

REALISING THE OIL SUPPLY POTENTIAL OF THE CIS: THE IMPACT OF INSTITUTIONS AND POLICIES

Summary Note of an EDRC Workshop, 23 June 2006

As chair of the first session, **Val Koromzay** (OECD Economics Department) opened the workshop with the observation that the surge in global oil prices of the last few years had thrown up two major surprises. The first was \$70 oil: the demand surge in 2004 that drove prices to levels not seen in a generation was anticipated by few observers even a short time before. The second was that the world economy was doing rather well anyway: in contrast to previous oil shocks, the oil-price rises of 2004–06 had not led to a sharp slowdown in growth or a strong resurgence in inflation.

Paul van den Noord (OECD Economics Department) addressed these puzzles in his brief overview of the [impact of high oil prices](#) on OECD economies. Mr van den Noord drew attention to the fact that the current oil-price shock has indeed been demand-driven, in contrast to the oil shocks of 1973–74 and 1979–80, which were triggered by supply disruptions. This is one reason for its less dramatic impact on the world economy. He then looked in turn at each of the three major transmission channels involved:

- *Terms of trade.* The deterioration in the OECD area's terms of trade during 2002–05 amounted to around 1.25% of GDP, compared with around 2% in 1973–5 and 3% in 1979–80.
- *Responding/recycling.* The lags in responding have been longer than in previous oil shocks. Petrodollars are also being recycled through financial markets to a greater extent than before, and this has helped to support stock market valuations and keep long-term interest rates fairly low.
- *Inflation and monetary policy.* The impact of oil price rises on core inflation in the OECD is estimated at around 0.3–0.4 percentage points in both the Euro area and the United States. Since there are lags involved, this figure is expected to rise to around 0.5 percentage points.

Alan Rousso (EBRD) turned the focus of the discussion to the CIS region in his presentation on [reforms, governance and economic diversification](#) in the oil-producing countries of the CIS. He observed that CIS oil producers tended to lag behind other transition economies (including the non-oil CIS) in terms of reform. This lag was apparent in assessments of both the initial wave of mainly liberalising reforms and the more difficult 'second-phase' institutional reforms. Moreover, the pace of reform in the oil-producing CIS states appeared to have slowed as oil prices rose. Mr Rousso drew attention to evidence of a similar pattern with respect to indicators of the quality of governance, suggesting that CIS oil producers do indeed suffer from many of the institutional pathologies associated with the 'resource curse'.

The inverse relationship between oil prices, on the one hand, and indicators of reform and quality of governance, on the other, appears to underlie some deterioration in the business environment since 2002, as reflected in the 'BEEPS' enterprise surveys conducted by the EBRD and the World Bank. This deterioration, in turn, impedes the development of the SME sectors of CIS oil producers and thus makes it harder for these countries to diversify their production and export structures away from over-reliance on oil.

William Tompson (OECD Economics Department) concentrated on [property rights and taxation](#), arguing that unless Russia managed to reform both its system of oil-sector taxation and its subsoil regime, the investment needed to sustain (let alone increase) oil production over the medium term was

unlikely to be forthcoming. He observed that the Russian authorities understand the need for a more profit-sensitive system of oil taxation and a reform of the subsoil regime, and that they are committed – in principle, at least – to both these objectives.

However, oil-sector tax reform is proceeding slowly, on account of a combination of purely technical difficulties and concerns that a more sophisticated tax regime will make evasion easier. In the case of subsoil law reform, the picture is even less promising: though formally committed to the transition to a civil-law based system governing the subsoil, the authorities appear increasingly reluctant to give up the present licensing regime, which leaves tremendous discretionary power in the hands of officials. Moreover, the subsoil reform debate is increasingly dominated by the issue of restricting foreign access to ‘strategic deposits’.

As chair of the second session, **Andreas Wörgötter** (OECD Economics Department) opened with two questions:

- How much of the slowdown in Russian oil production growth was the result of policy?
- What will be the implications of China’s attempts to secure rapidly growing oil supplies for the rest of the world?

Vladimir Milov’s (Institute for Energy Policy, Moscow) presentation on [oil production prospects](#) for the region was even more critical of the Russian authorities than Mr Tompson’s. In response to the chair’s question, Mr Milov replied that the slowdown was overwhelmingly policy-driven. He argued, on the basis of company data, that Russian production could easily be 1.5mbd per day higher than it is. Mr Milov went on to state that Russian government policy towards the sector was moving in the wrong direction on virtually all fronts.

- State ownership in the sector continues to expand, despite the evidence that state-owned companies are inefficient and prone to rent-seeking.
- The authorities are increasingly concerned with restricting foreign investment in the sector, even though Russia needs foreign technology and finance to develop its hydrocarbon resources.
- Policy-making with respect to export infrastructure is slow, politicised and driven by geopolitical rather than commercial factors.
- Since Russia still has a tight grip on a large (but declining) share of Caspian oil exports, much Caspian crude is still subject to the vagaries of Russian policy. This problem is aggravated by the failure to resolve the status of the Caspian Sea.

Mr Milov acknowledged that the government’s proposed reform of oil-sector taxation does represent a step in the right direction but argued that it was far too small a step. Moreover, he maintained that the Ministry of Finance’s overriding concern with limiting tax evasion would continue to impede efforts to create a tax framework more favourable to greenfield investment.

Janet Xuanli Liao (Centre for Energy, Petroleum and Mineral Law and Policy, University of Dundee) presented a wide-ranging overview of [China’s international energy strategy](#) and its implications for the rest of the world. Having become a net oil importer only in 1993, China imported 144mt of oil in 2005 (equivalent to almost 4% of global production) and this is projected to rise to 500mt by 2020. China’s rapidly growing demand for imported oil has not only placed upward pressure on prices worldwide, it has also led to an increasing focus on energy in Chinese diplomacy.

In seeking to ensure access to oil supplies, China has tended to rely on a political–strategic approach more than on the market, in part because its ‘market-based’ moves have sometimes run into political difficulties. However, Ms Liao indicated that a lack of a coherent overall energy policy, encompassing energy efficiency, fuel mix and so on can hamper China’s strategic efforts. That said, she emphasised China’s energy diplomacy is rather clearly differentiated by region and that China has had some success in diversifying oil supplies, not least by engaging many second-tier suppliers: only three of China’s top ten oil suppliers are among the world’s top ten producers and the largest single supplier accounted for just 14% of imports in 2005. In some cases, China’s supply strategy relies on investing in countries where the major western oil companies find it particularly difficult to do business or which are regarded as ‘rogue states’ by some western powers. This may be a good thing for the world oil market in enjoying more security of oil supply, but it could be undermine China’s international reputation as a ‘responsible shareholder’. At the same time, China is actively engaged in other forms of energy cooperation (nuclear, clean coal, energy efficiency, etc) with developed and developing countries.

Link to background paper for the seminar

R. Ahrend and W. Tompson (2006), ‘[Realising the Oil Supply Potential of the CIS: The Impact of Institutions and Policies](#),’ *OECD Economics Department Working Paper* No. 484 (12 May).

Other relevant links

R. Ahrend (2006), ‘[How to Sustain Growth in a Resource-Based Economy? The Main Concepts and their Application to the Russian Case](#),’ *OECD Economics Department Working Paper* No. 478 (14 February).

R. Ahrend and W. Tompson (2004), ‘[Russia’s Gas Sector: The Endless Wait for Reform?](#)’, *OECD Economics Department Working Paper* No. 402 ECO/WKP(2004)25 (17 September).

OECD (2004), [OECD Economic Surveys: Russian Federation](#)

A. Esanov, M. Raiser and W. Buiter (2001), ‘[Nature’s blessing or nature’s curse: the political economy of transition in resource-based economies](#)’, *EBRD Working Paper WP#66* (November).

[International Energy Agency](#)

[The Institute for Energy Policy](#), Moscow

[The Centre for Energy, Petroleum and Mineral Law & Policy](#), University of Dundee

[BP Statistical Review of World Energy](#), June 2006