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Investment policy approaches to the energy sector: Russia's experience in light of the OECD Policy Framework for Investment and other countries' experiences

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Gas:

- ◆ **Gazprom controls the sector**
 - 85 % of production and whole transport network
 - Monopoly power
 - Largely regulated prices
- ◆ **Production and export growth modest**
 - Gazprom only modest growth in production; Old fields production declining, new large field in process – but when?
 - Role of Central Asian gas?
- ◆ **Production and export growth potential**
 - Energy efficiency and liberalisation of gas prices: politically difficult
 - Independent producers and condensated gas
 - Gas tax revenues also to stabilisation fund (good macroeconomy)
- ◆ **Export commitments:**
 - Gas equation more tricky than oil; supply security?
 - BOFIT estimate: Gazprom can deliver about 2-3 % gas export growth up to 2020 (2015)
 - Export capacity grows faster than domestic production
 - Increased domestic energy efficiency could somewhat change the picture
- ◆ **Do Russia need to increase production and export of gas faster than currently?**
 - Russia sits on a quarter of world gas reserves and production

Oil:

- ◆ **State company increased involvement**
 - Now about 40 % of sector in state controlled firms hands
 - Russian oil sector ownership relation “normalizing” in international standards
 - Partly liberalised prices
- ◆ **Production and export growth slowed since 2004**
 - Capacity constraints
 - Increased taxes reduce incentives to invest
- ◆ **Tight tax regime on especially crude oil, now developing less strict regimes on oil product export**
 - Russia strives for higher more value of its oil sector
 - Good tool to neutralise excess liquidity
 - Prevent a resource boom from bursting (macroeconomy)
- ◆ **Uncertainty causes careful growth of investments**
 - Uncertainty in ownerships, rules, taxes and global price development
- ◆ **Investments key to higher production growth**
 - Although modest growth, Russia and CIS still fastest growing production area in world oil supply
- ◆ **Is there a political interest to increase production faster than currently?**
 - R/P ratio 22 years (BP statistical review 2007)

Electricity:

- ◆ Different pattern than on Oil and Gas sector
 - Liberalisation after state led investments not working
 - Liberalisation now one of the most liberal and ambitious in the world
 - Increase foreign ownership – needed to modernise the sector
 - Now fast growth in investments – was there an option?
- ◆ Ambitious reform proceeds nearly in time:
 - Nearly all production and wholesale companies established
 - Also foreigners on the sector actively
 - Will the liberalisation work - remain to be seen
- ◆ Huge risks for investments: Uncertainty
 - Will the ownerships remain?
 - Moreover a political risk, could also be triggered from unexpected events likes e.g. weather

Investment climate in the energy sector

Three models: Gas vs. Oil vs. Electricity

<u>Gas model</u>	<u>Oil model</u>	<u>Electricity model</u>
<ul style="list-style-type: none">◆ State controlled◆ Only minority stakes for foreigners◆ Production growth slow and diversification of export routes◆ Potential for production growth larger than political will◆ Foreigners needed in investments (knowledge) in Shtokmann and Yamal?	<ul style="list-style-type: none">◆ Partly re-nationalisation◆ Foreigners given only minority stakes◆ Windfall revenues not accepted◆ Production growth modest and strive to increase refinery and more value added of oil◆ Investment climate for foreigner oil giants similar to other large oil producing countries	<ul style="list-style-type: none">◆ No other option to improve sector◆ One of most advanced liberalisations of the electricity sector in the world◆ Foreigners needed with investments and knowledge, and are given large stakes◆ Investment growth currently rapid◆ Ambitious investment programme, which will fall, if rules are changed during the process

Russian Energy sector investment climate from a foreign prospective

- ◆ Three various models: Electricity, Oil and Gas
- ◆ But they are all depending on the general development of the Russian Investment climate:
 - A degree of Uncertainty
 - A degree of Nationalism
 - A real Political risk
 - Still a normal investment climate for an oil and gas producing country in average
- ◆ The new rules: Strategic sectors law
 - Aim to clarify rules – create stability
 - A lot of questions yet how the law works and increased political influence of foreign investments?
 - Do the law really clarify the rules? – remain to be seen
- ◆ Foreign investments risk premium (Finnish view)
 - SMEs price the risk in the investment plan
 - In the end the premium is paid by the Russian consumers
 - Risk premium affect especially large scale investments to Russia

Two interests in energy sector:

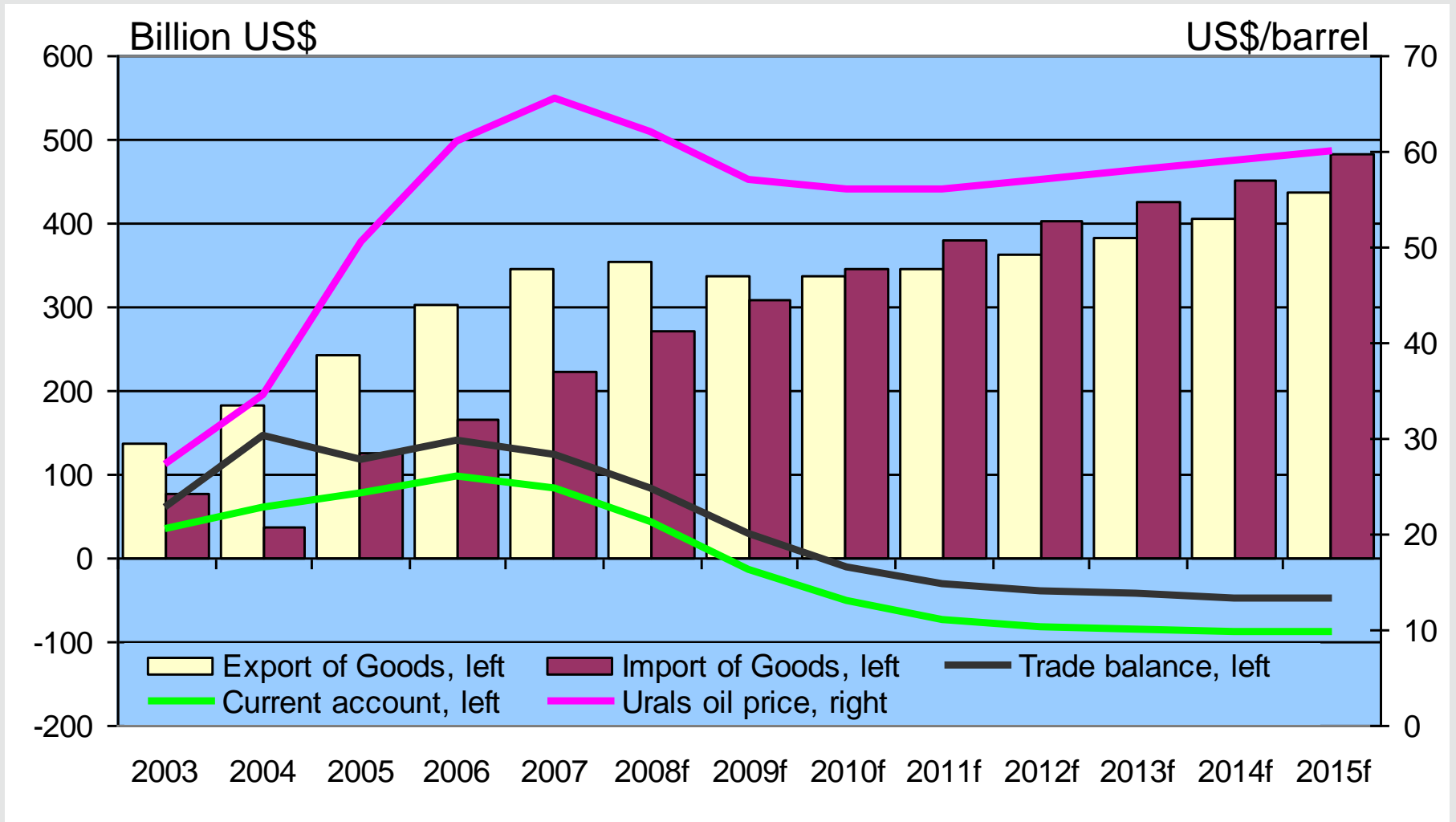
◆ European interest:

- Russian energy attractive energy resource for European Union growing energy demand
- More gas needed to fulfil the post-Kyoto requirements
- Russia largest energy provider next to EU

◆ Russian interest:

- Investments increase carefully in all energy sectors
- Does Russia want to increase growth of oil and gas production faster than currently?
- Macroeconomic stabilisation
 - Economic Theory: burst the resource boom by careful and modest use of non renewable natural resources
 - Monetary policy: Neutralise excess liquidity to the economy by tight taxation
 - Still Current Account surplus melting and expected to vanish around 2010-2011 → modernisation of the economy
- Challenges to get investments (especially knowledge) in new expensive fields in difficult circumstances

Russian Current Account and Oil Price



Sources: MinEcon long term forecast to 2020, from October 2007 and BOFIT estimate February 2008

How to Improve the overall investment climate?

- ◆ The big question: How to create stability and predictability
 - Legislative frameworks exists, implementation varies
- ◆ Currently one way integration of Russian business:
 - Russian energy firms enjoy relatively open European market, but protect their own backyard
 - Still electricity sector reform encouraging example - liberalisation can work
- ◆ Real stability and predictability by integrating the economic system:
 - Firms integrate as long as they can go, but e.g. custom issues and harmonising legislation is up to the politicians
 - Pushing for integration to the World Economy and increased foreign competition
 - WTO, OECD, EU PCA etc
 - For successful modernisation of the Russian economy and keep up rapid economic growth when oil price stop growing - the only option to open up the economy.



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THANKS

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