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RUSSIAN FEDERATION

STRENGTHENING THE POLICY FRAMEWORK FOR INVESTMENT

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2008

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Russian Federation

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Foreword

The Review has been undertaken under the aegis of the OECD Investment Committee as a part of its co-operation programme with the Russian Federation. The Ministry of Foreign Affairs of Finland has provided financial support for this work.

*The OECD investment policy reviews aim to facilitate dialogue between OECD and partner countries, share experience and support investment policy reforms. The work of Russia's Review has benefited from contributions of OECD and Russian officials and experts which participated in the two expert meetings organised in May 2007 in Helsinki and in April 2008 in Moscow. The 2008 Review provides an update to the 2006 Review on recent developments in Russia's investment flows and policy and reports on corporate responsibility practices of listed Russian companies. It also examines Russia's energy investment policy in light of the OECD Policy Framework for Investment.**

The Review is based on a background report prepared by Blanka Kalinova, Senior Economist in the Investment Division headed by Pierre Poret, in the OECD's Directorate for Financial and Enterprise Affairs. Hanna Peltonen provided research and statistical support. Pamela Duffin is the Division's communication officer.

* The cut-off point for information in this report is May 2008.

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List of Abbreviations

APEC	Asia-Pacific Economic Co-operation
ATS	Administrator of Trading Systems
BIT	bilateral investment treaty
BRIC	Brazil, Russia, India and China
CBR	Central Bank of Russia
CEFIR	Centre for Economic and Financial Research
CIS	Commonwealth of Independent States
CTPA	Centre for Tax Policy and Administration
ECT	Energy Charter Treaty
EITI	Extractive Industries Transparency Initiative
EIU	Economist Intelligence Unit
EBRD	European Bank for Reconstruction and Development
ESCO	Energy service company
FAS	Federal Antimonopoly Service
FDI	Foreign direct investment
FIAC	Foreign Investors Advisory Council
FIAS	Foreign Investment Advisory Service
FSFM	Federal Service for Financial Markets
FTS	Federal Tariff Service
IEA	International Energy Agency
IPA	Investment Promotion Agency
IPO	Initial public offering
ICSID	International Centre for the Settlement of Investment Disputes
LME	Large and medium enterprises
LNG	Liquefied natural gas
MFN	Most-Favoured-Nation
MIGA	Multilateral Investment Guarantee Agency
NADI	National Agency for Direct Investment
NGO	Non-governmental organisation
OECD	Organisation for Economic Co-operation and Development
PFI	Policy Framework for Investment
PPP	polluter pays principle
PSA	Production Sharing Agreements
RosStat	Federal Service for State Statistics

SEZ	Special economic zones
SME	Small and medium enterprises
SOE	State-owned enterprise
TGC	Territorial generation companies
TPA	Third party access
TRIM	Trade-Related Investment Measures
UAC	United Aircraft Construction Corporation
UGSS	Unified Gas Supply System
UNCTAD	United Nations Conference on Trade and Development
UNECE	United Nations Economic Commission for Europe
VTB	Vneshtorgbank
WAIPA	World Association of Investment Promotion Agencies
WGC	Wholesale generation companies
WTO	World Trade Organization

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Executive Summary

The 2008 *Investment Policy Review of the Russian Federation* examines developments in the country's investment flows and policy since the last OECD Review published in 2006.* It also analyses Russia's energy investment policy against various aspects of the Policy Framework for Investment and considers corporate responsibility practices of large Russian companies.

In 2007 **Russia's international investment flows** reached the highest levels recorded so far. With USD 52 billion of foreign direct investment (FDI) inflows and USD 46 billion invested by Russian enterprises abroad, the country counts now among the world largest recipients and sources of FDI. Russia's FDI stock has considerably increased and the degree of FDI penetration has become comparable to other emerging market economies. Inward investment originates from a relatively few partner countries and is concentrated in the primary sector, manufacturing and traditional services such as trade. Russia's potential for attracting further foreign investments is significant giving its abundant natural resources and large and dynamic domestic market. The motivations of Russian enterprises investing abroad have considerably evolved in recent years. They now aim at internationalising their activities and controlling their value chains. This trend which concerns both state-controlled and large private enterprises is likely to continue in future.

A strengthening of state control has characterised Russia's recent economic development and has important implications for foreign investors. The new **law on strategic sectors** that entered into force in May 2008 defines 42 sectors in which the control by foreign investors will be subject to prior authorisation delivered by a special governmental commission. In replacing former *ad hoc* approval practices, the law is an important step in enhancing legal transparency and predictability. However, its sectoral coverage is broader and delays for notifications of governmental decisions longer than OECD recommended best practice which provide for investment restrictions narrowly focused on essential security and public order and a limited timeframe for completing reviews and notifying decisions. Another related phenomenon is the emergence of large state-controlled conglomerates which have often been

* OECD Investment Policy Review of the Russian Federation: "Enhancing Policy Transparency", Paris 2006.

established through consolidation of existing state-owned enterprises. These companies usually enjoy dominant market positions in their areas of activity. The scope and modalities of private sector participation, including by foreign investors, in these conglomerates are tightly controlled. An approach offering more opportunities for a positive contribution by the private sector and for beneficial competition would be better aligned with the government's declared strategy of modernising and enhancing the competitiveness of the Russian economy.

The overview of Russia's **energy investment policy** shows 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. 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 world energy prices, significant sunk costs and usually long-term returns on investment. Several policies appear to be essential: continue the alignment of domestic energy prices with production costs, secure property rights, adapt the tax regime to differentiated production conditions and improve transparency of tax procedures, ensure effective competition policy and strengthen the independence of sectoral regulators. Maintaining the vital role of Russia's energy sector for the 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.

Responsible business practices have become an increasingly important element in evaluating countries' investment environment. As documented by OECD research, general awareness of international standards of corporate responsibility has been relatively low in Russia not only compared to OECD countries but also other emerging markets. The situation seems to be changing rapidly in conjunction with external exposure of large Russian enterprises. Recent studies indicate that large Russian enterprises have started to catch up with their counterparts in OECD and other emerging market economies. They now publish relatively detailed annual reports and provide information on their websites, including for instance on compliance with environmental standards. However, large Russian firms still give comparatively limited information on their adoption and observance of codes of conduct and management systems in place to promote business ethics. Dissemination of responsible business practices can boost Russia's creditworthiness and reliability as inward and outward investor.

The Annex summarises the findings of recent comparative **business surveys of the Russian investment climate**. Despite Russia's growing investment attractiveness evidenced by increased FDI inflows, many investors still perceive Russia's business climate uncertain and less favourable than in some other emerging markets. While expected high returns in the natural resources sector may make large foreign investors less sensitive to traditional investment barriers and explain a part of large FDI inflows recorded, the surveys report a number of factors which affect investors' perceptions, notably the persistence of regional disparities in business conditions and difficulties experienced by some categories of firms, especially small and medium-sized enterprises and exporters in obtaining information and in the face of regulatory uncertainty.

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Chapter 1

Recent Trends in International Investment

In 2007, Russia has recorded its highest international investment inflows and outflows to become one of the world largest recipients and sources of foreign direct investment (FDI). According to the Central Bank's data, Russia's FDI inflows reached USD 52.5 billion in 2007 and Russian enterprises invested USD 45.6 billion abroad. As a result, the degree of Russia's FDI penetration in terms of the shares of FDI in its GDP and investment has significantly increased and become comparable to some other emerging market economies. Inward investment originates from a relatively few partner countries and its sectoral structure is concentrated in the primary sector. Russia's natural resource endowment and large and vibrant domestic market will continue to offer attractive opportunities to foreign investors. Russia's outward investment is also expected to grow, motivated by the efforts of Russian state-controlled and private enterprises to internationalise their activities and control their value chains.

1. Developments in Russia's international investment in 2006-2007

Since 2000, Russia's domestic economic situation and international investment position have improved remarkably. Inward foreign direct investment has been growing since 2003 and Russia has become a net FDI recipient since 2004.[1] In 2006, FDI inflows more than doubled allowing Russia to achieve its peak FDI net position (USD 9.2 billion). Although inward FDI remained dynamic in 2007 (+62%), an even more rapid growth of FDI outflows reduced Russia's FDI net position to USD 6.8 billion (see Figure 1.1). Due to the high levels of inward and outward investment in 2006 and 2007, Russia confirmed its leading position in the international investment landscape.

Russia's international investment displays a number of specific features. First, the predominance of 'other investment' both in total outflows and inflows (51% and 68% respectively in 2007) indicates that Russian private and state-controlled firms strongly rely on external financing, partly due to under-developed domestic financial markets and because the appreciation of the national currency has made external financing attractive. Second, compared to many other countries, portfolio investment (6.3% of total inflows in 2007) remains under-represented in Russia's international investment (see Table 1.1).

In 2007, foreign direct investment in mining and quarrying has tripled compared to the previous year thus reinforcing the prominence of the primary sector in Russia's FDI. The manufacturing sector has remained the second

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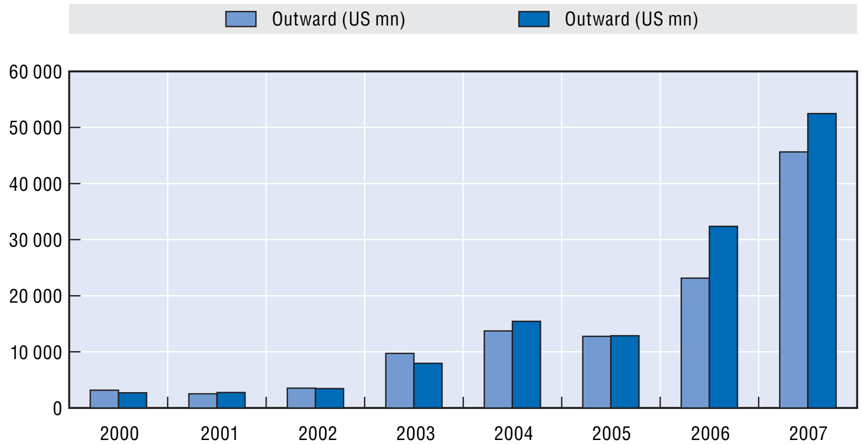
Figure 1.1. **Russia's inward and outward foreign direct investment 2000-2007**



Source: Central Bank of Russia, *Balance of Payments*, April 2008.

Table 1.1. **Russia's international investment flows, 2005-2007**

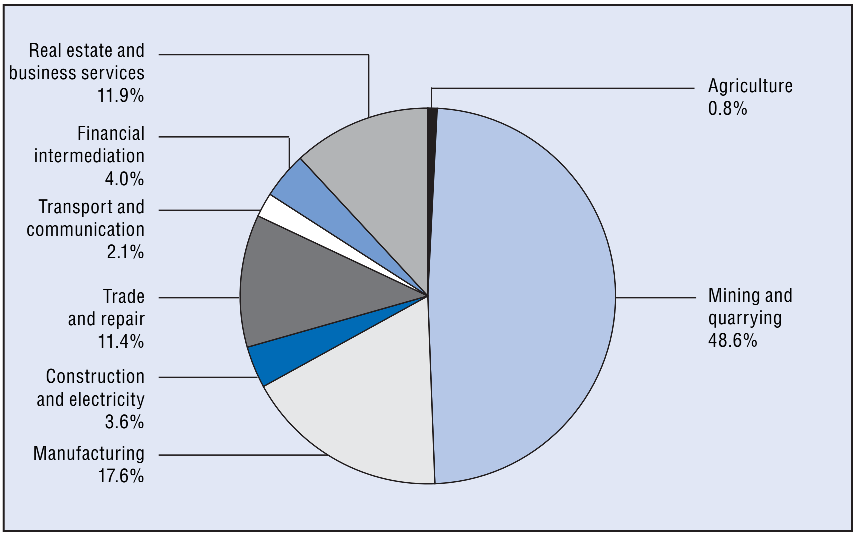
Millions of US dollars

	2005	2006	2007
Total outward investment flows *Of which:*	56 056	78 679	107 852
• Direct investment	12 767	23 151	45 652
• Portfolio	10 666	6 248	7 039
• Other investment	32 623	49 280	55 161
Total inward investment flows *Of which:*	54 416	71 851	202 002
• Direct investment	12 886	32 387	52 475
• Portfolio	- 828	9 124	12 729
• Other investment	42 358	30 340	136 798
Inward FDI stock	180 313	271 590	n.a.
Outward FDI stock	146 679	209 559	n.a.

Source: Central Bank of Russia, *Balance of Payments Statistics*, April 2008.

largest recipient, representing almost 18% of total FDI inflows in 2007. Although FDI in financial services and communications has also increased in recent years, traditional services such as trade and repair continue to prevail (Figure 1.2). In terms of the location of FDI within Russia, investments are strongly concentrated in certain regions: Moscow city remains the first destination for foreign investment in Russia (38% of the total in 2006), followed by Sakhalin (15%) and the Moscow region (less than 10%).

Figure 1.2. **Russia's FDI inflows: Sectoral structure, 2007**
Per cent



Source: Federal Service of State Statistics (RosStat), February 2008.

Russia's FDI flows come from a limited number of partners: in 2007, the share of the two largest investors represented more than 68% of inward and some 65% of outward FDI stocks (Table 1.2). The important position of Benelux countries is not unusual and corresponds to a large extent to the activities of special purpose entities and holding firms established by multinational enterprises in these countries to finance and manage their cross-border investment. The position of some other major investing partners reflects their role as a source of round-tripping flows, *i.e.* investment by Russian companies often seeking to circumvent domestic regulatory restrictions.

Since its economic opening at the beginning of the 1990s, Russia has been an active outward investor. As a relative newcomer in the international investment landscape and a catching up middle-income country, Russia's position as a net outward investor has been considered puzzling.[2] Although the presence or liberalisation of capital control could be a part of the explanation, outward investment by Russian firms in the 1990s was due to a great extent to the instability of the domestic situation and their efforts to avoid high taxes, administrative constraints and the risk of expropriation, as well as by the opportunities of acquiring strategic assets available through privatisation in former Soviet republics.

Over the past few years, the motivations of Russian firms have evolved considerably. The growing financial capacity of large Russian firms has allowed them to envisage internationalising their activities and controlling

Table 1.2. **Russia's foreign direct investment: Geographical structure, 2007**

Per cent

	FDI inward stock	FDI outward stock
Total *of which*	100	100
Cyprus	34.4	13.5
Netherlands	34.2	51.9
Luxembourg	0.7	–
United Kingdom	3.3	4.7
Germany	4.4	1.9
United States	3.5	8.1
Ireland	0.4	–
France	1.5	–
Switzerland	1.6	0.6
Virgin Island	2.8	0.3
Austria	–	0.0
Ukraine	–	0.9
Belarus	–	4.7
Others	13.2	13.4

Source: Federal Service of State Statistics (RosStat), February 2008.

their value chains. Since 2004, foreign assets of the top 25 Russian large firms have more than doubled to reach USD 58.4 billion in 2006. Some 65% of this investment has been made by four firms: two oil/gas companies (Lukoil and Gazprom) and two companies specialised in metal/mining (Severstal and Rusal).[3] In 2007, Russian large privately-owned companies continued to be strongly involved in outward investment.[4]

According to available data, only two countries of the Commonwealth of Independent States (CIS), Ukraine and Belarus, are among the 10 most important destinations of Russia's FDI outflows, representing together less than 6% of the total outward FDI stock in the 2007 (Table 1.2). However, these official figures certainly underestimate Russia's actual investment in the CIS region as many deals in these countries are not recorded in the balance of payments because investments are realised through offshore units or by Russian companies already present in CIS countries.[5]

2. Russia's foreign direct investment flows in international comparison

Notwithstanding its relatively recent entry into the international investment scene, Russia has become an important player, ranking among the 25 largest FDI recipients worldwide since 2006. In relative terms, *i.e.* FDI per head and as a share of domestic investment, Russia outperformed China in 2006 (see Table 1.3). However, the degree of FDI penetration, measured by the ratio of FDI inward stock to GDP, remained still lower in 2006 in Russia (9.5) than in Brazil (20.1)

Table 1.3. **FDI indicators for BRIC, 2006**

Indicator	Brazil	Russia	India	China
FDI inflows (in billion USD)	18.8	28.7	17.5	78.1
FDI outflows (in billion USD)	28.2	18.0	9.0	17.8
FDI inward stock (in billion USD)	214.3	93.9	67.7	699.5
FDI outward stock (in billion USD)	107.5	75.2	21.1	82.3
FDI inflows per head (in USD)	102	201	16	60
FDI inflows as per cent of gross fixed investment (%)	10.5	16.3	6.4	6.8
FDI inward stock per head (in USD)	1 160	660	60	530
FDI stock as per cent of GDP (%)				
• Inward	20.1	9.5	7.3	25.7
• Outward	10.1	7.6	2.3	3.0
Outward/inward FDI stock ratio (%)	50	80	31	12

Source: EIU (2007), *World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk*, September 2007.

and especially China (25.7). According to 2007 preliminary data, Russia's international investment inflows continued to be higher than the amounts received by Brazil and India but still considerably below China's performance.[6]

As already noted, Russia's emergence as an outward investor has intervened earlier than in other countries. It became the third largest outward investor among emerging markets already in 2003 (after Hong Kong-China and Singapore), despite the fact that capital controls were still applied at that time in Russia. Even if Russia has not provided until recently[7] official government support for increased outward investment, comparable for example to China's "Go Global" programme,[8] its FDI outward stock remains significant in absolute terms and as the share of GDP. Russia's ratio of outward to inward FDI stock (80%) is high compared to the three other countries, especially China (12%) (Table 1.3).

3. Russia's potential to attract foreign investment

Russia's FDI attractiveness has benefited from prudent macroeconomic policies leading to a surplus in the state budget, declining unemployment, rising per capita income as well as external debt repayments and a substantial increase in foreign exchange reserves. An upward trend in Russia's international investment flows is expected to continue in the medium term, supported in particular by an ambitious infrastructure investment programme and Russian companies' external borrowing.

Despite impressive growth in FDI inflows, Russia's potential for attracting further investment is far from being fully exploited. Until recently, Russia's domestic investment was sluggish and the share of public and private investment in GDP (18.9% of GDP on average in 2000-2005) was significantly lower than in most developed and emerging economies. This performance was in striking contrast with the government's declared objective of economic diversification and the need to modernise outdated and deteriorating infrastructure. Fixed investment started to increase in 2006 (by 13.5%) and its growth further accelerated in 2007 (21%). The Russian authorities have launched an ambitious investment programme for infrastructure development, financed in large part through the recently created Investment Fund and Development Bank (see Box 1.1). Although these new initiatives mainly rely on public financing, participation of private, including foreign, investment is also envisaged and recognised to be necessary not only from a financing point of view but also to ensure the technological viability of projects.

In light of recent developments, current forecasts of Russia's outward investment (USD 25 billion annually between 2007 and 2011, representing 10% of GDP)[9] could be considered modest. But the sectors concerned will likely be similar to those which dominate Russia's current outflows, *i.e.* the energy sector, metallurgy and manufacturing. The main players will continue to be both major state-controlled enterprises (Gazprom and Rosneft) and large private companies, such as Severstal, Norilsk Nickel and Evraz. Although the CIS region will remain an important destination, the Russian companies are expected to be increasingly active in other regions, including Africa.

Certain risks may threaten Russia's dynamic economic growth and investment. The main external danger would be a significant downturn in energy prices with inevitably negative consequences especially on public financing capacities. Russia's investment programme could also suffer from aggravating domestic economic bottlenecks, in particular labour shortages and the lack of specific skills, which have already been affecting some projects of both domestic and foreign investors. However, the most important obstacles to further domestic and foreign investment in Russia are essentially of a policy nature, notably greater state interference in economic activities and the uncertainty resulting from the postponement of necessary administrative and regulatory reforms.

Most foreign investors consider that Russia's natural resource endowment and large and dynamic domestic market offer significant opportunities for competitive returns on investment. For example, the Russian Federation is ranked fourth (after China, India and the United States) among the most attractive locations for FDI for 2007-2008 in the UNCTAD survey on FDI prospects.[10] Russia is expected to attract considerable amounts of FDI (more than 2% of the world total) between 2007 and 2011, with annual FDI inflows higher than Brazil and India though still considerably lower than China. If these estimates prove accurate, Russia should significantly improve its international ranking, taking the 13th position among the world's largest FDI recipients in the next five years.

Box 1.1. **New sources of public financing for investment in infrastructure**

The new three year federal budget rules for 2008 2010 were approved in April 2007 with the objective of achieving better transparency and long term stability and planning. The new rules have also been introduced for using energy windfall savings. Starting in 2008, the Stabilisation Fund currently collecting oil taxes and income from oil export tariffs will also receive tax revenues from natural gas and export tariffs when the gas price increases above a certain level. Furthermore, in February 2008 the Stabilisation Fund was split into a Reserve Fund and a National Welfare Fund.

The Reserve Fund has to be maintained at the level of 10% of GDP and the funds available above this limit will go into the *National Welfare Fund*. The assets of the Reserve Fund will be invested in high grade sovereign bonds and those of the National Welfare Fund in a broader range of assets. Before these new rules were to come into effect in 2008, RUB 300 billion was withdrawn from the Stabilisation Fund to capitalise existing and newly created state development agencies: the Investment Fund, the Development Bank and the Russian Venture Company, which are to finance projects in infrastructure and high technology industries with the financial contribution of the private sector.

The *Investment Fund*, was created in 2006 to support public-private partnerships, especially in infrastructure. Several major projects have been approved in transport, oil refining, water and regional development with a total value of RUB 870 billion. The Fund is supervised by the Regional Development Ministry.

The *Development Bank* was formed in May 2007 by restructuring the state controlled bank, Vneshekonombank, with the injection of RUB 650 billion of state funding. Its role will be to promote and finance innovation, exports and infrastructure development, encourage activities of small and medium sized enterprises, provide export guarantees and participate in most state investment projects. The new financial organisation will not be subject to central bank supervision and its supervisory board will be chaired by the Prime Minister.

The *Russian Venture Company* established in 2007 by the Ministry of Economic Development and Trade received resources from the government to be supplemented by an approximately same amount provided by private investors. The objective of the fund is to contribute to technological development and to an innovation driven economy by providing financing to innovative companies, including those with foreign participation.

In addition, the current investment boom in Russia has also been enhanced by national priority programmes financed from the federal budget, in particular the housing programme, and by already existing instruments, such as subsidized interest rates available for infrastructure development in special economic zones. Investment for the 2014 Winter Olympics will also be majority financed by the State.

Notes

1. There are two main sources for FDI data in Russia, which – owing to different statistical methodologies – continue to differ in their estimates of the total value of the country's inward and outward international investment and its components. In contrast to the Federal Service for State Statistics (RosStat), the Central Bank of Russia (CBR) includes reinvested profits of foreign subsidiaries into direct investment. Some other items are considered as long-term loans by RosStat but as direct and portfolio investments by the CBR. Geographical and sectoral breakdowns of international investment are available only from RosStat.
2. Kalotay, K. (2007), "Russian Transnationals and International Investment Paradigm", *Research In International Business and Finance* (2007).
3. Survey of Russian multinationals; Skolkovo Moscow School of Management and the Columbia Program on International Investment (CPII), Moscow-New York, December 2007.
4. The biggest investment transaction so far realised abroad by a Russian entity has been the purchase by the Russian private firm Norilsk of the Canadian firm LionOre for USD 6.2 billion.
5. Vahtra, P. (2006), "Expansion or Exodus? Trends and Developments in Foreign Investment of Russia's Largest Industrial Enterprises", Pan-European Institute, 1/2006, available at *www.tukk.fi/pei/pub*.
6. UNCTAD Investment Brief, number 1/2008.
7. "Medvedev urges push to invest in foreign companies", in *Financial Times*, 1 February 2008.
8. Karl P. Sauvant (2006), "Inward and Outward FDI and the BRICs", p. 243; in Subhash C. Jain, edit: *Emerging Economies and the Transformation of International Business – Brazil, Russia, India and China,* Edward Elgar, 2006.
9. EIU (2007), "World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk", September 2007.
10. UNCTAD (2007), *World Investment Report 2007*, p. 30; New York/Geneva 2007.

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Chapter 2

Russia's Strategic Sectors and Corporations

Recent economic developments in Russia have been characterised by a strengthening of state control which has important implications for foreign investors. The recently adopted law on strategic sectors specifies the sectors in which the control by foreign investors will be subject to prior governmental approval. In replacing former case-by-case authorisations, the law seeks to improve transparency and predictability for foreign investors. However, the law has a broader sectoral coverage and longer timeframe for notification of governmental decisions compared to OECD recommended best practice which provide for investment restrictions narrowly focused on essential security and public order and shorter delays for notifications of government decisions to the applicants.

Another related phenomenon has been the emergence of large state-controlled conglomerates which have been often created by merging existing state-owned enterprises. These new corporations usually enjoy dominant market positions in their areas of activity. The scope and modalities of private sector participation, including by foreign investors, in these conglomerates are tightly controlled. An approach offering more opportunities for a positive contribution by the private sector and for beneficial competition would be better aligned with the government's declared strategy of modernising and enhancing the competitiveness of the Russian economy.

1. Law on strategic sectors

In his annual address in April 2005, President Putin invited the government to prepare a law clarifying the conditions of foreign participation in strategic sectors. The draft bill was initially submitted to the Duma in July 2007 but withdrawn by the government after the first reading. The Russian government appointed in September 2007 presented a new draft which was adopted by the Duma and then by the Federal Council in March 2008. The law was signed by President Putin on 5 May 2008.

Compared to the initial 2007 draft, the final version of the federal law on "Procedures of Making Foreign Investment in Business Entities of Strategic Importance to National Defence and Security of the State" has a broader sectoral coverage (42 sectors against 39 initially) and includes more restrictive conditions for foreign involvement in the subsoil exploration and exploitation. The final version also describes in more details the documents and information to be

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provided by applicants and the role of governmental bodies involved in the approval procedures.

The 2008 law states explicitly that its provisions do not apply retroactively. However, foreign investors should submit information to the relevant governmental body if they acquired 5% or more shares in strategic business entities before the entry into force of the new federal law. Such information should be provided in 180 days after the date of application of the law.

The 42 sectors enumerated by the new law can be grouped into the following broader categories:

- Hydro-meteorological and geophysical activities.
- Activities using pathogens of infection diseases.
- Activities involving nuclear and radioactive materials and their waste, including research, equipment design, construction and operation of nuclear installations, extraction and processing uranium and radioactive substances.
- Activities related to coding and cryptographic equipment and electronic devices for the secret reception of information.
- Design, manufacturing, maintenance, sales and use of weapons systems and arms, ammunition, explosives and military equipment and technology.
- Space-related technologies and activities.
- Design, testing, manufacture and maintenance of aviation equipment and technology, including dual-purpose aviation equipment and technology; aviation safety activities.
- TV and radio broadcasting covering the territory inhabited by half or more of the overall population of the Russian Federation.
- Production, services and trade in areas covered by the federal law on natural monopolies (excluding electrical power and municipal heating distribution and postal services).
- Activities carried out by business units included in the register provided for in the federal law "On protection of competition" and holding a dominant position in the territory of the Russian Federation in communication services (excluding Internet providers).
- Manufacturing and sale of metals and alloys used for manufacturing of arms and military technology (if the target company has a predominant position in these activities).
- Geological surveys of subsoil and/or prospecting for and extraction of minerals in subsoil plots of federal importance.
- Exploitation of water biological resources (fisheries).

- Printing services provided by business units printing 200 or more millions lists a month; editing and publishing activities if they concern 1 million or more copies).

Foreign control over Russian firms involved in one of these activities is subject to prior authorisation. Foreign control is defined as 50% of voting shares and giving the possibility to foreign companies to appoint half or more members of the managing body of the new business entity. In the case of companies involved in geological survey of subsoil and/or prospection and extraction of minerals in subsoil plots of federal importance, foreign control corresponds to 10% and more of total shares. If the proposed transaction involves a foreign state-owned company, international organisations and companies under their control, the threshold for the prior governmental approval is 25% of the capital in companies active in strategic sectors and 5% of the capital in companies involved in geological survey of subsoil and/or prospection and extraction of minerals in subsoil plots of federal importance. Russian companies in which the state accounts for more than 50% of the capital are not subject to the new law, therefore they are not required to seek the prior approval, except if the foreign investor is a foreign state or international organisation or if the transaction concerns subsoil plots of federal importance.

The approval process includes several subsequent steps:

- The submission of the application by foreign investors to the "authorised body": the submission should contain in particular information concerning foreign investors' main activities during the two years before the application, a draft business plan of the new strategic entity and the information about the composition of the shares. The body has 14 days to register and check the application. After the registration, the body should notify in 3 days the applicant if it considers that the transaction does not result in the control of strategic enterprises. In other cases, the body has 30 days to inform and transmit the application to the Government Commission for Control over Foreign Investment (hereafter the Commission) and the Federal Security Service Agency.
- The Federal Security Service Agency has 20 days to consider whether the proposed transaction represents a threat to the country's defence and security.
- The Commission, chaired by the Prime Minister, has three months to give or not its approval. In exceptional cases, this timeframe can be extended by additional three months.
- A transaction is not considered approved until the authorised body has granted its explicit consent.

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The approval procedures thus take four months minimum and could last up to seven months. The law establishes that the decisions and actions or the absence of action by the responsible governmental bodies can be appealed in the courts. A decision of the Commission to refuse the approval could be subject to redress in the High Arbitrazh Court of the Russian Federation. The law addresses the issue of confidentiality of information communicated for the purpose of the inquiry and foresees that eventual damages due to the divulgation of such information should be sanctioned in accordance with the "procedures stipulated by the legislation of the Russian Federation".

In clarifying the conditions of foreign investors' involvement in the so-called strategic sectors, the new law responds to its main objective to replace former case-by-case approvals and enhance policy transparency and predictability. Foreign investors also appreciate that the law will not be applied retroactively. However, several provisions of the new law raise concerns. The main criticism is the broad sectoral coverage of the law going far beyond the usual areas motivated by essential security interest. In particular, the inclusion of natural monopolies within the "strategic sectors" means that governmental control extends over large parts of Russian economy.[1] The economic rationale of strict limitations on foreign participation in geological subsoil prospection and extraction of minerals in subsoil plots of federal importance could also questioned as such restrictions risk further aggravate the situation especially in oil and gas upstream activities which already face difficult exploitation conditions and struggle to cope with growing domestic and international demand pressures. The four to seven month delay for notifications of governmental decisions to the applicants is longer than timeframe of approval procedures usually applied in OECD countries.

As already mentioned, transactions between foreign private enterprises and Russian majority state-owned enterprises are not within the competence of the new law on strategic sectors. This confirms the special position of "strategic" corporations in which the state intends to maintain its majority ownership and which are considered as the central piece of its economic strategy (see below).

It remains to be seen how the new law will be implemented and what will be its impact on foreign investment. In this context, discussions within the ongoing OECD project on "Freedom of investment, national security and 'strategic' industries",[2] in which Russia has also participated, are particularly relevant. The exchange of experiences and information among participating countries has shown that whereas existing legal provisions and regulatory practices vary in individual countries there is strong support for three principles for investment policy measures addressing essential security interests: *i)* transparency and predictability of investment review procedures, *ii)* proportionality requiring that investment restrictions are not more costly or more discriminatory than needed to achieve the security objectives and do not duplicate what is, or could be, better dealt with other regulations; and *iii)* accountability of implementing authorities, including public reporting and procedures for parliamentary oversight, judicial review and periodic regulatory impact assessments.

2. Strategic corporations

Although the private sector represents a major part of Russia's GDP,[3] public ownership is still strong and concentrated in large state-controlled firms. Most of these conglomerates have been created through the consolidation of incumbent firms, some of them having already the status of "strategic" corporation in accordance with the Decree of the President of the Russian Federation "On adoption of the list of strategic enterprises and strategic joint stock companies" (Decree No. 1009 of 4 August 2004). These corporations usually enjoy the dominant position in the domestic market in their areas of activity. The government sees these large firms as the main instrument of its modernisation strategy aimed at enhancing Russia's international competitiveness in selected sectors. The status of strategic state corporations prevents the privatisation of such firms while allowing them to obtain funding from the federal budget and, in some cases, also to receive private financing. Foreign investment in these entities is not excluded, but the state has to retain a majority stake. Some of these conglomerates are encouraged to undertake outward investment or enter into partnerships with foreign partners as a part of their modernisation strategy.

As shown in Table 2.1, the sectors in which the government intends to maintain its control, including over inward and outward foreign investment is quite extensive. In addition to the energy sector and aircraft industry, it includes shipbuilding, car manufacturing, banking and the forestry. This leaves only a relatively limited number of sectors completely outside of state control.[4]

Given its critical role in Russian economy, the **energy sector** has been the first area where the new policy has been implemented. Majority ownership has been imposed on the two largest energy producers and their dominant position in the domestic market has been reinforced. In the gas industry, the state increased its stake to obtain a controlling interest in Gazprom in 2005 and opened the remaining 49% of the company's capital to other investors in 2006. The initial public offering has allowed Gazprom to attract significant capital, thus becoming one of the world's largest companies by market capitalisation (USD 270 billion in 2006). In parallel, Gazprom has strengthened its dominance in the domestic gas market through its participation in Russian independent producers, including Novatek, Northgaz and Itera. In 2006-2007,

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Gazprom took control of energy projects in which foreign investors had previously held majority stakes, in particular Sakhalin-2.

Gazprom's active acquisition policy both in the domestic and external markets, financed largely through external borrowing, extends well beyond its core activities. As a part of its diversification policy, Gazprom has acquired shares in Russian oil companies (76% of Sibneft and 37% of Slavneft in 2005) and in electricity (Mosenegro, the main electricity producer in the Moscow region) and has recently concluded a joint venture with Siberian Coal Energy Company (SUEK), one of Russia's largest coal mining companies. Gazprom is also the world's largest operator of a natural gas transport system and its monopoly over gas exports was confirmed by law in 2006.

In recent years, Gazprom has intensified its outward investment: following its strong involvement in upstream and downstream activities in traditional export markets in the CIS regions and the Baltic States, it has been developing partnerships with European companies to reinforce its presence in European distribution and energy transport networks. This active acquisition policy has been a source of political concern in Europe given its strong energy dependence and the lack of reciprocity for the access of foreign investors to Russia's energy market. Gazprom has also been criticised for a lack of coherence and an inadequate investment strategy which privileges external expansion of downstream activities at the expense of much needed modernisation of existing extraction sites and further exploration.

The government adopted a similar development strategy in the case of Rosneft, which represents the state's interests in the oil industry. The 2006 initial public offering (IPO) resulted in the reduction of the state ownership share but at the same time the dominant position of Rosneft has been reinforced by the acquisitions of Yuganskneftegaz, the main production facility of former Yukos. After western oil companies were compelled to abandon their majority stakes in several major projects (Shell-Mitsui-Mitsubishi in Sakhalin-2; TNK-BP in the Kovykta field), both Gazprom and Rosneft have promoted a new form of strategic alliance with foreign companies consisting of general co-operation agreements (Rosneft with Shell and Gazprom with BP), partnerships in specific projects (*e.g.* Gazprom with Total for developing the Shtokman filed) and joint investment in long-term energy projects, including via assets swaps in Russia and abroad.

Russia's third largest energy company, Lukoil, remains privately-owned but has in many respects followed a similar international acquisition strategy as its state-controlled counterparts. In 2004, more than 80% of its revenues were generated abroad due essentially to upstream production in the CIS and the Middle East and to its international presence in refineries and distribution in Eastern and Western Europe and the United States.[5]

Table 2.1. **Strategic corporations**

Sector	Umbrella company	Company's profile	Exposure to foreign investment
Gas	Gazprom	Created from the Ministry of Oil and Gas in 1989, partly privatised in 1993; currently the 3rd world largest publicly traded company. Until 2004, the government had a 38.7% stake and foreign ownership was limited to 9%; in 2005, the state ownership was increased to 50.01% together with the ceiling for foreign participation. Active acquisition policy in Russia in: *i)* its core activity through purchases of Russian entities (*e.g.* Novatek, the largest independent gas producer in Russia) and increasing its participation in projects involving foreign participation (Sakhalin 1 and 2, the Kovykta field); *ii)* related activities in view of control of its value chain (distribution and construction of pipelines) and *iii)* additional activities to pursue its diversification (electricity, oil, coal).	Foreign involvement: E.ON is the major foreign shareholder, owing 6.5%. Outward investment: operations in upstream (Turkmenistan) and downstream (Ukraine, Belarus, Baltic States); joint ventures and partnerships with EU marketing and distribution companies (*e.g.* Wingas, GDF, MOL); China.
Oil	Rosneft (national strategic corporation)	Previously 100% state-owned; as a result of the 2006 initial public offering (IPO) of USD 10.4 bn, state ownership reduced; 40% of the issued shares bought by undisclosed Russian investors. Rosneft's purchase of Yuganskneftegaz (USD 30 bn) was financed through foreign borrowing. The state has to keep 75% of Rosneft's shares.	Foreign involvement (resulting from the 2006 IPO): 21% of the issued shares bought by BP, the China National Petroleum Company and Petronas; the remaining by international portfolio investors. Outward investment: participation in foreign upstream ventures (Algeria, Columbia, Kazakhstan, China).
Energy transport	Transneft Transnefteproduct Gazprom	All state-controlled; discussions on possible merger of Transneft and Transnefteproduct; Gazprom controls pipeline construction and transports for exports. The objective is to develop Russian ports and increased export capacity of terminals to be able to avoid transport routes through other countries.	
Electricity	RAO UES	Initially Russia's state-owned electricity monopoly, divided in 2007 into regional electricity generating companies to encourage competition. State ownership is equivalent to 52.7 % of capital.	Foreign involvement: opening of several regional production companies to private investors, including foreign. Outward investment: mainly in CIS through subsidiaries or participations in energy facilities (Georgia, Armenia, Moldova, Ukraine, Belarus).

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Table 2.1. **Strategic corporations** *(cont.)*

Sector	Umbrella company	Company's profile	Exposure to foreign investment
Nuclear energy	Rosatom	Wholly state-owned company controlling the nuclear power stations in Russia.	
Nuclear energy equipment	Atomenergoprom (national strategic corporation)	The umbrella company created through consolidation of existing companies with state participation. It controls uranium extraction, fuel production and electric generation, construction of nuclear power plants in Russia and abroad. As the state strategic company, it cannot be privatised and should remain controlled by the government.	
Defence industry and strategic materials	Russian Technologies (national strategic corporation)	Former Rosoboronexport, it became a state strategic corporation under the name of Russian Technologies in October 2007 with the objective to take a lead in modernisation and development of Russia's heavy industry. It controls RusSpetsStal (a specialized steelmaker) and AvtoVAZ (the major domestic car producer).	Outward investment: a controlling stake (66%) in VSMPO-Avisma (the world leading titanium producer).
Aircraft	United Aircraft Construction Corporation (UAC) (national strategic corporation)	Created in 2006 through the merger of the main Russian producers, including Ilyushin, Irkut, MIG, Sukhoi, Tupolev and Yakovlev. The state should remain the majority owner (75%) and foreign participation restricted to civil and transport aviation. The objective is to make Russia the third world largest aircraft civilian transport producer and increase its market share from the current 1% to more than 10%.	Foreign investment involvement: acquisition of a 25% plus-one-share in Sukhoi's civil aircraft division by a subsidiary of Italian Finmeccanica. Outward: partnership with Airbus and Boeing under consideration.
Ship-building	Sovkomflot (national strategic corporation)	Created through the merger of Novosphip and Sovkomflot to form one of the world's largest shipbuilding companies. As a strategic company, it cannot be privatised.	
Car industry	Rosoboronexport	In 2005, Rosoboronexport, Russian arm exporter, acquired the Russian largest car producer AvtoVAZ with the dominant though diminishing production share in the domestic market.	Despite the local content requirements, foreign car producers/ assemblers are present in Russia.

Table 2.1. **Strategic corporations** *(cont.)*

Sector	Umbrella company	Company's profile	Exposure to foreign investment
Banking	Sberbank Vneshtorgbank (VTB) Gazprombank Bank Moskvy	The 4 largest state-controlled banks accounted in 2006 for 41% of the assets of Russia's banking sector. The State's participation progressively reduced (Sberbank: 58%; VTB: 77.5%) but the majority state ownership (51%) is to be maintained in future. As a part of WTO agreement still under discussion, Russia envisages to limit foreign ownership of the national banking sector to 50%.	Foreign investment involvement through the 2 IPOs in 2007 (Sberbank raising USD 6 bn and VTB USD 8 bn). Outward investment: acquisitions in banking (Belarus, Ukraine, Kazakhstan) and other sectors (VTB purchased 5% of the EADS, European aircraft manufacture).
	Development Bank	Created in 2007 by restructuring of Vneshekonombank (the state-controlled bank managing Russia's foreign debt payments) as a special financial organisation, not subject to the Central Bank' supervision. It provides services for promoting innovation and exports and developing infrastructure. The initial capital increased through funding from the state budget (RUB 650 billion). The bank expects to attract contributions from private, including foreign, investors.	
Telecoms	Svyazinvest	The state-controlled holding with controlling stakes in the 7 regional fixed lines telecoms companies and in Rostelcom, a monopoly of long-distance in Russia and international calls. Its privatisation under discussion but the state is expected to maintain majority ownership. (Russia's mobile telecommunications are almost completely privatised).	Inward: entry of domestic investors (Comstar) and foreign participation expected to be authorised.
Television broadcasting	ORT, TV Channel, NTV	ORT and TV Channel are both public entities; NTV acquired by Gazprom.	
Nano-technologies	Rosnanotekh (state strategic corporation)	Established in July 2007 to finance nanotechnology projects, education and training in this area; initial capital received from the federal budget.	

Table 2.1. **Strategic corporations** (*cont.*)

Sector	Umbrella company	Company's profile	Exposure to foreign investment
Healthcare, housing, education and agriculture	National priority projects	The federal budget fund for the four priority programmes amounted to RUB 135 bn in 2006 and to RUB 206 bn in 2007. Within healthcare and education programmes, available funds serve mainly to increase salaries; in housing programme for construction and in agriculture programme for interest support.	
Forestry and wood industry		Foreign ownership of forests not allowed. Increase of raw wood export tariffs aims at encouraging development of wood processing industries in Russia.	
Fishing		In 2007, fishing quotas proposed to be granted in priority to domestic fish processing companies.	

Source: Author's Compilation.

Energy transport is under the competence of the law on natural monopolies. Gazprom has the monopoly over the gas transport network and the two 100% state-owned energy transport companies (Transneft and Transnefteproduct), control oil and oil product transport. These companies represent the central piece of the government's energy strategy. The control of access to transport routes is the most efficient instrument to exert influence on the volume of production of independent companies and their exports.

The state is also still a majority owner of the largest electricity producer RAO-UES which generates some 70% of all electricity produced in Russia. The separation of several regional electricity generating companies was followed by the opening of their capital to other investors, including foreigners. RAO-UES has been an active outward investor, focussing on the CIS region by directly operating through its own subsidiaries or by purchasing shares in energy facilities. RAO-UES is also present in Western Europe mainly in energy trading activities (see Chapter 3).

The consolidation and state control of the **nuclear energy** sector is underway. The two state-controlled companies – Rosatom and Atomenergoprom – control the whole value chain from extraction and production to electric generation. A similar strategy has been applied in the **aircraft** industry: the consolidation of the sector under the United Aircraft Construction Corporation (UAC) with 75% state ownership ensures the government's oversight of the industry's development, including the participation of foreign investors. These two sectors have been included in the list covered by the new law on strategic sectors.

The recent merger of the two **shipbuilding** companies (Novoship and Sovkomflot) marks the beginning of the consolidation and the imposition of state control in this sector also considered critical for economic development given its potential to become a major exporter. Finally, through the recent transformation of Rosoboronexport to a new strategic state corporation "**Russian Technologies**" the state has imposed its control over a large part of the industry – from the defence and strategic materials (*e.g.* titanium) sectors to the car industry (see below). The objective of the new state corporation is to lead modernisation and development of the heavy and machinery industries.

The strategy adopted by the authorities in **banking** combines state control with a partial opening of the sector to foreign investment. Despite a large number of banks operating in Russia (1215 in 2006), the sector remains highly concentrated as the "Big Four" (Sberbank, the Vneshtorgbank group, Gazprombank and Bank Moskvy) represent 41% of Russia's total banking assets. Together with other smaller public sector banks, usually controlled by regional governments or state-owned entities (*e.g.* Rosneft), public ownership in Russia's banking sector was estimated at 44% in 2006, an increase from some 30% in 1998.[6] Following public offerings by Sberbank and Vneshtorgbank, foreign investors obtained minority stakes in these banks but the state maintains its control as the majority shareholder. Given the current ban on the establishment of branches by foreign banks in Russia, foreign investors have been increasing their presence by establishing wholly foreign-owned subsidiaries (48 in mid-2007). Russia's banking system thus consists of a few strong state-controlled entities, dominating the market, the minority foreign sector and a number of private domestic banks.

The state-controlled Rosobonexport has acquired the major domestic **car producer** AvtoVAZ. But domestic car production continues to stagnate and its market share has declined to less than 40%, despite significant protection of domestic production through relatively high custom duties. Local content requirements have not succeeded in encouraging domestic production as foreign car producers have been unable to find local subcontractors capable of coping with their volume and quality demands.

Telecommunications are an interesting example of the co-existence of a state-controlled fixed-line segment and a privatised mobile-phone segment. The state-controlled company Svyazinvest has controlling stakes in the seven regional fixed-line telecoms companies and in Rostelcom, which has a monopoly in long-distance and international calls. Privatisation of Svyazinvest is under discussion but the state intends to maintain majority ownership as confirmed by the new law on strategic sectors. In contrast, Russia's domestic mobile telecom market is dominated by private companies with foreign involvement. These companies have successfully expanded to the CIS region where they often control large parts of the CIS market. For example, MTS, the largest Russian mobile operator, controls the leading mobile companies in Ukraine, Belarus and Uzbekistan, while VimpelCom, the Russian second largest mobile operator, has a strong presence in Kazakhstan and Turkmenistan.

Some other sectors have been subject to reinforced state oversight though the motivations and the modalities of state involvement vary. The government's control over television broadcasting, confirmed by the law on strategic sectors, is more for political than economic motives. Fishery has also been included among the strategic sectors. By increasing export duties, the government intends to influence investment in forestry and wood processing industries. Nanotechnologies, healthcare, housing, education and agriculture are not strictly speaking strategic sectors but their status as **governmental priority programmes** gives them access to significant federal financing which allows the government to influence investment decisions.

In addition to this sectoral approach, the government's economic modernisation and sectoral diversification strategy has an important regional dimension. The regional strategy aims at tackling existing bottlenecks that prevent different regions from realising their economic potential. The underlying principle of the new regional policy which is still in the process of elaboration is to take better account of the levels of development of individual regions and their specific conditions, for example the demographic situation and the state of their infrastructure.

The law on special economic zones (SEZs) adopted in 2005 was an initial step in this direction. Among the first zones created by the end of 2005, four sites (Zelenograd, Dubna, St. Petersburg and Tomsk) were selected as technology-innovative zones and the two others (the Lipetsk region and Elbuga in Tatarstan) as industrial production zones. Additional zones were created in 2007 to focus on development of tourism (Irkutsk, Zelenograd, Sochi, Krasnodar, Altai and Stavropol). The federal government's supervision of the programme is ensured by the Federal Agency for Managing SEZs, which oversees tender procedures. It also negotiates financial guarantees and privileged credit conditions for SEZ-based firms.

Regional and local authorities have to keep a certain degree of autonomy in decision-making to adjust development objectives to their specific conditions. In principle, this gives regional authorities more room for manoeuvre as regards private and foreign participation. The importance of regional aspects within the modernisation strategy was recently confirmed when more important prerogatives were given to the Regional Development Ministry in the government appointed in September 2007. The Ministry will now supervise the Investment Fund which disposes of significant resources for infrastructure development.

3. Summing up

The new law on strategic sectors adopted by the Duma in March 2008 defines procedures of prior governmental approval in the defence-related activities motivated by national security reasons and in a number of other sectors such as natural monopolies. The entry of foreign state-owned companies and participation of foreign investors in subsoil prospection and extraction are subject to stricter ownership limitations. In replacing former *ad hoc* authorisations, the new law enhances legal transparency and predictability. Foreign investors also appreciate that the law will not be applied retroactively. However, several aspects of the law could be questioned, in particular its broad sectoral coverage and the fact that foreign Russian majority state-owned enterprises are not subject to the provisions of the law. Strict restrictions on foreign participation in oil and gas prospection and extraction risk further aggravate the situation in these sectors facing difficult exploitation conditions and struggling to cope with growing domestic and international demand pressures.

In addition to "strategic" sectors, certain other sectors have been identified as potential leaders in economic development, technological innovation and exports. These selected sectoral clusters cover large segments of the Russian economy and include, in addition to the energy sector and the aircraft industry, shipbuilding, car manufacturing, banking or wood-processing industries. These sectors are often developed under the umbrella state-controlled company in which the minority participation of private, including foreign, investment is possible but subject to the government's direct oversight. In a situation where large incumbent firms enjoy a privileged position and the entry of other domestic or foreign entities is limited, competitive pressures in the internal market are inevitably reduced. In light of the unconvincing experience with "national champions" in many countries, Russia's economic priorities of modernisation and sectoral diversification would be better aligned with a strategy that seeks to improve competitiveness by encouraging competition in the domestic market including through the entry of foreign investors.

Notes

1. According to some preliminary estimates, the sectors covered by the new law account for more than half of the Russian economy. See "Russia curbs foreign investment in key sectors", Financial Times, 5 May 2008.
2. Freedom of Investment, National Security and "Strategic" Industries: Progress Report by the OECD Investment Committee, available at *www.oecd.org/daf/investment/foi*.
3. According to the EBRD, the private sector represented 65% of Russia's GDP in 2006. These estimates differ from official data as they also include informal activities and consider as "private company" enterprises in which private individuals or entities own the majority of shares. See EBRD Transition Reports 2004-2006.
4. Some important industries remain private-owned, notably steel (Evraz, Severstal), aluminium (RusAL/SUAL) and strategic metals (Norilsk Nickel) and are also undergoing a process of consolidation.
5. Peeter Vahtra, *Expansion or Exodus – Trends and Developments in Foreign Investment of Russia's Largest Industrial Enterprises*; Pan-European Institute, 1/2006.
6. Andrei V. Vernikov, *Russia's Banking Sector in Transition: Where to?* Bank of Finland, Institute for economies in transition, BOFIT Discussion Papers 5/2007.

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Chapter 3

Russia's Policy Framework for Energy Investment

The energy sector plays a key role in Russia's economy[1] and has contributed to a large extent to its current robust growth.[2] 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.

This chapter uses a selection of relevant questions posed by the OECD Policy Framework for Investment (see Box 3.1) 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.

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.

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, continue to adapt the tax regime to differentiated production conditions and improve transparency of tax procedures, ensure effective competition policy and strengthen independence of

Box 3.1. 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 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.

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. Investment policy

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.

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 new law on strategic sectors signed by President Putin in May 2008 covers the geological surveys of subsoil, prospection and extraction of minerals in subsoil plots for federal importance as well as nuclear energy and energy transport.

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

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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.

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.

The bill on strategic sectors of May 2008 clarifies the situation for foreign investors in the sectors concerned by this law, *i.e*. oil and gas prospection and exploration, nuclear energy and energy transport. The foreign control in these sectors is subject to prior governmental approval. As already noted in the previous chapter, foreign control in most strategic sectors is defined as 50% foreign ownership (or 25% in the case of foreign-state ownership). In oil and gas sectors, the threshold for foreign control is considerably lower: 10% for foreign private investors and 5% in the case the foreign partner is a foreign state-owned company.

The law is certainly a welcome step in stabilising the legal framework for energy investment and thus reducing the risks of bureaucratic discretion and opaque implementation associated with former *ad hoc* decisions. However, the lack of experience with the concrete application of the new law and the low thresholds for foreign investment, especially in gas and oil exploration, could have an adverse impact on energy investment and further exacerbate the discrepancy between Russia's declining production capacities and mounting energy demand in domestic and external markets.

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.

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.

According to the law "On Arbitration (Conciliation) Courts in the Russian Federation (Federal law No. 102-FZ of 24 July 2002) and the law On International Commercial Arbitration" (Federal law No. 5338-1 of 7 July 1993), both foreign and domestic investors have access to arbitration tribunals. Foreign investors are also entitled to submit their claims in accordance with the procedures stipulated in the bilateral investment treaties (BITs) in force between the Russian Federation and their home State.

Contract enforcement nevertheless 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.

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.

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 assets of the dismantled private oil company Yukos 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).

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 considered to be below its 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.

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. State ownership and market position of state-controlled energy firms have been strengthened 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.

The gas upstream is currently largely dominated by Gazprom, responsible for 85% of production whereas foreign companies represent just 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,[5] though the distinction between "foreign" and "local" is increasingly difficult in the context of global capital markets and given the existence of Russia's large round-tripping flows. 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 ConoccoPhillips owns some 20% of the shares, the remaining 80% is in hands of Russian partners), TNK-BP, Rosneft, Surgutneftegaz and Sibneft.[6]

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).

As of 1 May 2008, Russia has signed 60 bilateral investment treaties (BITs), of which 41 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

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?**
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.

and of its Model BIT[7] noted that Russia's approach is 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.

Updating of Russia's BIT regime should aim at reducing current uncertainties to permit the BITs to play fully their role in promoting investment. This could include in particular the clarification of standards and procedures for expropriation and compensation and dispute settlement. Of special importance to energy investors would be the broad prohibition of the use of performance requirements, including domestic-content obligations typically tied to energy projects.

Given that there is limited public information available on differences in interpretation of Russian BIT provisions and the ultimate adjudications of investment disputes,[8] 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.

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 awards[9] 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 interfere with valid arbitrations and enforce foreign arbitral awards accordingly. Although the Russian Federation applies the Convention and its provisions are implemented in the Arbitration Procedural and Civil Procedural Codes, 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.

Russia signed the 1966 Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention)[10] 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.

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.

1.1. Specific sub-sectoral issues

1.1.1. Energy transport

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.

Transport of crude oil and oil products is under control of two state-owned entities Transneft and Transneftprodukt 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

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foreign ownership of entities which own regional gas supply or distribution assets.[11] In accordance with the law "On natural monopolies" (Federal law No. 147-FZ of 17 August 1995), the natural monopoly companies can not deny the access to services rendered (such as transportation via pipelines) to any other person or company when such denial is made on the grounds of technical absence of free capacities. It remains that the control over access to pipelines, especially export routes has a direct impact on the level of energy production and exports, especially by independent oil and gas production companies.

Russia's gas and oil transport system needs significant investment to modernise existing facilities, in particular to reduce the high level of technical losses,[12] 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.

1.1.2. Electricity generation, transmission and distribution

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.

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.

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-*energos* (*energos*) utilities with regional monopolies on distribution and supply. Under the reform package, generation assets are being unbundled from both UES and the *energos*. 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 *energos* 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 *energos*. 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.

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 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.

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

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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.

The most important foreign investment in the sector was realised by the international energy giant E.ON, which acquired 47% of WGC 4[13] in a competitive auction process. E.ON is expected to take another 23%, when the firm's additional shares go up for sale.

1.1.3. Alternative energy and energy efficiency

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.

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.[14] 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 fines[15] 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.

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.

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.

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.

2. Investment promotion and facilitation

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.

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

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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.

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?

Information provided by the website of the Russian National Agency for Direct Investment (NADI)[16] 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.

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

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.

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.[17]

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.

3. Trade policy

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.

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 differential between domestic and export energy prices represents a subsidy to domestic energy-intensive industries and has distorting effects on investment allocation.

Russia has already made some significant steps to improve the compliance of its trade regulations and practices with international standards, for instance by adopting the new Customs Code in 2004. Russia's participation in several capacity-building projects sponsored by international organisations 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.

Russia's energy trade and transit relations especially with Belarus, Ukraine, Moldova 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.

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.

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.

4. Competition policy

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.

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

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.

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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.[18]

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.[19] A FAS decision to require a rail transportation entity, partially owned by Gazprom, to register under its merger control regulations also received judicial confirmation.[20] 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.[21]

4.1. Specific sub-sectoral issues

4.1.1. Oil and gas

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 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.

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.

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.

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 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.

4.1.2. Oil and gas transport and storage facilities

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.

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.

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.

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.

4.1.3. Electricity and gas transmission and distribution

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.

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*.

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.

4.1.4. Alternative energy and energy efficiency

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.

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.

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.

5. Tax policy

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.

Table 3.1 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-

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

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.[22]

Table 3.1. **Crude oil and gas taxation in Russia**

Energy product	General taxes	Energy sector specific taxes		Comments
		Mineral resources extraction tax	Export Duty	
Oil	Corporate Tax VAT Profil tax Unified social 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	Corporate Tax VAT Profil tax Unified social tax	Levied on extracted gas volume at a rate set annually. In 2006: RUB 147/1 000 m^3.	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.

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.

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.

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.

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

6.1. Corporate governance

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.

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 RosUkrEnergo, an offshore company controlled by Gazprom, which is in charge of Turkmen gas transit to Ukraine and Europe.

In the electricity sector, two Territorial Generation Companies (TGC) obtained a moderate score in the Standard and 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.

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.[23]

6.2. Infrastructure development

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.

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.

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.[24] For such projects, concessions agreements could also be an appropriate solution.

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.

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

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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.

6.3. Public governance

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 Russian Federation" that entered into force in May 2007. The law reinforced 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.

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 laws on strategic sectors and concessions. However consultations of other stakeholders, including non-governmental organisations (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.

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.

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.

7. Summing up

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. The new law on strategic sectors improves transparency and predictability for foreign investors in the oil and gas upstream activities, but imposes strict limitations on foreign ownership in these areas. 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.

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.

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 transparent implementation of the new 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.

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.

Notes

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 OECD 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*.
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. Ernst & Young, *Overview of the Oil and Gas Industry in Russia*, 2007.
6. IHS data as reported in UNCTAD (2007), *World Investment Report 2007*, p. 117.
7. OECD Investment Policy Reviews, *Russian Federation: Enhancing Policy Transparency*, Chapter 5; Paris 2006.
8. 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.
9. 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.
10. 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, *www.worldbank.org/icsid/*.
11. 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: *www.encharter.org*.
12. 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.
13. E.ON reportedly paid about USD 3.9 billion for its 47% of WGC4 which possesses about 8 630 MW of installed capacity.
14. 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.

15. 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 *www.minprom.gov.ru/eng.*

16. *www.napi.ru/enabout.*

17. 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: *www.encharter.org/fileadmin/user_upload/document/Blue_Book_2007_ENG.pdf.*

18. 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.

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

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

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

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

23. 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.

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

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Chapter 4

Responsible Business Conduct in Russia

Responsible business practices have become an increasingly important element in evaluating a country's investment climate. As documented by OECD research, general awareness of international standards of corporate responsibility has been relatively low in Russia, not only compared to OECD countries but also other emerging markets. Compliance with corporate responsibility standards by Russian firms has been generally limited, notably concerning business codes and ethics as well as environmental matters.

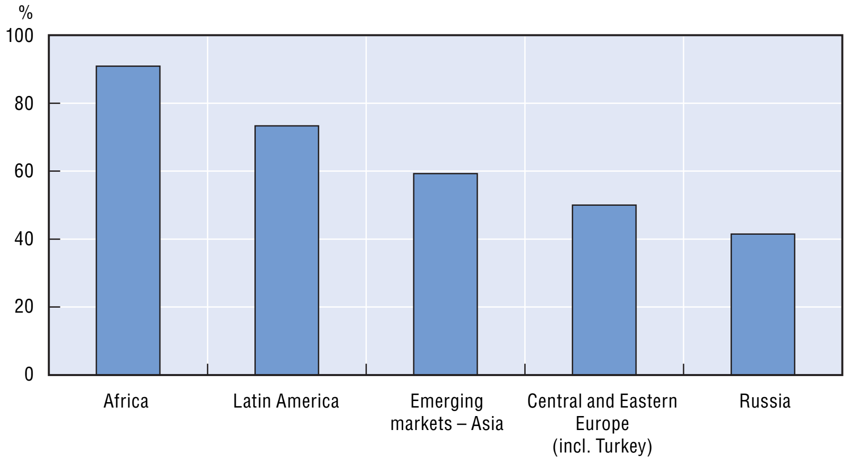
The situation seems to be changing rapidly mainly in conjunction with the external exposure of Russian large enterprises. Recent studies indicate that these enterprises have started to catch up with their counterparts in OECD and other emerging market economies. They now publish relatively detailed annual reports and provide information on their websites, including for instance on compliance with environmental standards. However, large Russian firms still give comparatively limited information on their adoption and observance of codes of conduct and management systems in place to promote business ethics. Dissemination of responsible business practices can boost Russia's creditworthiness and reliability as both an inward and outward investor.

1. Russia's starting point in adoption of responsible business conduct practices

The OECD study on trends in corporate responsibility in the Russia Federation[1] used public reports of 41 leading Russian companies listed on the Russian Trading System to analyse their initiatives in this area. These results were compared to previously collected data concerning 125 companies in 20 emerging market economies and 1740 companies in high-income OECD countries, examined in the 2005 OECD study.[2] Although an unequal geographical coverage makes the comparisons difficult, the analysis indicates that at the beginning of 2006 corporate responsibility initiatives and reporting were proportionally less developed among Russian companies than in enterprises in high-income OECD countries and also less frequent than in other emerging markets.

In 2005, only 40 per cent of Russian companies produced sustainability reports 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, which provided such reports. Russian companies also compared unfavourably with their peers in Central and Eastern Europe (see Figure 4.1).

Figure 4.1. **Companies with public corporate responsibility reporting**



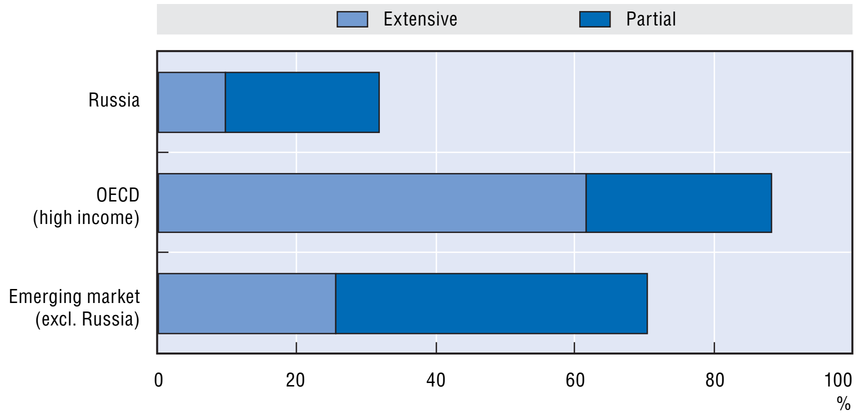
Note: Data for OECD countries and non-Russia emerging markets taken from 2005 OECD study; Russian data are from original database of 41 Russian companies.

Source: OECD (2007), *Corporate Responsibility in the Russian Federation: Recent Trends.*

Russian companies have generally performed poorly on almost all 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. In particular the publication of codes of ethical practices largely developed in OECD companies (88% of surveyed firms) and also, though to a lesser extent in emerging markets (70%), has been adopted by less than one third of Russian companies analysed (Figure 4.2). Moreover, ethics management systems ensuring effective implementation of ethics policies are in place only in 15% of Russian firms compared to 36% in other emerging market economies (Figure 4.3).

Based on their reporting in 2005, Russian companies appear to be significantly weaker on environmental matters than surveyed firms in both high-income OECD countries and emerging market economies. Environmental policies measured by various indicators such as the reference to key environmental issues facing the sector, allocated responsibility for environmental matters, and relevant monitoring and public reporting are reported by only 25% of Russian surveyed firms. An environment management system necessary for the effective implementation of environmental policy and which is assessed through companies' documented structures and procedures, auditing, internal reporting and review was also significantly less developed in the Russian sample than in surveyed firms of other countries. (see Table 4.1). A more detailed analysis of companies with a substantial environmental impact, strongly represented in Russia's sample (30 companies out of the total of 41), reveals that only four among them had put in place more developed environmental policies.

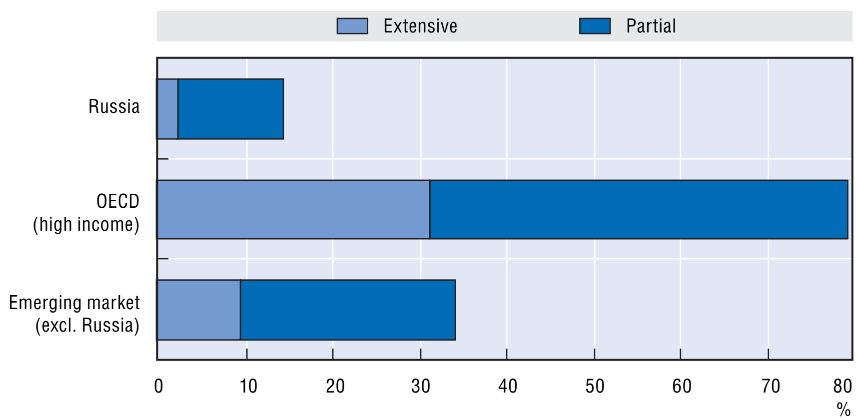
Figure 4.2. **Published codes of business ethics**



Note: "Partial" codes of business ethics provide minimal details and coverage, or have only partial applicability (*e.g.* applicable only to board members). "Extensive" business ethics codes apply to all employees and cover a range of issues such as bribery, facilitation of payments, conflicts of interest, unfair competition, etc.

Source: See Figure 4.1.

Figure 4.3. **Ethics management systems**



Note: A company has an "extensive" ethics management system if at least three of the following exist: credible supporting material or examples provided: employee training, "whistle blowing" procedures/hotlines, compliance monitoring or regular review of the code. Under a "partial" management system, a company reports on at least one among above mentioned aspects.

Source: See Figure 4.1.

Table 4.1. **Companies with environmental policies and environment management system in large emerging markets**

	Number of companies assessed	Companies with published environmental policy (in %)	Companies with environment management system (in %)
South Africa	16	87.5	68.8
Brazil	11	81.8	90.9
India	10	80.0	80.0
China	19	31.6	36.8
Russia	41	25.0	29.3

Source: See Figure 4.1.

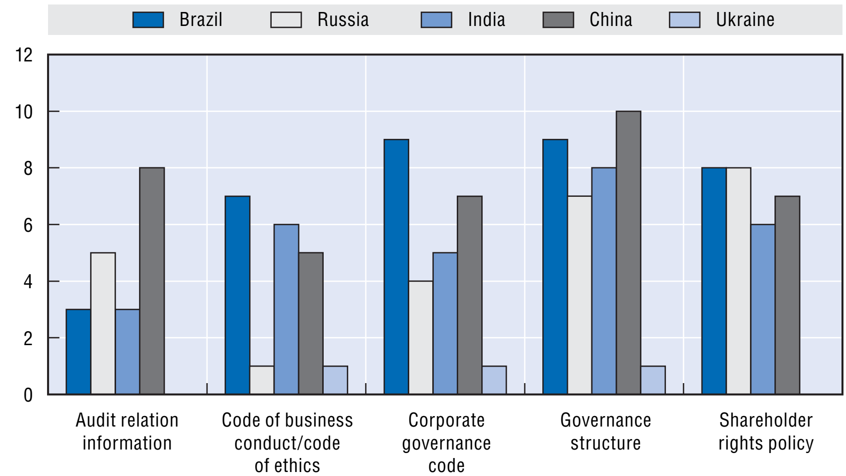
2. Recent progress

Increasing external exposure, such as through the introduction and listing on international financial markets, has prompted a number of Russian firms to improve their general transparency and accountability, including with respect to responsible business conduct. A more recent database using information available as of September 2006 compared environmental, social and governance reports issued by the ten largest listed companies in the four BRICs (Brazil, Russia, India and China) and Ukraine.[3] The survey showed that all Russian firms under review[4] made available English-language websites, as did firms from Brazil, India and China but not Ukraine, though not all of them published their annual reports. Information disclosure of Russian surveyed firms was comparable to that of Brazilian, Indian and Chinese ones concerning audit-related information and governance structures but less frequent as regards the codes of business conduct, corporate governance codes and shareholder rights policy. In general, reporting on social aspects (employment policy, health and safety policies) appeared more developed in the BRICs than their information disclosure on environmental aspects.

The second survey realised in April 2007[5] using the data of the same firms indicates that Russian firms have started to catch up with their counterparts in other BRICs notably as regards the publication of English-language annual reports. However, information on the codes of business and corporate governance structure provided by the analysed Russian firms remains less frequent than for other countries' large firms (see Figure 4.4).

Between September 2006 and April 2007, Russian surveyed firms further improved their website reporting on compliance with environmental standards and the listing of their environmental departments (especially on their websites). Reporting by Russian firms on their environmental performance was the most developed among BRICs. However, in contrast to Brazil, India and China which

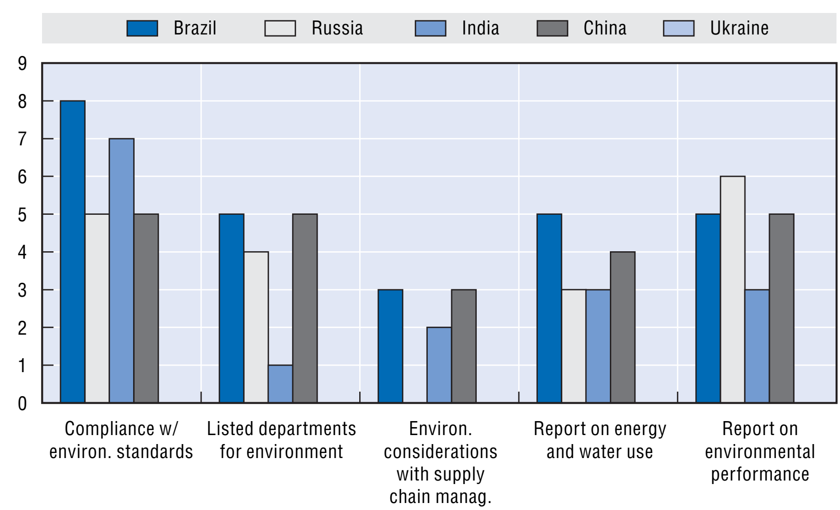
Figure 4.4. **Corporate Governance Reporting by BRIC (April 2007)**
Website



Source: Partners for Financial Stability (PFS) Program (2007), Survey of Reporting on Corporate Social Responsibility in BRIC and Ukraine, April 2007.

have developed their information on environmental considerations with supply chain management, the Russian firms have not yet published this kind of information in their annual reports and website (Figure 4.5).

Figure 4.5. **Environmental Reporting by BRIC (April 2007)**
Website



Source: See Figure 4.4.

Responsible business practices are still addressed only indirectly in international comparative studies and business surveys. Among the surveys reviewed in the Annex (see Table A.2), some aspects of responsible business conduct are taken into account within broader categories of investors' protection (World Bank Doing Business Database, Heritage Foundation's Index of Economic Freedom) or under the indicator of consensus building (Bertelsmann Transformation Index). The two indices of competitiveness consider some issues relevant for responsible business conduct under their evaluation of management practices: the World Economic Forum estimates the quality of management within the index of business sophistication. The World Competitiveness Yearbook of the Institute of Management and Development looks at management practices and attitudes and values within its indicator of business efficiency. Russia's rating for these indicators is generally modest.

Weak observance of standards of responsible business conduct could be one reason why some emerging market economies, including Russia, are not always perceived as fair and reliable investment partners even if their investment conditions are considered otherwise relatively favourable. Starting from a low level of awareness of international standards for corporate responsibility, Russia has made rapid progress in this area, particularly regarding the dissemination of information on responsible business practices. This favourable development reflects the increasing external exposure of large Russian firms some of whom have seen their ambitions to expand abroad countered due to perceived shortcomings in their business practices. However, more work remains to be done especially with respect to management practices supporting responsible business conduct. Russia's shortcomings in this area are apparent, particularly in OECD research which looked not only at dissemination of relevant information but also covered corresponding responsible conduct management systems.

The main responsibility for ensuring responsible business conduct rests with business, but governments also have an important role to play in this area. The OECD Policy Framework for Investment (PFI) developed by OECD and non-OECD countries, including Russia, integrates responsible business conduct within ten policy areas to be addressed by the authorities seeking to enhance their investment climate. The governments are encouraged to provide an enabling environment that clearly delimits the respective roles of government and business in developing responsible business practices. They should foster a dialogue on norms for business conduct and actively support companies' efforts to comply with the law and respond to societal expectations communicated by channels other than the law. The PFI also highlights the importance of intergovernmental cooperation in improving awareness within the business community of internationally agreed concepts and principles in this area. In Russia, public support is also critical for encouraging corporate efforts to develop reporting on responsible business conduct and to put in place management systems promoting business ethics.

Notes

1. OECD (2007), "Corporate Responsibility in the Russian Federation: Recent Trends"; prepared by Jeremy Baskin, in *Investment for Development, Annual Report 2007*, OECD Paris 2007.
2. 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*. 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.
3. 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 and First-time Comparison with Peers in BRIC and Ukraine; Warsaw, September 2006 Available at *www.pfsprogram.org*.
4. The ten Russian surveyed firms in this study are the following: Gazprom, LUKoil, Surgutneftgaz, Sberbank, RAO UES, SibNeft, TatNeft, MosEnergo, Baltika Beer Brewery and Rostelecom.
5. East-West Management Institute/USAID Partners for Financial Stability Program (2007), Survey of Reporting on Corporate Social Responsibility by the Largest Listed Companies in 11 Central and Eastern Countries, Second-time Comparison with Peers in BRIC and Ukraine, Warsaw, April 2007. Available at *www.pfsprogram.org*.

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ANNEX A

Overview of Recent Business Surveys

Notwithstanding robust economic growth and dynamic FDI inflows, the Russian business climate is still perceived by many investors as more risky and less favourable than in OECD countries and some other emerging markets. According to a number of international indicators monitoring various aspects of the investment climate, Russia often ranks behind Brazil, India or China. High expected returns in the natural resources sector may make large foreign investors less sensitive to traditional investment barriers than others and explain a part of large recorded FDI inflows. However, available business surveys identify a number of factors which affect investors' perceptions, notably the persistence of regional disparities in business conditions and difficulties experienced by some categories of firms, especially small and medium-sized enterprises and exporters, in obtaining information and in the face of regulatory uncertainty.

1. International comparisons

The 2006 OECD Investment Policy Review collected the views of foreign investors operating in Russia concerning investment policy transparency. According to this business survey, foreign investors found that publicly available information on existing regulations and procedures has improved in many areas but information on regulatory changes remains inadequate, mainly due to insufficient public-private consultations. Foreign investors also considered some procedures to be time-consuming and costly, in particular land and property registration and work permits.[1]

An increasing number of other studies and surveys analyses various aspects of the business environment and compares developments in different countries.Table A.2 summarises the methodologies of several recent analyses and presents their main findings concerning Russia. Some of these analyses are typical business surveys, based on questionnaires addressed to business representatives in the analysed countries, in particular the EBRD/World Bank Business Environment and Enterprise Performance Surveys, the Russian

Centre for Economic and Financial Research (CEFIR) regular surveys and the World Bank Survey of Competitiveness and Investment Climate in Russia. Some others, such as the World Bank Worldwide Governance Indicators, the Index of Economic Freedom, the Competitiveness Indices by the Institute of Management and Development and the World Economic Forum are essentially perceptions-based indicators based on experts' evaluations of various relevant aspects. These studies rank countries and provide time-series that can help assess the evolution of the business climate in individual countries. The World Bank's "Doing Business" database belongs to the category of factual indicators, which compare selected measurable facts characterising the business climate, such as the costs, time and number of procedures for starting or closing a business.

Available indicators have inevitable shortcomings, owing in particular to the selected criteria and facts, which usually focus on *de jure* factors, such as for example the existence of an anti-corruption law, rather than on *de facto* aspects, *e.g.* implementation of anti-corruption laws. Most studies imply experts' subjective evaluation and interpretation and often use complex aggregation procedures, which are not sufficiently transparent for outside users, including in the analysed countries.[2]

Keeping in mind criticisms of available international indicators and caution concerning their use and interpretation, it is nevertheless interesting to examine how studies and surveys perceive recent developments in Russia's business environment and its evolution compared to other countries. Although it is difficult to sum up the findings based on diverse methodologies and data, certain patterns characterising recent developments in Russia's investment climate emerge. First, since 2000, two periods in the perception of Russia's business environment can be distinguished. Most surveys point to favourable developments observed between 2000 and 2003, reflecting the gradually improving macroeconomic situation after the 1998 financial crisis and the government's sustained reform efforts, in particular in reducing the tax burden, licensing and inspection requirements. During this first period, the government undertook important legal and regulatory initiatives, including introducing new laws on inspections (2001), licensing (2002) and registration (2002), by simplifying taxation for small enterprises (2003) and by adopting the new Land Code (2001), the Code of Corporate Conduct (2002) and the new Customs Code (2003).

Starting in 2004 the image appears less favourable as several surveys indicate deterioration in perceptions of Russia's regulatory environment by insiders and external observers. For example, Russia's performance has worsened since 2004 according to the World Bank Governance Indicators of Government Effectiveness and Regulatory Quality and has not significantly evolved for the Rule of Law and Control of Corruption. Most other comparative international surveys also see some deterioration in Russia's indicators in 2006-2007 (the World Economic Forum Global Competitiveness Index) or only a marginal improvement (*e.g.* the World Bank "Doing Business" database and the Heritage Index of Economic Freedom).

The second observation that can be drawn from recent business surveys and assessments is that despite some progress, realised especially between 2000 et 2003, Russia's business environment is still perceived as less favourable than in developed countries and in certain aspects also in large emerging markets – particularly Brazil, China and India. For instance, Russia's 2006 scores for the World Bank Governance Indicators of Government Efficiency, Regulatory Quality and Rule of Law are considerably lower not only compared to the OECD average but also than the level reported for Brazil, India and China. Several other available international comparisons also show Russia's ranking behind these three countries (*i.e.* the Economic Freedom of the Heritage Foundation, Bertelsmann's Management Index) or behind at least two of them (*i.e.* the World Economic Forum's Global Competitiveness and the Institute for Management and Development's World Competitiveness) (see Table A.1).

Table A.1. **BRICs ranking in selected international comparisons of business environment**

Indicator	Number of countries covered	Ranking: Brazil	Russia	India	China
World Bank Worldwide Governance Indicators (2006): percentile rank 0-100 (best governance)	212				
• Government Effectiveness		52.1	37.9	54.0	**55.5**
• Regulatory Quality		**54.1**	33.7	48.3	46.3
• Rule of Law		41.4	19.0	**57.1**	45.2
World Bank Doing Business Database (2006): countries' ranking	175				
• Doing business (overall)		121	96	134	**93**
• Starting business		115	**33**	88	128
• Closing business		135	81	133	**75**
Bertelsmann Transformation Index (2006); countries' ranking	119				
• Management Index		**13**	87	32	70
Heritage Foundation Index of Economic Freedom (2007); countries' ranking	157				
• Economic Freedom		**70**	120	104	119
Institute for Management and Development: World Competitiveness Yearbook (2007); countries' ranking	55	49	43	27	15
World Economic Forum: Global Competitiveness Report (2006); countries' ranking	126	66	62	43	54
EIU: Business environment ranking	82				
• 2002-2006 countries' ranking		**41**	59	62	58
• 2007-2011 countries' ranking		**46**	63	54	53

Note: For a given indicator, the best performance among the four countries is indicated in bold.
Source: Table A.2.

Table A.2. **Summary of recent studies and surveys on business environment and their main findings on Russia**

Project/Study	Used methodology	Main findings on Russia
World Bank Worldwide Governance Indicators Country coverage: 212 Availability: 1996-2006 *www.govindicators.org*	Six aggregate indicators measure *i)* Voice and Accountability, *ii)* Political Stability and Lack of Violence/Terrorism, *iii)* Government Effectiveness, *iv)* Regulatory Quality, *v)* Rule of Law, and *vi)* Control of Corruption. Indicators are based on 33 data sources providing views of the public and private sectors and NGO experts. The indicators are presented in percentile ranks corresponding to the percentage of countries worldwide that rate below the selected country. Higher values indicate better governance ratings. The indicators most relevant for the investment climate include: • Government Effectiveness: the quality of public services and policy formulation and implementation; credibility of the governments' commitment to such policies. • Regulatory Quality: the ability of the government to formulate and implement sound policies and regulations promoting development. • Rule of Law: the extent to which agents have confidence in and abide by the rules of society; the quality of contract enforcement.	Among 6 aggregate indicators, Russia records in 2006 its best score for Government Effectiveness (38), followed by Regulatory Quality (34) and Control of Corruption (24). Its lowest score is for Rule of Law (19). During the observed period (1996-2006), Russia's improvements in Control of Corruption and Rule of Law were only limited. Regulatory Quality increased after 2000 to reach its peak in 2004 (45), but since then it has been deteriorating. Government Effectiveness increased in 2000-2003 (50 in 2003) but has decreased afterwards.
World Bank Doing Business Database Country coverage: 175 Availability: 2004-2007 (annually) *www.doingbusiness.org*	Ten measures of business regulations and their effect on small and medium domestic firms, including: • Starting business • Dealing with licenses • Employing workers • Registering property • Getting credit • Protecting investors • Paying taxes • Trading across borders • Enforcing contracts • Closing business The overall index of doing business is the simple average of country ranking on each of 10 topics, ranking economies from 1 (the best) to 175.	For the aggregate "doing business" ranking, Russia marginally improved its position (97 in 2005 to 96 in 2006). Its best performance is for "enforcing contracts" (25) and "starting business" (33); the worst performance for "dealing with licenses" (163) and "getting credit" (159). Compared to 2005, Russia improved its ranking for "paying taxes" and "dealing with licenses", but lost its position for "trading across borders" and "registering property".

Table A.2. **Summary of recent studies and surveys on business environment and their main findings on Russia** *(cont.)*

Project/Study	Used methodology	Main findings on Russia
Business Environment and Enterprise Performance Survey (World Bank and EBRD) Country coverage: 27 Availability: 1999, 2002, 2005 *www.worldbank.org/eca/governance*	The 2005 Survey covered 9 500 firms from 26 transition countries (plus Turkey). Around 90% of surveyed firms were private small and medium-sized enterprises; foreign-owned firms represented 10% of the sample. 7 main aspects of the business environment are monitored: • Business regulation: land, customs, trade regulations, regulatory policies • Labour: labour regulations, skills and education • Taxation: tax rates and administration • Institutions and property rights: judiciary, corruption, theft and disorder. • Infrastructure: telecommunications, electricity, transport and access to land • Finance: access to and cost of financing • Macroeconomic environment: inflation, exchange rate Different factors assessed by firms on a scale of 1 (minor obstacle) to 4 (major obstacle).	Compared to the previous 2002 survey, Russia's business environment improved in 2005 as regards labour regulations but deteriorated in the area of business regulations and infrastructure. The most serious obstacles: cost of business regulations, poor quality institutions, weak property rights. These obstacles affect mainly the most dynamic enterprises, *i.e.* private firms, exporters and smaller businesses. State-owned enterprises are less affected.
European Bank for Reconstruction and Development Transition Report Country coverage: 29 Availability: 1996-2006 (annually) *www.ebrd.org*	The Transition Indicator covers 4 main elements of a market economy: • Enterprise reform: privatisation, governance and restructuring • Markets and trade reforms: price, trade and foreign exchange liberalisation • Financial institutions reform: development in the banking sector, interest rate liberalisation, securities markets and non-bank financial institutions • Infrastructure: reform measured in 5 sectors: electricity, railways, roads, telecommunications and water and waste water. The measurement scale ranges from 1 (no change from a rigid centrally planned economy) to 4+ (the standards of an industrialised market economy).	In 2006, Russia is given the score of 4 for small-scale privatisation and price liberalisation; 3 for large-scale liberalisation, trade and foreign exchange liberalisation, financial institutions reforms and infrastructure. Progress is considered limited (score 2) in governance and enterprise restructuring and competition policy. In 2006, Russia improved its score in financial institutions reform.

Table A.2. **Summary of recent studies and surveys on business environment and their main findings on Russia** *(cont.)*

Project/Study	Used methodology	Main findings on Russia
Heritage Foundation Index of Economic Freedom Country coverage; 157 Availability: 1995-2007 (annually) *www.heritage.org*	The Index of Economic Freedom consists of 10 components: • Business freedom: freedom to start business, obtain license and close business. • Trade freedom: average tariff rate, existence of non-tariff barriers. • Fiscal freedom: tax rates on individual and corporate incomes. • Freedom from Government: government spending as a portion of GDP • Monetary freedom: inflation rate, price controls. • Investment freedom: restrictions on foreign investment. • Financial freedom: openness of financial system, banking regulations. • Property rights: security of protection of property rights. • Freedom from Corruption. • Labour freedom: wage, hour and other labour restrictions. The components assessed on a scale of 0-100, with higher scores representing higher levels of freedom or lower levels of government interference in economy.	Russia's overall ranking in 2007 is 120 with the score of 54.01 (the 2007 world average score: 60.6*), i.e.* a minor improvement compared to 2006. Russia's highest scores: Fiscal freedom (86.3), followed by Freedom from government (71.6). Its scores for Business and Trade freedoms (66.6 and 62.6) are close to the world average. Its lowest scores are for Freedom from corruption (24), Investment freedom and Property rights (both 30).
Institute for Management and Development World Competitiveness Yearbook Country coverage: 55 Availability: 1989-2006 (annually) *www.imd.ch*	Over 300 competitiveness criteria taken into consideration: • Economic performance (79 criteria): domestic economy, international trade and investment, employment and prices. • Government efficiency (72 criteria): public finance, fiscal policy, institutional framework, business legislation and societal framework. • Business efficiency (71 criteria): productivity and efficiency, labour market, finance, management. • Infrastructure (101 criteria): basic infrastructure, technological and scientific infrastructure, health and environment and education. Countries' ranking based on the evaluation of different criteria from the most competitive (the index score 100) to the least competitive.	In 2007 Russia ranks 43rd among 55 countries (46th in 2006). Main improvement for Government Efficiency (39), due mainly to good public finance management, and for Infrastructure (37). Its lower ranking for Economic Performance (52) takes into account high inflation and lack of diversification. Russia's mediocre ranking for Business Efficiency (48) due to weak management practices (unsatisfactory shareholders' rights, limited social responsibility awareness).

Table A.2. **Summary of recent studies and surveys on business environment and their main findings on Russia** *(cont.)*

Project/Study	Used methodology	Main findings on Russia
World Economic Forum Global Competitiveness Report Country coverage: 126 (121 for Business Competitiveness Index) Availability: 1996-2006 (annually) *www.weforum.org*	Global Competitiveness Index takes into account 9 pillars of factors driving productivity and competitiveness (institutions, infrastructure, macro-economy, health, education, market efficiency, technological readiness, business sophistication and innovation), which are organised into 3 sub-indexes,: • Basic Requirements: institutions, infrastructure, macro-economy, education. • Efficiency Enhancers: market efficiency, technological readiness. • Innovation and business sophistication. Business Competitiveness Index identifies competitive strengths and weaknesses in terms of business environment, company operations and strategy.	In 2006, Russia's overall ranking (62 among 125 countries) is lower than in 2005 (53), due to its low ranking for Innovation and Business Sophistication (71) and its weak position in Basic Requirements (system of rules shaping incentives and economic interaction). Business Competitiveness Index (79) reflects still unsatisfactory national business environment (77) and company operations and strategy (78).
Centre for Economic and Financial Research (CEFIR) – Monitoring of administrative barriers in Russia Coverage: Russia Availability: 2001-2006 *www.cefir.ru*	Six subsequent rounds of the surveys monitor the level of administrative regulation in small business (2000 firms in 20 Russian regions) and analyse the effects of deregulation reform in the areas of: • Registration • Licensing • Inspections • Certification • Tax administration	The laws on inspections (2001), licensing (2002) and registration (2002) induced significant positive changes. The enforcement improved gradually (*e.g.* only half of firms manage to complete registration procedures within the deregulation target), but progress not geographically uniform. Tax inspections were a more serious problem in 2006 compared to 2004.
Economic Intelligence Unit: Investor survey Coverage: senior executives Availability: June 2007 *www.cpii.columbia.edu*	The survey addressed to 602 senior executives of multinational companies in western Europe, North America and Asia conducted in June 2007 on economic opportunities *versus* political risks in 2007-2011. The survey considers the risks of political violence, FDI protectionism, geopolitical risk and government instability.	Russia receives high rating for its importance in firms' future investment strategy even if it is considered as the 2nd riskiest country, due to political risks and increasing FDI protectionism. Greatest opportunities for high returns appear to offset high risk perceptions.

Source: Author's compilation.

The World Bank's Doing Business database gives a relatively more favourable picture of Russia: its overall "doing business" index ranks Russia (96) behind China (93) but ahead of Brazil (121) and India (134). Among 10 analysed topics, Russia performs better than the other three countries for starting a business, paying taxes and enforcing contracts but does less well than the other countries in dealing with licenses, getting credit and regarding cross-border trade regulations.

Available surveys and comparative assessments also point out several particular features which, although not specific to Russia, seem to be prominent in this country. One such element is a large gap observed between formal restrictions, which could be considered relatively moderate (although still higher than in OECD countries)[3] and informal barriers faced by business operators and investors in Russia. This problem is usually revealed through Russia's low ratings in corruption and the rule-of-law related aspects, reported by most available studies.

Some surveys capture specific difficulties met by various types of firms in Russia. The World Bank Survey of Competitiveness and the Investment Climate in Russia highlights more acute barriers faced by small and medium-sized enterprises compared to large firms, particularly regulatory and policy uncertainty. The regular surveys by the Centre for Economic and Financial Research (CEFIR) show important regional differences that persist when it comes to implementing various legal and regulatory measures. The three successive rounds of the Business Environment and Enterprise Performance Survey undertaken on behalf of the World Bank and the EBRD indicate that some surveyed obstacles, such as costs of business regulations and weak property rights, affect mainly the most dynamic firms, including small private enterprises and exporters. In contrast, state-owned enterprises suffer significantly less from these problems. Although the challenge to ensure equal treatment for all types of firms at the national level is shared by many other economies, the absence of a level playing field is particularly harmful in Russia's context. Indirectly these shortcomings are reflected in Russia's modest performance in available international comparisons of country competitiveness. It ranked 43rd among 55 countries in the 2006 World Competitiveness Yearbook of the Institute for Management and Development and lost ground in the 2006 World Economic Forum's Global Competitiveness Index.

A few studies seek to forecast future developments in the business climate in individual countries. According to the EIU Business Environment Ranking, Russia sees its situation deteriorate (from 59th to 63rd rank), mainly because of increased investor uncertainty (Table A.1). In a separate survey conducted by the EIU in 2007, senior executives from multinational companies also expressed their concerns regarding growing risks both at the political level and regarding FDI restrictions in Russia, but important business opportunities and high returns on investment in Russia seem partly to offset these high risk perceptions.

Notes

1. OECD Investment Policy Reviews, *Russian Federation: Enhancing Policy Transparency*, Chapter 2, Paris, 2006.
2. Hans Christiansen, *ODA and Investment for Development: What Guidance can be drawn from Investment Climate Scoreboards?* Working Paper on International Investment, 2004/5, OECD 2004; Christiane Arndt, Charles Oman, *Use and Misuse of Governance Indicators*, OECD Development Studies, OECD 2006.
3. According to the OECD FDI Regulatory Restrictiveness Index, Russia's level of statutory restrictions has been higher than the OECD average. See OECD's FDI Regulatory Index: Revision and Extension to More Economies in *International Investment Perspectives: Freedom of Investment in a Changing World*, 2007 Edition, OECD 2007.

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