said during a meeting with CEO of NIS on 23 October, 2017 that NIS was the top contributor to the Serbian budget with EUR 1.3 billion by the end of 2017, close to 15 % of the country's 2017 budget revenues and 16 % of the government spending (2.5-3 % of GDP). According to our estimates, Lukoil contributes additional 4-5 % to the total budget revenues. For the quote of ucic see http://www.b92.net/eng/news/business.php?yyyy=2017&mm=10&dd=23&nav_id=102621

tions and led to some allegations of corruption.[60] The total value of NIS, according to the preliminary estimates of privatization advisors in 2006, was between EUR 1.2 and 1.6 billion. In other words, 51 percent of NIS was worth EUR 612-816 million (excluding the value of the domestic oil reserves). Interestingly, the Agreement and its associated protocol set the purchasing price for the controlling stake in the NIS at EUR 400 million, with the obligation that Gazprom would finance a modernization program worth EUR 500 million. Gazprom then borrowed funds to fulfill its obligation instead of using its own equity. By raising debt instead of using equity, Gazprom committed NIS to repay the loan with interest. In addition, the Agreement granted Gazprom favorable terms for the extraction of oil and gas in Serbia. It set NIS's mining tax at 3 percent (lower than 7 percent tax for other companies, and far below the international practice of between 15 and 30 percent), and exempted NIS from future tax increases until the company becomes viable. Considering Gazprom's massive modernization project and ongoing oil and gas explorations, such terms may mean that that the Serbian state has decided to forego a great amount of potential future revenue. Most Serbian energy officials claim that the mining tax for NIS should remain the same until the Agreement's expiration in 2038. In 2009, the Serbian Constitutional Court upheld the constitutionality of the bilateral Agreement.[61] The Russian company's favorable mining tax treatment and its excessively privileged position on the market are amongst the most contentious points of the deal.[62]

The privatization of Beopetrol by Lukoil in 2003 also raised concerns about Russian involvement. According to the privatization agreement, Lukoil pledged to invest USD 106.8 million in the company's infrastructure. In a September 2013 report on Beopetrol's privatization, the Serbian Anti-Corruption Council said that Lukoil never honored the agreement, causing damage to the company equivalent to millions of U.S. dollars. According to the Council's report, instead of investing in Beopetrol's infrastructure, Lukoil violated the privatization arrangement by actually dipping into Beopetrol's funds to lend the parent company USD 120 million, or around 90 percent of what it had just paid to purchase this state-owned company. The Council claimed that Serbia's Agency for Privatization never really controlled the process and never prevented Lukoil from proceeding with the loan transfers.[63] Moreover, Lukoil's then head in Serbia, Srdjan Dabic, who was involved in the privatization, has been linked to a Belgrade mayor, Sinisa Mali (a close associate of Serbia's then Prime Minister, Aleksander Vucic), who bought 14 apartments on Black Sea coast from Dabic for USD 6.1 million in 2012.[64] Mali denied that he bought the apartments.[65]

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60 Even before his election, Alexander Vucic, criticised the corrupt nature of the agreement with Gazprom and the acquisition of NIS saying that a higher share of its profit should be transferred to the state budget, and the proceeds should be used to repay Srbijagas's debt to Gazprom. When Vucic became Serbia's Prime Minister, Serbia's prosecution opened an investigation into the 2008 deal. Media reported that the investigation was to pressure the Russian side to take over the petrochemical company, Petrohemija, which in 2014 owed around EUR 20 million to NIS for the fuel it was using for its production. The investigation was completed in 2016 but no indictment has ever been made.

61 International and Security Affairs Centre – ISAC Fund and Law Office 'Nikolić, Kokanović, Otašević', (2009), "Pravna analiza aranžmana između Srbije i Susije u oblasti naftne i gasne privrede," December 21, 2009, p. 6, accessed on December 21, 2017 at https://www.isac-fund.org/download/Pravna%20Analiza%20Aranzmana%20Rusije%20i%20Srbije%20u%20obalasti%20Naftne%20i%20Gasne%20Privrede-FINAL.pdf

62 The mining royalty for NIS (Gazprom) is 7 % of the revenue, while the company pays just 3 %. In many other oil and gas producing countries, the royalty is between 20 and 30 %.

SerbiaEnergy. (2017). "Serbia mining: According to experts, little chance to increase the mining royalty in Serbia." February 23, 2017.

63 Dojčinović, Stevan, Peco Dragana and Tchobanov, Atanas. (2015). "The Mayor's Hidden Property". Organized Crime and Corruption Reporting Project. October 19, 2015, accessed on November 30, 2017 at https://www.occrp.org/mayorsstory/The-Mayors-Hidden-Property/index.html

64 Ibid.

65 "Mali: Nemam milione ni 24 stana, podneo sam prijave", 24 December 2015, *N1*, accessed on 21 December 2017 at http://rs.n1info.com/a120718/Vesti/Mali-Nemam-milione-ni-24-stana.html

Russia has also sought to mix politics and business to obtain preferential treatment in railway modernization. Since international agreements are exempt from Serbia's laws that govern public procurement contracts, Russian loan-based activities in the railway sector have not been organized transparently or based on competitive tenders. Instead, the agreement awarded project opportunities directly to Russian Railways, the former CEO of which, Vladimir Yakunin, is reportedly one of the closest associates of the Russian President. Most recently, in February 2017, Russian Railways announced that it would acquire a Serbian infrastructure maintenance company, which would further expand the company's control over the Serbian railway sector.[66] Serbia's inability to implement in a timely fashion the USD 800 million loan for railway modernization also potentially provided an opportunity for the Russian government to pressure Serbia on other issues.

Serbian's decision to back Sberbank during the Agrokor crisis shows that its independent institutions, including the courts, tend to follow executive policies. In handling the crisis, both Serbia and Sberbank have been determined to keep Agrokor's subsidiaries afloat. Sberbank has great exposure to the debt and the Serbian economy could face a severe shock. However, Serbia's current soft position provided an opportunity for Russian financial institutions to expand their economic presence in Serbia. While the negotiations are ongoing, Sberbank's prominent seat at the table means that, whatever the outcome, Russian-owned entities can take advantage of a crisis in Serbia. Sberbank's potential takeover of key assets would allow Russia to control a considerable part of the Serbian retail market.

Policy Recommendations

Several key policy recommendations include:

- Economic and investment agreements should be evaluated based on their business merits and should not be the result of geopolitical bargaining.
- Before concluding any long-term energy agreements or embarking on expensive infrastructure projects, the government should conduct a comprehensive cost-benefit analysis that takes into account security concerns, costs, and the flexibility of contractual obligations.
- Serbia should ensure that infrastructure projects funded by foreign governments are not exempt from EU and national laws on public procurement and transparency, and are in accordance with relevant international rules.
- Serbia's energy infrastructure projects should be in compliance with the country's obligations on the European level, including in the areas of ownership of gas transmission, supply, and production.
- Serbia should explore efforts to complete a natural gas interconnector with Bulgaria to allow for diversification of the gas supply.
- The Commission for Protection of Competition should prevent the concentration of ownership in strategic sectors, such as the oil and gas sector, and monitor possible market collusion that hinders competition and can lead to monopolies.
- There needs to be a clear separation of the management of state-owned energy companies and politics. The government's nominations of professional management should be considered by Parliament to ensure independence from external pressure.
- Serbia's government, in collaboration with Parliament, should introduce corporate governance standards that clearly separate politics from the day-to-day management of state-owned companies, and adopt competitive staffing procedures that would ensure individual accountability and transparency in decision-making.
- Serbia should eliminate or reduce subsidies for loss-generating enterprises, as well as household heating and gas prices, because they contribute to enormous debts that ultimately the increase citizens' tax burden.
- The government should end the inefficient practice of converting debts into equity. Serbia should take control of the wholesale gas supplier's distressed

[66] "Ruske železnice kupuju u Srbiji firmu koja održava pruge," 1 February 2017, *N1*, accessed on 21 December 2017 at http://rs.n1info.com/a225088/Biznis/Ruske-zeleznice-kupuju-firmu-u-Srbiji.html

subsidiaries and resell them to private investors through transparent privatizations. If Serbia cannot find buyers for these assets, the companies should be allowed to default.

- Serbia should not allow state-owned energy companies to be in charge of managing behemoth infrastructure projects. Instead, strategic private investors should carry the burden of financing and managing such projects, which would also make it more likely that only cost-effective infrastructure is built.
- Serbia should ensure that the sale of distressed companies and assets is transparent and should be careful about the potential concentration of capital in the hands of a small number of politically-connected businesses.
- The government should strengthen its financial intelligence institutions, such as the Administration for the Prevention of Money Laundering and the relevant unit in the Serbian Security Intelligence Agency, to closely monitor foreign transactions associated with large-scale merger and acquisition deals, in order to prevent the illicit transfer of funds and formation of opaque ownership structures in strategic sectors.
- Serbia's media and communications regulators, the Republic Broadcasting Agency and the Republic Telecommunications Agency, should investigate the ultimate beneficial ownership of media and alert counterintelligence in cases of foreign covert operations involving disinformation campaigns in the country.
- The private sector and civil society should be more engaged in advocacy, relevant decision-making and monitoring processes to close the above-mentioned gaps.
- Civil society organizations and investigative journalists should focus more on shedding light on corrupt practices in public procurement, privatization procedures and intergovernmental negotiations of major economic deals.
- The media should play a critical role in objectively informing (even educating) the public about how strategic economic sectors, such as energy, function, in order to debunk existing misconceptions and expose decisions that harm Serbia's public interest. In this respect, the government should ensure that media outlets operate in a safe environment and are granted full access to public data and information.