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Session 2.3.: The policy challenges of involving private investment in key primary sectors: the water and energy sectors in focus

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RUSSIA'S POLICY FRAMEWORK FOR ENERGY INVESTMENT¹

1. The energy sector plays a key role in Russia's economy² and has contributed to a large extent to its current robust growth. Maintaining this position requires considerable investment in exploration, production, transport, electricity generation and distribution.³ Energy savings and development of alternative energy resources represent further investment challenges. Energy windfalls have allowed the government to devote significant public financial resources to investment, making direct financial contribution of private, including foreign investments apparently less vital. However, existing market structure dominated by a few large state-controlled companies, especially in oil and gas upstream activities and energy transport, is not necessarily well adapted to respond to mounting pressures of growing domestic energy demand and increasingly difficult production conditions. By injecting competition, the entry of new investors could enhance economic efficiency and accelerate managerial and technological innovation in the energy sector.

2. This chapter uses a selection of relevant questions posed by the OECD Policy Framework for Investment (see Box 1) to review several policy areas which influence Russia's investment climate in the energy sector and evaluates the main aspects which contribute to make investment conditions favourable. This analysis could not be exhaustive but seeks – in line with the general ambition of the Policy Framework for Investment – to consider investment policy coherence and identify main policy options to boost the energy investment environment.

Box 1. The Policy Framework for Investment and its application to Russia's energy investment policy

The Policy Framework for Investment (PFI) was developed to help governments to “mobilise private investment that supports steady economic growth and sustainable development, and thus contribute to the prosperity of countries and their citizens and the fight against poverty” (PFI Preamble).

Developed by a task force of officials from some 60 governments in association with ten OECD Committees and working groups and endorsed by OECD ministers in 2006, the PFI provides a comprehensive multilaterally backed approach for improving investment conditions. It addresses 82 questions to governments in ten policy areas to help them design and implement good policy practices for attracting and maximising the benefits of investment. The PFI is based on the common values of rule of

1. This paper was prepared by James Chalker, Emmanuel Bergasse acting as external consultants to the OECD Investment Division, and Blanka Kalinova. It benefitted from a review by the Centre for Tax Policy and Administration (CTPA), the Competition Division and the Corporate Affairs Division.
2. In 2006, the oil and gas sectors represented some 25% of Russia's GDP, energy exports accounted for almost 60% of total export earnings and energy-related taxes constituted some 50% of budget revenues. See DAF/INV/WD(2007)8: Seminar on recent developments in Russia's investment environment and policy: Issues for discussion, OECD, April 2007; Diagnosing Dutch Disease: Does Russia have the symptoms? IMF Working Paper, April 2007.
3. The International Energy Agency (IEA) estimated investment needs of Russia's energy sector from 2003 to 2030 to USD 930 billion. Of this total, roughly 40% would be needed for the oil sector, with gas and electricity requiring the remaining 32% and 25% respectively. IEA, *World Energy Outlook 2004*.

law, transparency, non-discrimination and protection of property rights, public and corporate sector integrity, and international co-operation. The PFI can be used in various ways and purposes by different constituencies, for instance for self-evaluation by governments or peer reviews in regional or multilateral discussions.

This chapter adopts a sectoral approach, i.e. uses the PFI in the context of the energy sector by identifying the key issues relevant for the energy sector. Russia's recent energy investment policy developments are reviewed in light of these selected elements. Among the ten policy areas covered by the PFI, some such as investment policy are examined in relatively great detail whereas several others, notably competition, tax and trade policies only highlight main issues to be addressed by the government and relevant agencies.

3. The analysis confirms a significant heterogeneity in the policy approach adopted in the energy sector. While the state has strengthened its ownership and managerial control over oil and gas upstream activities and energy transport, the reform in the electricity sector has been actively pursued through the unbundling process associated with partial privatisation. The policy shift towards the reinforcement of the state control has not been limited to the extractive industries as some other parts of the Russian economy are also considered "strategic" and subject to state economic oversight.

4. Based on the analysis of the policy areas reviewed in this chapter, several aspects appear to be determinant to enhance the energy investment environment, in particular speed up the alignment of domestic energy prices with production costs, secure property rights, improve transparency of tax regime and procedures, ensure effective competition policy and strengthen independence of sectoral regulators. Implementing a coherent energy investment policy framework is critical to cope with Russia's huge energy investment needs and sector-specific challenges, in particular volatility of international energy prices, significant sunk costs and usually long-term returns on investment. Maintaining the vital role of Russia's energy sector for domestic economy and external economic relations thus depends not only on geological reserves and technological capacities but also on a sound energy investment policy framework enabling to attract adequate investment.

1.1. Investment policy

5. The quality of investment policies directly influences the decisions of all investors, be they small or large, domestic or foreign. Transparency, property protection and non-discrimination are investment policy principles that underpin efforts to create a sound investment environment for all. These aspects are particularly relevant for investment in the energy sector, confronted with sector-specific risks, in particular world commodity price volatility and long gestation period for generating returns on investment.

PFI Question 1.1.	What steps has the government taken to ensure that the laws and regulations dealing with investment and investors and their implementation and enforcement are clear, transparent, readily accessible and do not impose unnecessary burden?
Issues relevant for energy investment policy	Transparency and predictability of the legal and regulatory framework for energy investment, implementation and enforcement practices.

6. Russia's legislative framework for investment in the energy sector is still work in progress. In particular, the situation in the oil and gas upstream activities, which are of key interest to foreign investors, is unclear. Investment in these sub-sectors has been managed by the legislation on Production Sharing Agreements (PSA) adopted in 1995 and the 1992 Subsoil law. The PSA legislation was used only in three operations, namely Sakhalin 1 and 2 and the Kharyaga oil field in arctic Siberia. Most other contracts involving foreign investors have been in the form of joint ventures or concessions. Several provisions of the Subsoil law were amended, for example regarding the simplification of the transfer of subsoil use rights from a parent company to a subsidiary and transfers between subsidiary companies. More substantial

revisions of the law envisaged by the government have not yet been finalised. The draft law on strategic sectors submitted by the government to the Duma in July 2007 concerned in principle the nuclear energy and energy transport, but the government appointed in September 2007 decided to withdraw the initial proposal and prepare a new legislation.

7. The limited use of a PSA-based legislation in Russia contrasts with the situation prevailing in many energy producing countries where such investment regime represents more than half of all known contracts in oil and gas upstream activities in force in June 2007.⁴ Foreign investors would like to see improvements in the current PSA legislation, in particular the removal of the current high local content requirement for PSA projects, which is inconsistent with the WTO Agreement on Trade-Related Investment Measures (TRIMs). They would also favour the abolishment of the 2003 amendment which has resulted in the fact that a field becomes eligible for a PSA project only if an auction under the concession system has been unsuccessful. Although the PSA regime has not been applied recently, there are some indications that the government envisages to simplify PSA negotiating procedures and use the scheme in some specific cases (e.g. for offshore projects) under the condition that state companies are involved in the projects.

8. The Subsoil law provides for licensing procedures and a tax and royalty system for investments in the upstream oil and gas sector. Investors have proposed several revisions, especially the possibility for awardees to register their licenses as property, which would permit them to obtain finance and adopt a longer-term business perspective. The authorities have envisaged several amendments such as authorising subsoil users already holding exploration and production licenses to obtain necessary licenses for a geological study of the subsoil and clarifying the procedures for the termination of the subsoil rights. Some investors expressed concerns regarding the implementation procedures, considering that the complexity of the licensing system gives a room for regulatory discretion with a risk of discriminatory or arbitrary behaviour by the administration. The governmental proposal to create a federal agency to prepare and conduct tenders for obtaining the subsoil use rights could address some of these concerns.

9. The draft bill on strategic sectors of July 2007 would clarify the situation for foreign investors in the sectors concerned by this law, i.e. nuclear energy, electricity generation and distribution, and energy transport. According to the proposal, foreign control of these activities, defined as 50% foreign ownership (or 25% in the case of foreign-state ownership) would be subject to prior governmental authorisation. Investment in the oil and gas sectors was expected to remain within the competence of the PSA and the Subsoil laws. The withdrawal of the initial proposal was reportedly motivated by a disagreement on the sectoral coverage of the legislation. It could also indicate that the government intends to adopt a global approach and design the new legislation on strategic sectors in conjunction with other relevant legislation on natural resources, including the Subsoil law and possibly PSA.⁵

10. The lack of the stabilised legal framework for energy investment frequently leads to *ad hoc* decisions entailing risks of bureaucratic discretion and opaque implementation. Resulting diminishing policy predictability is particularly harmful for energy investment requiring a long-term horizon and could put in danger future developments in Russia's energy sector marked by growing discrepancy between declining production capacities and mounting energy demand in domestic and external markets.

4. The remaining part of known existing projects consists in joint ventures and concession (41%) and service agreements (2%). UNCTAD (2007), World Investment Report 2007, p. 159.

5. The Moscow Times, "Strategic Sector Bill Off Until 2008", 9 November 2007.

PFI Question 1.4.	Is the system of contract enforcement effective and widely accessible to all investors?
Issues relevant for energy investment policy	Specific problems encountered in contract enforcement in the energy sector.

11. The strong increase in energy prices has led a number of energy producing countries to revise initial contracts concluded in the context of low energy prices. In Russia, several important existing contracts have also been reconsidered. Recent examples involving foreign investors include the Gazprom's takeover of majority interest in the Sakhalin Energy Investment Company diluting the stakes of foreign partners (in particular for Shell from the initial 50% to a 27.5% stake) and the revision of the initial PSA for Sakhalin-2, allowing Russia's government to receive a large annual dividend before the recovery of capital expenditures by shareholders.

12. Contract enforcement greatly depends on the existence of an independent, impartial and highly competent judiciary, capable of handling often complex commercial cases. Such a system had to be built almost from scratch in Russia and therefore a number of international projects have been developed to improve the judiciary's institutional and human capacity. Russia's current system of appellate and trial level courts, with the Supreme Arbitrazh Court at the top, still faces difficulties in dealing with a growing number of commercial disputes and its pending caseload is steadily increasing. A constantly evolving legal environment requires development of training activities and supporting legal reference materials necessary to consider complex disputes. Enforcing court judgments in Russia, especially those against state entities can be sometimes problematic, mainly because of the limited capacity of the Federal Bailiff Service, the entity responsible for executing all judgments and the voluntary nature of execution against Russian state entities, i.e. the prohibition on seizing state property to satisfy court judgments. In view of persisting problems of the judiciary, it would be important for investors to get access to alternative dispute settlement mechanisms such as conciliation and arbitration.

PFI Question 1.5.	Does the government maintain a policy of timely, adequate and effective compensation for expropriation also consistent with its obligations under international law? What explicit and well-defined limits on the ability to expropriate has the government established?
Issues relevant for energy investment policy	Experience of foreign investors in the energy sector with expropriation and compensation for expropriation.

13. Recent cases of revocation of contracts and expropriation have affected both Russian independent and foreign investors. Although the reasons evoked for revocation of different contracts have varied, the outcome has been a further consolidation of the oil and gas sectors allowing the state to restore its control over energy production and exports. The dismantlement of Russia's largest private oil company Yukos was justified on tax evasion grounds and its assets have been subsequently acquired by the state-controlled companies Gazprom and Rosneft. Other large projects have been revised because of a non-fulfilment of the contract terms (by TNK-BP in the Kovykta gas field) or environmental concerns (in the Sakhalin-2 project by Shell and its partners).

14. A tax dispute, warnings of possible license revocation for failure to produce enough gas and difficulty in securing export-pipeline access/capacity led TNK-BP to sell to Gazprom for USD 700-900 million its assets reportedly worth substantially more. Likewise, the USD 7.45 billion Gazprom paid for its majority share of Sakhalin 2 were below market value. These cases indicate that any among existing forms of investment (the PSA regime for Sakhalin 2; a joint venture operating under a license in the case of Kovykta) have provided the investors with enough security to hold on to their investments and left them with the perception that the investment protection leaves a large room for interpretation to the authorities.

In both the Kovykta and Sakhalin 2 agreements, Gazprom offered subsequently to concerned foreign companies the possibility of cooperation in future projects. Partnership with the Russian large state-controlled entity thus seems for the moment only viable investment strategy for foreign partners in energy projects offering the possibly best guarantee against revocation of their contracts.

PFI Question 1.6.	Has the government taken steps to establish non-discrimination as a general principle underpinning laws and regulations governing investment? In the exercise of its rights to regulate and to deliver public services, does the government have mechanisms in place to ensure transparency of remaining discriminatory restrictions on international investment?
Issues relevant for energy investment policy	Market structure of the energy sector: absence/presence of a dominant market participant, e.g. the state-owned enterprise with exclusive rights; position of private, including foreign investors; transparency of existing energy investment restrictions.

15. Russia's oil upstream was privatised essentially for the benefit of Russian investors, mainly through the loans-for-shares process in 1995-1997. Foreign investment in the energy sector has usually taken the form of joint projects with Russian partners, e.g. BP-TNK joint venture, E.ON-Gazprom and Sakhalin Energy, but overall amounts involved have remained modest. Before 2003, there was a marked difference between the oil sector, dominated by independent companies and recording dynamic production growth, and gas upstream that remained in state hands and generated stagnating output. As in some other energy-producing countries, the Russian authorities have changed their attitude towards private and foreign energy investment following the dramatic increase in energy prices. The Russian government has sought to strengthen state ownership and market position of state-controlled energy firms, in particular through the acquisition of Yuganskneftegas, main oil production subsidiary of Yukos, by Rosneft, and takeover of Sibneft by Gazprom. At the same time, the assets of these major state-controlled energy firms have been open to minority shareholders.

16. The gas upstream is currently largely dominated by Gazprom, responsible for 85% of production whereas foreign companies represent just for 0.2% of production. The market structure in the oil upstream is more dispersed: state-controlled companies and Russian independent firms (Lukoil, Russneft and Surgutneftgas) representing each some 40% of production and foreign-owned companies 2%. In 2006, foreign portfolio investment in the Russian oil and gas stocks was estimated at USD 50 billion,⁶ though the distinction between "foreign" and "local" is increasingly difficult in the context of global capital markets. In 2005, there were 10 Russian companies among the 50 world largest oil and extraction companies ranked by total production, in particular Gazprom (the 2nd largest), Lukoil (in which ConocoPhillips owns some 20% of the shares, the remaining 80% is in hands of Russian partners), TNK-BP, Rosneft, Surgutneftgaz and Sibneft.⁷

17. The continuing consolidation process in Russia's oil sector has resulted in the increasing state control over major investment operations and imposed new rules of the game for co-operation with foreign investors in the oil and gas sector. The situation in oil and gas upstream and energy transport is in a striking contrast with developments in the Russian electricity sector in which the reform has been actively pursued giving a possibility for private sector participation, including on the part of foreign investors (see below).

6. Ernst & Young, Overview of the Oil and Gas Industry in Russia, 2007.

7. IHS data as reported in UNCTAD (2007), World Investment Report 2007, p. 117.

PFI Questions 1.7. and 1.8.	Are investment policy authorities working with their counterparts in other economies to expand international treaties on the promotion and protection of investment? Has the government ratified and implemented binding international arbitration instruments for settlement of investment disputes?
Issues relevant for energy investment policy	Relevance of bilateral investment treaties for energy investment; adherence/ratification to the Energy Charter Treaty; Examples of recent arbitration cases/awards concerning the energy sector.

18. Russia has signed 54 bilateral investment treaties (BITs), of which 34 have entered into force. Among ratified BITs, several ones cover important energy partners, including China, France, Germany, Japan, the Netherlands, Norway and the United Kingdom. The BIT between Russia and the US was signed but not ratified. The OECD analysis of some 20 Russia's BITs and of its Model BIT⁸ noted that Russia's approach in this area is in many respects similar to that adopted in other countries. There are, however, certain disparities among existing BITs concluded by Russia, for instance as regards the scope of exceptions to Most-Favoured-Nation (MFN) and national treatment, assessment of property value for the purpose of compensation for expropriation and the inclusion or not of some specific provisions such as umbrella clauses, performance requirement and key personnel. Russia's Model BIT contains the provision on exceptions to the standard national treatment which is formulated in a broader manner than is commonly found in BITs. It also does not include a reference to fair and equitable standard of treatment but provides for "just treatment".

19. Revising and updating of Russia's BIT regime should aim at reducing current uncertainties making the rights and obligations of the two parties more stable and predictable thus permitting to BITs to play fully their role in promoting investment. This could include clear obligations for fair and equitable treatment, clarification of standards and procedures for expropriation and compensation and dispute settlement. Of particular importance to energy investors would be the broad prohibition of the use of performance requirements, including domestic-content obligations typically tied to energy projects.

20. Given that there is limited public information available on differences in interpretation of Russian BIT provisions and the ultimate adjudications of investment disputes,⁹ it is difficult to judge whether potential ambiguities of some BIT provisions, such as those concerning MFN or national treatment, pose concrete problems to foreign investors from signatory countries.

21. In addition to BITs, Russia's obligations towards foreign investors may result from other international instruments. An important part of the arbitral process is the recognition and enforcement of awards. Russia has undertaken international obligations in this respect through its signature and ratification of the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. The New York Convention covers the recognition and enforcement of investor-state arbitration awards¹⁰ and commercial arbitrations, i.e. those between two commercial entities typically based on a contract and not a BIT. For the New York Convention to work properly, national courts must adhere to its provisions and not

8. OECD Investment Policy Review of the Russian Federation: Enhancing Policy Transparency, Chapter 5; Paris 2006.

9. According to publicly known information, several investment treaty arbitrations have been initiated against the Russian Federation, in particular by Yukos' shareholders. There have been 3 awards, namely *Sedelmayer v. Russian Federation (Germany/USSR BIT)* in 1998; *Bershader v. Russia (Belgium/Russia BIT)* in 2006; and *RosInvestCO UK Ltd v. Russian Federation* in 2007.

10. The New York Convention does not contain any express reference to the recognition and enforcement of arbitral awards against the state. Nevertheless it is well established that it also covers awards involving states.

interfere with valid arbitrations and enforce foreign arbitral awards accordingly. Limitations of Russia's judicial capacity raise the risk that the courts consider properly the subject of arbitration and fail to enforce valid foreign arbitral awards.

22. Russia signed the 1966 Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention)¹¹ in 1992, but has not ratified it. Russia has also not ratified the Energy Charter Treaty (ECT), but it has announced that it applies the Treaty provisionally, pending ratification. It was hoped that ratification would follow once Russia and the ECT members successfully negotiated a transit protocol, but negotiations on that document have stalled. Despite its inaction on ratification, Russia has remained an active participant within the Energy Charter Secretariat. An indication of Russia's provisional application of the ECT will be its treatment of recent international-arbitration claims filed under that treaty. Among several matters being litigated in relation to the Yukos case, at least three are the ECT-based claims. The system of public ownership of oil and gas resources is compatible with the ECT, which applies only once an investment is realised, imposing in particular non-discriminatory treatment and "prompt adequate and effective compensation" in the case of expropriation.

23. By improving policy predictability, including as regards protection to foreign investment, Russia's ratification of the ICSID Convention and the ECT would contribute improving the energy investment climate. The ratification of the ECT would also give the possibility for individual investors to enforce the provisions of the ECT through international arbitration.

Specific sub-sectoral issues

a) Energy transport

24. The main aspects relevant for investment in energy transport are the possibility for private entities, including foreign nationals, to build and operate transport facilities, legal provisions on private, including foreign investors' access to oil and gas transport facilities and transparency of authorisation procedures.

25. Transport of crude oil and oil products is under control of two state-owned entities Transneft and Transneftprodukt respectively and gas transport is the monopoly of state-controlled Gazprom. These three entities share among them the control over the construction and operations of oil and gas transport facilities. The boards of directors of these companies include a number of high-level governmental officials. The oil and gas transport regime is closed to private investment, domestic and foreign alike. There is also a 20% limit on foreign ownership of entities which own regional gas supply or distribution assets.¹² The direct control of state-owned and state-controlled companies over access to pipelines, especially export routes give them a *de facto* control over the level of energy production and exports by independent oil and gas production companies.

11. The Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention) provides facilities and provisions for conciliation and arbitration of disputes between investors from a member-state and the member-state hosting the investment. It does not serve as an arbitration agreement, and in order for a dispute to be brought before it, there must be a written agreement to arbitrate, most often in the form of a BIT. It is administered by the International Centre for Settlement of Investment Disputes, a member of the World Bank Group, <http://www.worldbank.org/icsid/>.

12. See Russia's exceptions to non-discriminatory treatment of investors from the Energy Charter Treaty member countries as notified in the Energy Charter Secretariat's Blue Book available at: <http://www.encharter.org>

26. Russia's gas and oil transport system needs significant investment to modernise existing facilities, in particular to reduce the high level of technical losses,¹³ and increase and diversify transport capacities especially for exports. Future developments also imply considerable technical challenges in particular development of liquefied natural gas (LNG) facilities and adapted storage capacities. Geopolitical aspects have become increasingly important, in particular development of new export routes with implications on future geographical distribution of energy exports, notably between Europe and Asia. Whereas it is legitimate that construction of future energy transport routes takes into account political, strategic and regional development concerns, the dominant position of energy transport companies as constructors and providers of transport services increases the risk of commercially unsound investment decisions such as construction of new economically unjustified expensive energy transport routes.

b) *Electricity generation, transmission and distribution*

27. Investment in electricity generation, transmission and distribution depends essentially on progress in the privatisation and unbundling process and the possibility for private, including foreign, ownership of generation and distribution assets. Investors will also take into consideration the level of competition within existing market structure and the level of tariffs in electricity and gas transmission.

28. Given the current state of Russia's electricity generation and distribution network and expected dynamic growth in domestic consumption, the sector will need considerable investment over the next twenty years. The objective of the ongoing reform of the electricity sector is, in part, to utilize market forces to spur investment.

29. Since 2003, Russia has pursued steadily a legislative and regulatory program to implement Decree No.526, *On Restructuring the Electric Power Industry of the Russian Federation*. Prior to this reform Russia's electricity sector was highly vertically integrated with the state-owned RAO United Energy Systems (UES) controlling all large-capacity non-nuclear generation assets and the transmission system. It also controlled the 72 AO-*energors* (*energors*) utilities with regional monopolies on distribution and supply. Under the reform package, generation assets are being unbundled from both UES and the *energors*. Former UES thermal generation plants have been grouped together into six wholesale generation companies (WGCs) and their assets spread across multiple regions to reduce the possibility of market dominance. (The seventh WGC is comprised of hydro-assets only and remains under majority-government control). The *energors* have been structurally unbundled, with their generation, heat, distribution and supply assets turned into individual companies. The fourteen territorial generation companies (TGCs) have been created consisting of groups of generation plants separated from *energors*. Once all the assets are packaged and the minority shareholders compensated, there will be, in addition to the WGCs and TGCs, a number of regional energy companies engaged in generation and supply, plus the government-owned Federal Grid Company, in which the remnant of UES will merge as well as several majority-government-owned distribution companies.

30. The reform, which has aimed at establishing competitive power generation and supply markets, has gone quite far in unbundling generation and supply companies from the previously vertically integrated state electric company RAO-UES. By the end of 2007, nearly all newly created production units have been listed at the stock exchange and the state and the RAO-UES have already divested some of their holdings in these companies. However, it remains to be seen whether the resulting market structure can make private investment significantly more attractive. One area of concern is that the Russian state will continue

13. Energy intensity in the gas transmission system in Russia is 30-60% greater than that of comparable systems in other countries. Gazprom estimates that improvements in the transmission system could reduce its own gas consumption, saving up to 10 bcm/year. See *Optimising Russian Natural Gas, Reform and Climate Policy*, IEA 2006, pp. 19, 93.

to own a significant part of generation capacity, including a 100% ownership of all nuclear plants, a majority interest in hydro-plants and through Gazprom, as gas supplier and owner of additional electricity assets. As a result, the state is estimated to retain one quarter to one third of national generation capacity. Another concern is whether there will be a sufficient room for competition at the regional level. While generation assets have been distributed nationally to prevent any single generation company from abusing market power, the regional level shows much more concentration. For example, an analysis of the proposed generation market found that the top three power producers in the Northwest region would control over 75% of the market. Avoiding the abuse of such market position will require a strong and independent regulator. Moreover, adequate regulation is also needed to oversee Gazprom, which is a minority shareholder of the RAO-UES and the dominant supplier of gas to thermal plants and envisages to further expand its already significant participation in Russia's electricity sector.

31. The electricity market is regulated by the Federal Tariff Service (FTS) and the Federal Antimonopoly Service (FAS). The FTS regulates most wholesale and retail electricity prices, with about 95% of electricity traded under the regulated regime and the remaining 5% traded on a wholesale market via bilateral contracts and a day-ahead, spot market overseen by the Administrator of Trading Systems (ATS). The FTS also sets the tariffs and charges for the transmission and distribution networks. Regulated prices are being increased to bring them to market levels, and the cross-subsidization of individual consumers by commercial users is being corrected. The goal is to have all electricity prices set by the market within a price-cap system by 2011. It is important to maintain and if possible accelerate this time schedule of transition to market pricing.

32. The most important foreign investment in the sector was realised by the international energy giant E.ON, which acquired 47% of WGC 4¹⁴ in a competitive auction process. E.ON is expected to take another 23%, when the firm's additional shares go up for sale.

c) *Alternative energy and energy efficiency*

33. Investment opportunities in alternative energy and energy efficiency are closely related to the energy price setting and the existence of relevant governmental programs, in particular availability of grants, loans and guarantees, which should be transparent, competitive and non-discriminatory.

34. The 2003 *Energy Strategy for the Period Up to 2020 (Energy Strategy)* stresses the urgent need for Russia to reduce its strong energy intensity level, which is almost three times higher than the average of the OECD-Europe.¹⁵ The authorities are aware of the importance of market reform in reducing Russia's energy intensity and recognise that low regulated energy prices and insufficient payment discipline have contributed to wasteful energy use. Prices which do not reflect costs cannot provide consumers with incentive to save energy and give to energy enterprises enough revenues to invest in maintenance, upgrade and innovation. A proposal to require companies to adhere to an energy efficiency standard, enforced by fines¹⁶ suggests a movement toward implementing the polluter pays principle (PPP). These policies which fully internalize costs are the best for promoting energy efficiency. The appropriate implementation of PPP is also necessary for the adoption of cost-reflective pricing.

14. E.ON reportedly paid about USD 3.9 billion for its 47% of WGC4 which possesses about 8 630 MW of installed capacity.

15. According to the IEA calculations, Russia's energy intensity was in 2005 0.47 toe/1 000 USD PPP compared to 0.17 for OECD-Europe.

16. Proposed draft amendments to the Federal Law "On Energy Savings" as stated by Andrey G. Reus, Deputy Minister of Industry and Energy, in April 2007, see <http://www.minprom.gov.ru/eng>

35. There is a great potential for energy efficiency projects, ventures and technological innovation in Russia based on policies relying on market forces and addressing financing gaps. For example, energy service companies (ESCOs) can improve the energy efficiency of enterprises in return for compensation derived from those savings. Financing energy audits documenting the potential for energy savings and identifying abatement measures can provide incentives to utilize ESCOs. Several energy efficiency projects carried in Russia in partnership with other countries, the EU and international organisations such as the EBRD can help promote a market-based environment for energy efficiency in Russia.

36. The starting point of Russia’s energy investment policy has been the recognition of considerable investment needs for modernisation and development of the energy sector, but the adopted investment strategy has varied according to individual sub-sectors. In oil and gas production and transport, the authorities control investment decisions, mainly through state-controlled energy companies, which dominate these segments. Given recent generally disappointing production performance and investment efforts of these companies, there are some doubts whether they have sufficient financial, managerial and technical capacities to ensure necessary investment. The adequacy of their investment strategy has also been questioned, in particular in the case of Gazprom which seems to privilege outward expansion over development of domestic production and transit facilities.

37. In electricity generation and distribution, the state ownership of nuclear and hydropower facilities implies that corresponding investment needs, including for example the necessary alignment of Russia’s nuclear safety to international standards, have to be essentially covered from state funds. For the remaining electricity generation and distribution, Russia has made important progress in developing a more competitive environment in which investment decisions are not taken exclusively by the government. The *General Scheme for the Installation of Electricity Industry Facilities until the year 2020 (General Scheme)*, currently in the final stage of elaboration by the government, will be a helpful step in assessing available infrastructure, evaluating future investment needs in the sector and indicating the government’s overall investment strategy in this sector.

1.2. Investment promotion and facilitation

38. Investment promotion and facilitation measures, including incentives can be effective instruments to attract investment provided they aim to correct for market failures and are developed in a way that can leverage the strong points of a country's investment environment. Although at the first sight, investment promotion can appear less important for energy investors in natural-resource-rich countries, there is room for governmental investment promotion and facilitation activities also in the energy sector, in particular by improving information on policy orientation and business related regulations relevant for energy investment.

PFI Question 2.1.	Does the government have a strategy for developing a sound, broad-based business environment and within this strategy, what role is given to investment promotion and facilitation measures?
Issues relevant for energy investment policy	The Energy Law or official documents providing investors and other stakeholders with a clear indication of the government's energy policies, including security of supply, sustainable development and environment issues, the role of alternative energy and energy efficiency.

39. The 2003 *Energy Strategy for the Period Up to 2020 (Energy Strategy)* provides a broad description of Russia's energy policies and the basic assumptions underlying those policies, including budget projections of the government’s energy investment, based on the prudent forecasts of world oil and gas prices. It emphasises the need to create a well-functioning energy market based on non-discriminatory treatment of market participants, including for energy transit and acknowledges the importance of developing a strong legal regime for the energy sector. It presents guidelines for electricity-market reform

and promoting energy efficiency and outlines a general blueprint for a future stable, well-functioning energy market. However, the *Energy Strategy* is less explicit on the legislative and regulatory framework, including in such important areas as the delimitation of regulatory jurisdiction between regional and national authorities.

PFI Question 2.2.	Has the government established an investment promotion agency (IPA)?
Relevant issues for energy investment policy	Does the IPA or another agency address specifically energy investment, including the dialogue with investors on proposed energy-related legislation and streamlining of administrative procedures?

40. Information provided by the website of the Russian National Agency for Direct Investment (NADI)¹⁷ is relatively succinct. It offers information in Russian and English but the English information is limited and somewhat dated and there is no specific reference to the energy sector. It links to the Multilateral Investment Guarantee Agency (MIGA) and related investment promotion tools, but the section on legal and regulatory aspects refers to four inactive external links. Updated information in English on the internet would be very valuable to potential energy investors, especially SMEs, which could play a key role in certain key areas of the energy sector such as energy efficiency.

PFI Question 2.8.	Has the government made use of international and regional initiatives aimed at building investment-promotion expertises, such as those offered by the World Bank and other intergovernmental organisations?
Relevant issues for energy investment policy	Participation in international or regional investment promotion institutions, e.g. WAIPA, MIGA, the Energy Charter Treaty and Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects; to what extent government energy investment policies and practices reflect the best-practice guidelines of these institutions.

41. The World Association of Investment Promotion Agencies (WAIPA) lists as members Russia's National Agency for Direct Investment (NADI) and a sub-national IPA, the North-West Development and Investment Promotion Agency. Russia also belongs to the Multilateral Investment Guarantee Agency (MIGA), a World Bank body that provides for political risk insurance for foreign investments, including in Russia. Most of the 34 projects listed in the MIGA database for Russia relate to financial services or water; only one project with coverage of USD 100 million is an equity investment by a Dutch investor in a Russian oil production company. The World Bank has taken part in a number of general investment promotion and technical assistance projects. For instance, the Foreign Investment Advisory Service (FIAS) has contributed to Russia's efforts to improve its investment environment, in particular reducing red tape and promoting property ownership at the national and sub-national levels. Despite its non-ratification of the Energy Charter Treaty (ECT), Russia takes part in its activities, providing for instance information on some aspects of its legal framework in the energy sector.¹⁸

42. Russia's general investment promotion and facilitation activities remain modest and international co-operation in this area has not been actively developed. Although the energy sector is less dependent on investment promotion than many other sectors, improving access to business-related information and streamlining general administrative procedures would also be highly beneficial to energy investment.

17. <http://www.napi.ru/en/about>.

18. The Energy Charter Secretariat's Blue Book lists Russia's exceptions to non-discriminatory treatment of investors from ECT-member states, including limits on the ability of foreigners to own certain types of land, local content and services requirements. The latest Blue Book is available at: http://www.encharter.org/fileadmin/user_upload/document/Blue_Book_2007_ENG.pdf

1.3. Trade policy

43. Policies relating to trade in goods and services can support more and better quality investment by expanding opportunities to reap scale economies and by facilitating integration into global supply chains, boosting productivity and rates of return on investment. Improved trade policy transparency and predictability would also enhance the energy investment climate, in particular in energy transport and transit.

PFI Question 3.2.	What steps has the government taken to reduce trade policy uncertainty and to increase trade policy predictability for investors?
Issues relevant for energy investment policy	Implications of Russia's WTO accession for energy investment and its ratification of the Energy Charter Treaty package, including its trade provisions and transit protocol.

44. WTO membership will be an essential step in Russia's integration into the international trading system, consolidate its trade liberalisation achievements, enhance its overall policy predictability and allow partner countries to recourse to the WTO dispute settlement mechanism in the case of trade disagreement. After many years of negotiations, Russia's WTO accession still faces several unresolved problems, including energy-related issues. In particular, Russia's trading partners consider that the large differential between domestic and export energy prices represents a subsidy to domestic energy-intensive industries and has distorting effects on investment allocation.

45. WTO negotiations have already had positive effects on improving the compliance of Russia's trade regulations and practices with international standards, for instance the adoption of the new Customs Code in 2004. Russia's participation in several capacity-building projects sponsored by international organizations such as UNCTAD, APEC, UNECE and the EU has also contributed to enhancing customs procedures, notably shortening the delays of cross border transactions. Russia's progress in using international technical standards has a direct effect on energy traders and investors. Currently, international standards are accepted for some 30-40% of oil and gas equipment but foreign manufacturers wishing to export their oil and gas equipment to Russia continue to complain about long delays in getting technical approval. The high local content requirement for oil and gas projects (70% a year according to the 2003 amendments to the PSA law) also remains of serious concern to foreign investors. Accession to the WTO will bring Russia under the Agreement on Trade-Related Investment Measures (TRIMs), which prohibits local content requirements. Once Russia becomes a WTO member, it will have two years to eliminate such requirements.

46. Russia's energy trade and transit relations especially with Belarus, Ukraine and Georgia have been subject to considerable tensions following the decision by Russia to increase the previously below world-level prices and controversies about oil and gas transit fees. These price-related disputes confirm the key importance of economically sound and transparent price setting of energy products and transit. Although the agreements have been reportedly reached among involved parties, the lack of publicly available details on financial arrangements and other compensations has been a source of uncertainty which continues to also affect Russia's trade relations with other trading partners.

47. The ECT draft transit protocol prohibits the unauthorised taking of energy materials in transit and obligates good-faith and non-discriminatory treatment of energy enterprises requesting access to transit facilities. It requires the timely and objective consideration of requests by enterprises for permission to construct energy transport facilities. The draft protocol also mandates that transit tariffs be objective, reasonable, transparent and do not discriminate on the basis of origin, destination or ownership of energy materials and products in transit. In 2006, negotiations over the ECT transit protocol were revived, but remain stalled over the treatment of long-term energy supply contracts.

48. Russia's ratification of the Energy Charter Treaty (ECT) package, including its trade provisions and transit protocol would have positive effects directly relevant for energy investors. It would considerably improve Russia's credibility as a reliable energy supplier and provide Russia and its partners with a venue for resolving energy trade and transit disputes.

1.4. Competition policy

49. Competition policy favours innovation and contributes to conditions conducive to new investment. Sound competition policy also helps to transmit the wider benefits of investment to society. Regulated domestic energy prices and the dominant position of state-controlled energy companies make the implementation of competition policy in Russia's energy sector a particularly challenging task.

PFI Question 4.1.	Are the competition laws and their application clear, transparent and non-discriminatory?
Issues relevant for energy investment policy	Applicability of the competition law to the energy sector; facility of access to information on relevant regulations and procedures by foreign investors.

50. Russia's competition law (Federal Law No. 135-FZ "on Protection of Competition") which came into force in October 2006 is enforced by the Federal Antimonopoly Service (FAS). The FAS has recently intensified its activities, in particular its participation in the preparation and review of new legal acts and the application of competition law and implementation of competition policy. Among other functions carried out by the FAS, several are important for energy investors, notably the establishment by the FAS of the "Register of economic entities whose share in the particular commodity markets exceeds 35%", its supervision role in public procurements and its participation in foreign trade regulations such as for example the temporary abolishment of import duties on technological equipment not produced in Russia.¹⁹

51. The FAS had recently obtained some success in performing its duties. In May 2007, the Moscow Arbitrazh Court upheld the FAS decision to block a Gazprom entity from acquiring 100% of an independent gas distributor based on the argument that Gazprom would substitute its own gas for that of the independent producer that supplied the distributor.²⁰ A FAS decision to require a rail transportation entity, partially owned by Gazprom, to register under its merger control regulations also received judicial confirmation.²¹ Other recent cases dealt with by the FAS concerning the energy sector were the violation of the antimonopoly legislation by the public corporation "Mosenergo" in pricing procedures and the abuse of dominant position by an oil company, which applied differentiated payment conditions to different categories of consumers. In both cases, the infringements of the antimonopoly legislation have been established.²²

Specific sub-sectoral issues

a) Oil and gas

52. In oil and gas upstream activities, investment opportunities depend to a great extent on domestic energy price policy, in particular whether and the degree to which the government caps domestic energy

19. Annual Report on Competition Policy Developments in the Russian Federation, 2006, submitted by the Delegation of the Russian federation to the OECD Competition Committee; OECD document DAF/COMP(2007)25.

20. Federal Antimonopoly Service (FAS), Press Release "Gaspromregiongas," 18 May 2007.

21. FAS, Press Release, "Gaspromtrans," 27 April 2007.

22. DAF/COMP(2007)25, pp. 11-12.

prices, whether domestic prices reflect all costs and cross-subsidies between customer categories apply. Investors will also look whether the governments require producers to reserve a certain amount of oil/gas for the domestic market.

53. Russia's low domestic energy prices has many serious implications for energy investors, aggravated by energy transport capacity constraints, which oblige them to serve the domestic markets and limit the possibility of independent producers to export their production. The problem is the most serious in the gas sector given the specific commodity and transport network requirements and Gazprom's de facto monopoly of gas exports, confirmed by the Gas Export Law adopted in 2006. Russia's wholesale domestic price of gas has been gradually increased and should reach approximately 40% of current European export prices by 2010. Gazprom's export monopoly and the level of domestic prices below market rate and even below cost recovery make gas exploration and production unattractive for independent producers even if domestic demand is expected to grow beyond the current production capacities.

54. The recent creation of a gas exchange in Russia represents an important positive development. The sales are realised for half by Gazprom and the remaining half by other producers. The price of gas on the exchange has reached more than double of the domestic regulated prices. It should also be noted that the low price for domestic gas provides little incentive for oil producers to sell their associated gas. In addition to the negative environmental impact of the resulting flaring, this limits their return on investment.

55. Oil exporters do not face an export monopoly and have more transport options than gas producers, in particular transport by rail and road. Partly because electricity generation and thermal power is less dependent on oil, domestic oil prices are less regulated and closer to the market level than gas prices. Still, there are significant constraints on export capacity and the government makes use of export duties and other measures to keep domestic prices low, imposing for example a temporary freeze on petrol prices. In the refinery sector, price volatility is an additional inhibiting factor for investors.

b) Oil and gas transport and storage facilities

56. Investments in these sub-sectors depend on the regime for oil and gas transport, in particular on the existence of non-discriminatory access to transport and storage facilities and the existence of independent energy tariff regulator.

57. As already noted, oil and gas transport is under control of state-owned entities: Transneft, Transneftprodukt and Gazprom. The prices for gas and oil transmission through pipelines are set up by the Federal Tariff Service (FTS). Transneft grants access to its pipelines according to the amount of oil produced by a company so as export volumes are set proportionally according to output produced in the previous quarter. In principle such proportional access system could be considered fair and transparent but in practice numerous exceptions and the fact that the system functions close to full capacity and many installations are obsolete, make the access often unpredictable. The Ministry of Industry and Energy is currently working on the "*Master Plan for the Development of Oil Pipeline Transport for the Period till 2020*" with the objective to prepare investment and management decisions, in particular regarding the development of new trunk oil pipelines.

58. Gazprom controls and manages the Unified Gas Supply System (UGSS), whereas the Federal Tariff Service (FTS) oversees a third party access (TPA) regime. Russia's TPA regime offers a legal basis for independent producers to access the system, but Gazprom's control of the UGSS and its wide-ranging energy activities mean that many independent producers face difficulties in their access to the gas-transport network which operates near its full capacity. Gazprom's control of information relative to gas transport increases the opacity of the whole system. The lack of predictability inhibits the ability of independent producers to envisage long-term contracts. The FAS has proposed legislation regarding technical,

economic and informational requirements related to non-discriminatory provision of gas transportation services throughout a gas network or connection to a gas transportation network, but this proposal has been awaiting further action for over a year.

59. Gazprom also controls Russia's gas storage facilities, which are part of the UGSS and it owns storage facilities outside of Russia. It is currently building three storage facilities to add to the 24 already part of the UGSS. Gas storage is important for meeting daily and seasonal increases in demand. The control over this essential part of the energy value chain, which will become even more important with the development of LNG accentuates Gazprom's dominant position in Russia's domestic market and energy exports.

c) *Electricity and gas transmission and distribution*

60. Investment in electricity and gas transmission and distribution requires that there is fair access to transmission networks and storage. Transmission operation and regulation are to be separated from generation and distribution and an independent energy regulator has to ensure fair access and trading rules.

61. Under the 2003 Electricity Law and the 2006 Competition Law, the FAS is responsible for preventing collusion between market participants and abuse of dominant positions, merger and acquisition control, ensuring non-discriminatory grid access, and consumer protection. It also has responsibility for overseeing the Administrator of Trading Systems (ATS) management of the wholesale market. The FAS has already taken action in several cases to protect and promote competition in the electricity market, filing a case against a regional tariff service for refusing without justification to allow a tender from a company to serve as a guaranteed supplier. In another matter, following an audit of a regional energy grid company, the FAS concluded that the company violated the rules governing grid access, including price and information disclosure. It has also recently found that an electricity producer unreasonably avoided an agreement with an electricity supplier. The FAS, through its merger-and-acquisition control powers, is playing a direct role in the formation of the electricity distribution companies. For example, it recently approved the takeover by the Interregional Central Distribution Stock Company of several distribution companies unbundled from *energos*.

62. The national system operator, Centralized Dispatching Administration, remains over 75% state-owned. While it is currently independent from the National Grid Company, in which the state will also retain over 75% of ownership, combining the two entities is under consideration. Numerous activities of the system operator are important to investors in the electricity sector. Power generation companies rely on efficient, transparent and fair dispatch services. They need to know that system reliability procedures are maintained and that supply and demand projections are reasonably accurate. Sound emergency procedures need to be in place to provide market participants with notice so the market can react accordingly.

d) *Alternative energy and energy efficiency*

63. Efforts to promote alternative sources of energy and energy efficiency should not restrict competition, in particular at the benefit of incumbents and take advantage of market-based instruments, such as carbon emissions trading schemes.

64. Russia has ratified the Kyoto Protocol and, with its current emissions levels well below its quota, could gain a great deal of revenues from carbon trading. It is in the process of implementing its Kyoto action plan, but it is still unclear how it will implement its carbon-emissions-trading schemes. Given the considerable potential for increasing energy efficiency through maintenance and upgrade of existing energy and industrial enterprises, the FAS will need to remain vigilant to ensure that government funding

of such programs does not distort competition and adopts market-friendly options for promoting energy efficiency. For example, the EBRD is using loans to energy enterprises and to energy-intensive industries to fund replacement and upgrade of existing inefficient equipment, with repayment of the loans coming from energy savings. Many other energy efficiency initiatives have the potential to improve the competitive environment, for example reducing gas flaring would improve producers' return on investment.

65. Competition policy will continue to play a key role in the energy sector dominated by large state-controlled companies. The FAS should be given sufficient material and human resources to perform its function as a guardian of the level playing field also in this sector.

1.5. Tax policy

66. To fulfil their functions, all governments require taxation revenue. At the same time, the level of tax burden and the design of tax policy, including how it is administered, directly influence business costs and returns on investment. Sound tax policy enables governments to achieve public policy objectives while also supporting a favourable investment environment. Energy tax policy is one of the key macroeconomic variables in natural resource rich countries such as Russia, strongly dependent on energy-related taxes. Energy investors see taxation as a critical element in their investment decision and planning to develop mature fields and explore new ones. Volatility of world energy prices considerably complicates decision-making both for the government and investors.

PFI Question 5.1.	Has the government evaluated the level of tax burden that would be consistent with its broader development objectives and its investment attraction strategy?
Issues relevant for energy investment policy	The level of tax burden in the energy sector, including profit tax, specific energy taxes and VAT; tax exemptions and/or differences (if any) between domestic and foreign operators, taking into account statutory provisions, tax-planning opportunities, compliance costs and externalities; consistency of the tax burden with the country's development and investment objectives in the energy sector and energy use.

67. Table 1 summarises Russia's current tax oil and gas system. Russia's energy tax regime relies mainly on energy-sector specific taxes, i.e. the mineral-resources extraction tax, introduced in 2002, and export duties, both based on physical volumes and subject to adjustment according to the world energy price developments. General taxes, especially corporate income and profit taxes have a lesser significance, mainly because of the authorities' concerns about inherent risks of these taxes to allow tax avoidance via transfer pricing. With dramatically growing oil prices, the extraction tax and export duties have provided most of Russia's budget revenues. Since 2004 an equivalent of 50% of oil and gas revenues has been transferred to the Stabilisation Fund.²³

23. IMF Country Report on Russian Federation, Selected Issues, December 2006.

Table 1: Crude oil and gas taxation in Russia

Energy Product	General taxes	Energy-sector specific taxes		Comments
		Mineral Resources Extraction Tax	Export Duty (ET)	
Oil	Corporate tax VAT Profit tax	Levied on extracted oil volume at a rate of 22% on the excess of Urals price over USD 9/barrel	Levied on exports on the excess of Urals price over USD 15/barrel (65% for the excess over USD 25/barrel)	Revenues from the oil extraction tax and export tariff are channelled to the Stabilisation Fund for the part corresponding to the oil prices above USD 27/barrel.
Gas	Unified social tax	Levied on extracted gas volume at a rate set annually. In 2006: RBL 147/1000m3	30% (2005)	Gas-related taxes are currently lower than that levied on oil.

Source: Ahrend R., Tompson W.: Realising the oil supply potential of the CIS: The impact of institutions and policies, Economics Department Working Paper, No. 484, June 2006; Gazprom, Annual report 2005 and 2006.

68. In designing the energy tax system the Russian government faces a double challenge: secure an adequate level of budget revenues and, at the same time, provide sufficient incentives for energy investment, both public and private. Russian current oil and gas tax regime, based on volume-based instruments (extraction tax and export tax), has not taken sufficiently into account differentiated extraction conditions which have a strong impact on project profitability. Recent adjustments partly respond to this concern, in particular the reduction of extraction tax for production from fields that are for 80% depleted and the introduction of extraction tax holiday for fields in Eastern Siberia. Energy investors wish to further increase profit sensitivity of the extraction tax.

PFI Question 5.5.	Where the tax burden on business income differs by firm size, age of business entity, ownership structure, industrial sector or location, can these differences be justified? Is the tax system neutral in its treatment of foreign and domestic investors?
Issues relevant for energy investment policy	In the energy sector, tax laws and regulations are implemented and enforced in a fair and transparent manner and not used for protectionist purposes; the tax system is neutral in its treatment of domestic and foreign energy investors.

69. The Russian government is aware of the need to adapt energy tax regime to evolving exploration and production conditions in the energy sector and address the issue of transfer pricing. However, further differentiation of taxes and adequate implementation of new rules for transfer pricing requires an increased institutional capacity of tax authorities. It is important that the multiplication of different criteria, such as the geographical location, including water depth for offshore projects, the size or the level of depletion of the reserves, do not increase risks of arbitrary decisions by tax administration.

70. While tax administration has had to take actions against illegal tax-avoidance strategies adopted by certain Russian firms, its enforcement practices have been sometimes perceived as arbitrary and motivated by other than strictly law-compliance concerns. Recent declarations of Russian high level officials on the need to prevent unjustified actions of tax administration in reaction to these concerns have to be followed by concrete remedies especially the possibility of sanctions against inappropriate

administrative decisions. Current efforts to improve information access, including via regularly updated website of the Federal Tax Service in English, strengthen predictability and enhance transparency of tax regime and procedures should be actively pursued.

1.6. Other policy areas relevant for Russia's energy investment policy

a) Corporate governance

71. Corporate governance of state-owned enterprises (SOEs) is a critical issue for Russia's energy sector given the prevalence of majority state-ownership in the oil and gas upstream activities and energy transport and the still unfinished process of direct state disengagement in the electricity sector. External exposure of Russian large energy state-controlled companies such as Gazprom and Rosneft has prompted them to start publishing information on their ownership structure and financial statements. However, many Russian SOEs still remain less transparent than their Russian private counterparts as regards their publicly available financial and operational information. Another issue is representation of state interests in SOEs, in particular the participation of civil servants and the role of SOEs boards of directors in corporate decisions.

72. In the oil and gas upstream, complex corporate structures utilising large holding companies and the lack of independent audited consolidated financial statements prevent from getting a clear and accurate financial picture. The lack of clarity on the nature of relations between companies and the government also raises questions on possible conflicts of interest due to the concentration of policy, regulatory and ownership functions. In addition, Russian energy companies, including SOEs, use extensively offshore entities to conduct commercial operations and gain access to foreign markets such as for example RosUkrEnerg, an offshore company controlled by Gazprom, which is in charge of Turkmen gas transit to Ukraine and Europe.

73. In the electricity sector, two Territorial Generation Companies (TGC) obtained a moderate score in the Standard & Poor's rating of corporate governance, reflecting some improvements (e.g. veto power of minority shareholders on the key board decisions) but also remaining uncertainties, in particular the absence of independent directors and therefore weak control over conflicts of interest. The development of corporate governance in the electricity sector will depend on future market liberalisation and rules of privatisation for the generating companies.

74. Several important steps have been undertaken by the Federal Service for Financial Markets (FSFM), which are of direct relevance for SOEs in the energy sector, notably extension of legal administrative responsibility of boards of directors and executive managers and increasing sanctions for the violations of the administrative code. In light of experiences of OECD countries, further legal improvements have been proposed. The role of state representatives on SOE boards of directors and frequent conflicts of interest can be addressed by the legislation which would establish clear evaluation criteria for the performance of board representatives. Civil servants should be prohibited to serve on the boards of fully privately owned companies and the use of professionals as state representatives should be generalised.²⁴

24. See Summary Note of High Level Meeting on Corporate Governance Developments of State-owned Enterprises in Russia, co-organised by the Russian Ministry for Economic Development and Trade and the OECD, Moscow 14-15 December 2006.

b) Infrastructure Development

75. Aging and ill-adapted energy infrastructure represents an important impediment for the development of Russia's energy sector as a whole. Since considerable investment needs could not be covered only from public financial resources, private, including foreign, investment has a significant role to play in future infrastructure development. To encourage private sector involvement, several basic conditions have to be in place, including a transparent legal and regulatory framework for public-private partnership.

76. Russia's 2005 law "On Concession Agreements" has introduced into Russia the principle of public-private partnership, allowing for the participation of private investment in economic assets and projects which are not open to privatisation. The law introduces a tender process to ensure transparency, fairness and non-discrimination and sets up general conditions for submission of tenders and operations of concessions, which also apply to foreign investors. The FAS is empowered to regulate concession agreements, both in terms of government actions in creating and administering tenders and the concessionaire's operation of the concession. Concessionaires are obliged to provide non-discriminatory access to concession infrastructure.

77. The law has not been designed for use in activities such as oil and gas extraction, but could be applied in the electricity sector and possibly in oil and gas transport. However, so far, there have not been any energy-related project applications under this legislation. It could also be noted that many new energy projects in Russia are located in remote areas in which required traditional infrastructures such as roads and ports do not exist or need serious upgrading.²⁵ For such projects, concessions agreements could also be an appropriate solution.

78. Whether Russia's concession agreement system can spur investment in energy infrastructure will depend on a number of factors. The government must first select energy projects suitable for concession agreements. Transparency and fairness of the tendering process and bidding procedures will be particularly important in the energy-related concessions given the predominance of state-controlled enterprises in this sector. Oversight by competition authorities is also necessary given that concession agreements could benefit from a support e.g. in the form of revenue guarantees to offset low regulated tariffs.

79. Growing revenues from energy sales allow the Russian government to dispose of considerable financial sources which could also be used to finance development and modernisation of infrastructures, including in the energy sector and promoting alternative energy and energy efficiency. In particular, the Investment Fund established in 2006 and supervised by the Regional Development Ministry has been financing several projects in transport and oil refining. However, there is limited information publicly available on project selection procedures and ex-post control of the use of the funds provided by the Investment Fund. To reduce the risk of using government funds in a way which could distort the market, it is important that the Fund is administered in a transparent manner and uses market-based mechanisms that do not distort competition.

c) Public Governance

80. Among recent steps in administrative reform which are also important for energy investment is the adoption of the federal law no. 45-FZ "On introduction of alterations in the Code of Administrative Infringements of the Russia Federation" that entered into force in May 2007. The law reinforced

25. For example, the Sakhalin-2 project requires an infrastructure upgrade programme amounting to USD requires reportedly an infrastructure upgrade programme amounting to USD 390 million; UNCTAD World Investment Report 2007, p. 142.

administrative responsibility for non-observance of the legal decisions by governmental bodies and introduced direct administrative responsibility, including for example that of the Federal Antimonopoly Service (FAS) for abuse of dominant position or conclusion of agreements restricting competition. The law also allows disqualifying officials for the period up to three years for specified infringements.

81. One concern of investors in the energy sector has been insufficient consultations with the business community by the authorities on new legislative acts and regulations, though there has been some progress in this area, for instance consultations with the Foreign Investors Advisory Council (FIAC) during the preparation of the law on strategic sectors and concessions. However consultations of other stakeholders, including NGOs, for example on environment protection issues remain rare. It is important that recent regulations imposing new registration requirements for NGOs do not result in making their involvement more difficult.

82. It is generally recognised that the usually large scale of energy projects, their long lead time periods and important financial amounts involved could generate corruption pressures. International co-operation can greatly contribute to Russia's public reform by offering the examples of best practices and providing guidelines for governmental regulatory actions and implementing practices. Launched in 2002, the Extractive Industries Transparency Initiative (EITI) focuses on transparency and accountability in the extractive industries. It requires companies, which agreed to implement it and the signatory governments to publish their spending and payments in the oil, gas and mining industries.

83. As other parts of Russian economy, the energy sector and investment would be great beneficiaries of successful public sector reform as enhanced administrative capacities and more efficient regulatory framework would make pervasive state intervention less necessary. It has been sometimes observed that energy investors could be less sensitive to general regulatory quality as they are able to establish more direct links with authorities and ready to take more regulatory risks given expected high returns on their investment. However the lack of policy predictability, inefficient regulations and corruption-prone administration exert unquestionably a strong deterring effect also on energy investment.

1.7. Summing up

84. The PFI approach has been used to review and assess the main elements of Russia energy investment policy. The starting point is differentiated market structure and investment policy environment in individual energy sub-sectors. The oil and gas exploration, production, transport and gas distribution are controlled by large majority state-owned enterprises and, as a result, investment decisions and funding remain essentially in hands of the government. Private, including foreign investment can participate in specific gas and oil projects but in the absence of stabilised and generally applicable legal framework, investors' entry is often decided on a case-by-case basis. In contrast, Russia has actively pursued reform in the electricity sector. The unbundling process has been associated with partial privatisation in which foreign investors have been allowed to participate. These different starting conditions in the main energy sub-sectors have important investment policy implications.

85. Energy investment policy should take into account sector-specific constraints such as significant amount of financial and technological resources involved into energy projects, often long-term horizon for investment returns and exposure to volatility of world energy prices. Russia faces additional challenges as its energy sector requires considerable investment into energy infrastructure, especially in the electricity sector, and in oil and gas upstream due to a large number of mature fields close to depletion and new fields located in geographically more hostile locations. So far, the main policy response has been strengthening of state ownership and control, a trend which has also been observed in extractive industries in some other countries. However, direct state control could be lessened if several essential conditions are met, notably the alignment of domestic energy prices to production costs, stabilised property rights, transparent and

more profit-related taxation and efficient competition policy. Such policy changes would encourage not only private, including foreign investment but also investment by state-controlled companies.

86. The analysis of Russia's energy investment policy based on the PFI has confirmed the vital importance of legal predictability and transparency especially in the context of long-term energy projects. The clarification of the PSA and subsoil legislation and well-defined sectoral coverage of the future law on strategic sectors including in the energy area are preferable to a case-by-case approach. Russia's international credibility and its position as a reliable energy supplier will be considerably enhanced by its accession to the WTO and ratification of the Energy Charter Treaty. The role of competition policy as a guardian of the level playing field is essential given current market structure in the energy sector, dominated by large state-controlled companies in the oil and gas upstream and still rudimentary electricity market. Energy tax policy is a key macroeconomic variable in natural resource rich countries such as Russia, dependent on energy-related taxes, and, at the same time, it is a critical element in energy investors' decisions and planning. Volatility of world energy prices considerably complicates decision-making both for the government and investors. Recent measures modulating energy tax regime according to differentiated oil and gas production conditions have been welcomed by investors. Tax administration will need to dispose of sufficient material and human resources to deal with a more differentiated and sophisticated tax regime and continue to enhance transparency of tax regulations and procedures.

87. Among other policy areas covered by the PFI, corporate and public governance and infrastructure development are also highly relevant for the investment climate in the energy sector. The predominance of state-controlled companies in oil and gas upstream makes particularly important the application of sound corporate governance principles in this area, notably information disclosure of ownership structures and better transparency of usually complex corporate structures, including offshore entities. The 2005 Concession Law which has introduced the principle of public-private partnership in Russia could also be used in the energy sector context, especially energy transport if some basic conditions, such as existence of meaningful energy prices, are fulfilled. Public governance reform remains high on Russia's policy agenda and its main objectives such as reducing policy instability and burdensome administrative procedures and improving public-private consultations would also contribute to enhance the business climate in the energy sector.