ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

SEMINAR ON RECENT DEVELOPMENTS IN RUSSIA'S INVESTMENT ENVIRONMENT AND POLICY

Helsinki, 21 - 22 May 2007

Issues for Discussion

Introduction

1. The main objective of the seminar is to initiate the work on the next OECD Investment Policy Review to be completed in 2008. Exchange of views at the seminar among OECD and Russian officials, experts and representatives of the business community on the latest development in Russia's investment environment and policy will assist the Russian Federation and the OECD in framing key issues to be addressed in the Review. The seminar will also provide a good opportunity to discuss future OECD-Russia co-operation in light of the conclusions of the OECD Ministerial Meeting, which will take place on 15-16 May in Paris. Moreover, participants will also address issues on the agenda of the next International Economic Forum which will be held on 8-10 June in St. Petersburg.[1]

Session 1: Recent developments in Russia's investment environment

2. Russia's rich energy endowment, robust economic growth and its dynamic domestic market have made it increasingly attractive for international investment. According to data provided by the Central Bank of Russia, foreign direct investment to Russia doubled from USD 14.8 billion in 2005 to USD 28.7 billion in 2006. Increase in portfolio investment into Russia was even steeper reaching USD 11.5 billion in 2006 (compared to USD 0.8 billion in 2005).[2] However, the country's potential has not yet been fully exploited as prospective investors still consider it an insufficiently reliable investment destination. A number of traditional barriers, in particular corruption and red tape, do persist. Stability and predictability of the investment environment are of growing concern due to the rising economic involvement of the state both as owner and manager and political uncertainties related to forthcoming parliamentary and presidential elections.

3. In examining Russia's progress in enhancing the investment climate since the completion of the 2006 OECD Investment Policy Review,[3] several aspects might be considered:

a) What has been the experience in implementing the 2005 law on special economic zones (SEZ)? Have the costs and benefits of existing SEZ been assessed by the government? To what extent

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1. The St. Petersburg International Economic Forum is an annual event which has been held since 1997. Its objectives are to provide the appraisal of the Russian economy and economic relations with foreign partners and contribute to the development of partnership and discussions between business, political, intellectual and other leaders of the world community on basic problems in global development. The 2007 Forum will also address investment opportunities in BRICs (Brazil, Russia, India and China). For further information on the 2007 International Economic Forum see http://eng.forumspb.com/news.

2. As in the previous years, the data provided by the Central Bank of Russia differ significantly from statistics from the Russian Federal State Statistics Service, which reports that foreign direct investment reached USD 13.7 billion and portfolio investment USD 3.2 billion by the end of 2006, therefore both increasing only marginally compared to 2005.

3. OECD (2006), Investment Policy Review of Russian Federation: Enhancing Policy Transparency.

have the existing SEZ contributed to Russia's economic diversification, regional development and export potential? What has been so far the involvement of foreign companies in SEZ and how do they view their experience?

b) What has been the impact of the 2005 law on concessions on development of private-public partnership in infrastructure projects in Russia? How many projects have been so far undertaken under this scheme and what are the main sectors concerned? Have foreign investors been involved and how they evaluate their experience?

c) Modernisation, technological upgrading and innovation are the important objectives of Russia's economic policy agenda. What could be the contribution of foreign investment in this process and could it be further enhanced, for example by improving protection of intellectual property rights in Russia?

4. As underlined by the 2006 OECD Investment Policy Review, the law on strategic sectors will be seen as a test of the government's attitude toward foreign investment. The draft law agreed by the government in February 2007 should be soon submitted to the Duma. According to available information, the proposed draft law includes the "closed list" of specific sectors in which foreign participation will be limited to minority shareholding and defines procedures for approval by a newly created structure. In the ongoing OECD project on "Freedom of Investment, National Security and 'Strategic' Industries", in which Russia has also participated, it was observed that whereas countries adopt a variety of practices to protect essential national security interest, the impact on investment depends greatly on the extent to which three key regulatory principles have been taken into account, namely (i) proportionality of adopted measures in relation to the declared objectives; (ii) transparency and predictability of review mechanisms, and (iii) accountability of regulatory authorities in charge of authorisation procedures. Such principles could also be used to evaluate the possible impact of Russia's proposed law on foreign investment, in particular:

d) To what extent are the regulatory actions proposed by the draft law proportional to the public interest they intend to serve? In particular how precise and clearly delimited is the definition of strategic sectors and is it based on strict interpretation of essential security interest? Does the legislation require that the new review system is not used if existing remedies under other laws and regulations adequately deal with the issues at stake?

e) To what extent does the proposed law ensure general regulatory transparency and predictability? Are the modalities of government screening and review procedures clearly set up by the law? What mechanisms exist to protect confidentiality of sensitive business information?

f) Does the proposed law put in place mechanisms to ensure that regulatory authorities act within their mandate and adhere to commonly agreed good practices? Are there clear time limits for notifications of government decisions? Are the decisions susceptible to judiciary redress, including in respect to observance of the process?

Session 2: Russia as destination and source of foreign direct investment in the energy sector

5. Recent trends in Russia's energy production, trade and investment, which are increasingly shaping the country's economy and external position can be summarised by the following stylised facts:

- A significant role of the energy sector in the Russian economy and growth: in 2005, the oil and gas sector represented 30% of GDP but only 1.6% of employment. High energy prices have fuelled dynamic economic growth and improvements in terms of trade represented in 2004-2005 an impulse of 2 percentage points of GDP each year. Although the most serious symptoms of

"Dutch disease" seem to be so far minimised, diversification of the Russian economy away from its dependence on the energy sector should be the government's priority.[4]

- High fiscal dependence on energy revenues: energy-related taxes constitute some 50% of budget revenues. Energy windfalls have been so far mainly directed to the Stabilisation Fund that reached USD 100 billion in February 2007.
- A heavy reliance on energy trade: despite their fluctuations in volume, energy exports account for over 60% of total export revenues (46% from oil) and are at the origin of the sizeable current account surplus (13% of GDP in 2006) and considerable foreign exchange reserves (USD 270 billion by the end of 2006, i.e. the world's third highest, after China and Japan).
- Market structure of the energy sector: a major part of the oil sector was, until recently, mainly in private hands while the gas sector has stayed almost completely state-owned and transport network remains the state monopoly. Recent consolidations and re-nationalisation in the energy sector clearly points to the authorities' intentions to reinforce "national energy champions", i.e. Rosneft and Gazprom.
- Investment in the energy sector is insufficient and ill-adapted to increasingly demanding exploration and exploitation conditions which require considerable investment into upstream activities.[5] Most investment is going currently to downstream distribution facilities both domestically and through acquisitions of foreign assets.[6]
- Russia's energy consumption and energy intensity risk bringing down its export capacities: until 2000, domestic energy demand dropped simultaneously with overall output decline but was not matched by improved energy intensity, which has been 2 and 1/2 higher than the OECD average in 2003. Recent rapid upsurge in domestic energy demand has already started to cause domestic shortages and could soon threaten Russia's export capacities.
- Russia is the world's major energy producer: in 2005, it was the second largest oil producer with 12.1% of the world total production (after Saudi Arabia with 13.5%) and the main world gas producer (22% of the world total). It holds the largest proven natural gas reserves (26.6%) and 6.2% of world oil reserves.[7]
- Russia is and will remain a key player in world energy market. In 2005, Russia was the 2nd largest oil exporter and the world largest gas exporter. Currently, most Russian oil and gas exports are delivered to Europe. Russia's objective to diversify its energy export markets, in particular towards Asia, depends on development of new transit routes.
- Energy transport infrastructures: current capacities of state-monopoly pipelines (Transneft for oil, Gazprom for gas) are limited and their network geographically undiversified. Russia seeks actively to develop new transport capacities towards Europe (notably by bypassing Ukraine and Belarus) and expand its transport network outside Europe, in particular towards China. Aging transmission and distribution energy facilities are a major source of energy inefficiency.

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4. OECD (2006), Economic Survey of Russian Federation, Chapters 1 and 2.

5. The needs to bring on new sources of Russian gas and upgrade and maintain gas infrastructure are estimated to USD 11 billion annually [IEA/OECD (2003), World Energy Investment Outlook]. The needs to maintain Russian oil production at the current level are estimated to USD 14 billion annually [IEA/OECD (2004), World Energy Outlook].

6. OECD/IEA (2006), Optimising Russian Natural Gas: "In 2005, Gazprom management approved a 40% increase in its investment programme to USD 10.8 billion, mainly to finance the North European Gas Pipeline project. The IEA is concerned about the priority Gazprom seems to be placing on foreign acquisitions and export infrastructure as opposed to its domestic network and upstream." (p.16).

7. British Petroleum (2006), Quantifying Energy – BP Statistical Review of World Energy; June 2006.

- International investment in the extraction sector represented 20% of Russia's total inward international investment stock by the end of 2006. Although sectoral distribution of Russian outward direct investment is not available, it is likely that energy represents an important share of growing direct and portfolio investment outflows that reached USD 19.8 billion in 2006 compared to USD 13.9 billion in 2005.

6. Domestic financial resources stemming mainly from energy windfalls are not sufficient to maintain and develop Russia's energy production. Mobilising private investment, including foreign capital, is necessary not only to provide additional financial resources but also to bring technical and managerial expertise, and more generally to enhance competitive environment in the country. Growing control of the state over ownership and management of large firms in the energy and other sectors and its active support for their expansion abroad raise concerns regarding economic efficiency of such firms and their corporate strategy motivated not only by commercial objectives but used for broader policy goals.

7. In this session, participants may wish to consider the following questions:

a) What are the upsides and downsides of the dominant position of the energy sector in the Russian economy? What are the prospects for Russia's oil and gas exploration, production and energy export capacities? What are the solutions available to reduce high energy intensity in Russia? What role should the state play in these different areas?

b) How could the considerable investment needs of the energy sector be covered, in particular for exploration of new reserves, energy production and transport? What is the expected role of private and especially international investment in these different areas?

c) What are the reasons and objectives of Russian energy firms' outward investment and acquisitions abroad? What is the strategy of the Russian energy sector in terms of geographical orientation of oil and gas exports?

Session 3: Russia's public policies to promote responsible business conduct and the role of the OECD Guidelines for Multinational Enterprises

8. Weak observance of standards of responsible business conduct is one of the reasons why Russia is not always seen as a fair and reliable investment partner. The importance of responsible business conduct starts only to be recognised in Russia, notably by the government seeking to enhance its international creditworthiness and by a number of large Russian firms which have recently seen their ambitions to expand abroad countered due to perceived shortcomings in their business practices. Awareness of international standards for corporate responsibility remains still rudimentary in Russia among business and other stakeholders, including trade unions, workforce, consumers and other civil society groups.

9. The OECD background study presented at this meeting[8] examines corporate responsibility initiatives undertaken by 41 leading Russian companies listed on the Russian Trading System using their public reports. These results were compared to previously collected data concerning 125 companies in 20 emerging market economies and 1740 companies in high-income OECD countries,

8. OECD (2007), DAF/INV/WD(2007)9: Corporate Responsibility in the Russian Federation: Recent Trends, prepared by Jeremy Baskin; also available at: www.oecd.org/document/44/0,2340,en_2649_34893_38303340_1_1_1_1,00.html

examined in the 2005 OECD study.[9] This comparison shows that at the beginning of 2006 corporate responsibility initiatives and reporting have been substantially less developed among Russian companies than in enterprises in high-income OECD countries and are also less frequent than in other emerging markets. Only 40 per cent of Russian companies produced sustainability reports in 2005 or had a specific section on their website or in their annual report covering some aspect of corporate responsibility. This compares to over two-thirds of non-Russian emerging market companies in Africa, Latin America or Asian emerging markets, which provided such reports. Russian companies also compared unfavourably with their peers in Central and Eastern Europe. Russian companies performed generally poorly on almost every other indicators of responsible business conduct such as corporate social investment, business codes and ethics, environmental policies, non-discrimination policy and systems, women on company boards, training and occupational health and safety.

10. The situation seems, however, to evolve rapidly at least in Russian major firms, which have been prompted, usually due to their external exposure, to improve their transparency and accountability. The survey which compared environmental, social and governance public reports issued in 2006 by ten largest listed companies in each of eleven Central and Eastern European countries and four BRIC (Brazil, China, India and Russia)[10] shows that the majority of the Russian firms surveyed[11] now provide publicly most of the analysed information in their annual reports and websites. Compared to Brazil, China and India, information disclosure of Russian surveyed firms is relatively frequent concerning their governance structure, but less developed as regards their shareholder rights policy, audit-relation information, corporate governance code and especially weak on codes of business conduct. According to the survey, the Russian analysed firms' public reporting on environmental performance is more frequent than by their peers in Brazil, China and India, but less so for compliance with environmental standards. With an increasing number of Russian companies seeking listings and business abroad, it is likely that information disclosure and reporting practices by Russian firms will further develop and approach to international standards.

11. The main responsibility for ensuring responsible business conduct rests with business, but governments have an important role to play in this area. They should in particular provide an enabling environment that clearly defines the respective roles of government and business, encourage a dialogue on norms for business conduct, actively support companies' efforts to comply with law and respond to societal expectations communicated by other channels than law. Intergovernmental cooperation can greatly contribute to enhance awareness among the business community of internationally agreed concepts and principles for responsible business conduct.

12. Convergence of Russia's public policies for responsible business conduct towards best practices could be facilitated by adherence to the OECD Declaration on International Investment and its Guidelines for Multinational Enterprises. The declared objective of the OECD Guidelines for Multinational Enterprises to bolster confidence between enterprises and the societies in which they operate appears particularly relevant in the Russian context. Public support of corporate efforts contributing to sustainable development can alleviate the tensions and mixed feelings that still exits

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9. OECD (2005), Corporate Responsibility Practices of Emerging Market Companies: A Fact-Finding Study, Working Papers on International Investment, Number 2005/3, available at www.oecd.org/investment). It was also published in the 2005 Annual Report on the OECD Guidelines for Multinational Enterprises: Corporate Responsibility in the Developing World. This study covered only 2 Russian firms.

10. East-West Management Institute/USAID Partners for Financial Stability Program (2006), Survey of Reporting on Corporate Social Responsibility by the Largest Listed Companies in 11 Central and Eastern European Countries – First-time Comparison with Peers in BRIC and Ukraine; Warsaw, September 2006 Available at http://www.pfsprogram.org

11. The ten Russian surveyed firms are the following: Gazprom, LUKoil, Surgutneftgaz, Sberbank, RAO UES, SibNeft, TatNeft, MosEnergo, Baltika Beer Brewery and Rostelecom.

among Russian population towards the private sector in general and foreign investment in particular. Furthermore, national contact points to be established within the governments adhering to the Guidelines to oversee their implementation could be an important factor in improving a dialogue between the government and the private sector, which is still underdeveloped in Russia.

13. Public policies for promoting responsible business conduct should be integrated into governments' overall investment strategy aimed at improving investment climate and enhancing the development benefits of investment to society. Russia together with some other 60 OECD and non-OECD governments has participated in the development of the Policy Framework for Investment,[12] which includes a chapter on responsible business conduct. By encouraging public-private dialogue, the promotion of responsible business conduct practices could also help to clarify the respective role of the government and the private sector, which is currently one of the most controversial aspects of Russian economic life and policy management.

14. The following issues might be addressed in this context:

a) Do Russian participants and foreign investors consider that general awareness of standards of responsible business conduct is still relatively low among most Russian stakeholders? How do external observers evaluate recent efforts of Russian large firms to make publicly available information on their responsible business practices?

b) Would a better information disclosure and application of responsible business conduct by Russian firms improve the perception of Russian investors abroad? Are there any specific aspects of responsible business conduct, such as employment and industrial relations, environmental aspects, fight against corruption, which would need to be particularly developed by Russian firms?

c) What have been so far the Russian government's efforts to promote responsible business conduct among Russian firms? What could the government do to enhance the knowledge and dissemination of international standards of responsible business conduct in Russia? Does the Russian government think that the adherence to the OECD Guidelines for Multinational Enterprises would be a useful instrument to enhance public policy in this area?

12. See www.oecd.org/daf/investment/pfi