Policy Reform in Russia's Oil Sector

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Despite difficult circum– stances, policy reform in Russia's oil sector has been impressive. Nevertheless, further reforms and invest- ments in excess of $60 billion over the next 10 years will be needed to help the sector realize its potential.

RUSSIA'S OIL sector is critical to the country's overall economic recovery. Oil accounts for 5 percent of Russia's GDP, 20 percent of its foreign exchange earnings, and 10 percent of its fiscal revenues. Over the past five years, oil sector performance has fallen far below its potential. The world's largest oil producer in 1990, Russia has now slipped to third place, with production declining at annual rates of 7–14 percent. Investments on the order of $50 billion to $60 billion will be required over the next 10 years just to stabilize production, and even larger sums will be needed to bring about a recovery. Funding at these levels will not be forthcoming unless the private sector, both foreign and domestic, can be engaged. Private sector commitments will depend crucially on policy reform in the oil sector.

Achieving policy reform in Russia has presented major challenges. Many reform concepts were entirely new to Russia four years ago, especially those based on market principles or the need for legal transparency. The number and range of participants involved has also made the reform process highly complex (see table). Against this background, Russia's achievements in the oil sector have been impressive. Not surprisingly, however, a number of critical issues are still outstanding.

Oil prices

At the beginning of the reform period (1992), Russia's oil prices were administratively set at less than 5 percent of world levels. A move to market prices was urgently required to better allocate resources in both production and consumption. It was also recognized that appropriate pricing would reduce Russia's disproportionately high consumption of fossil fuels with beneficial effects on the environment.

These arguments seem straightforward enough but they ran into serious obstacles, among them charges that oil price liberalization would fuel inflation, cause unacceptable hardship for consumers, and create windfall profits for the "oil barons." Similar arguments against price reform were commonly heard in the industrial countries following the leap in world oil prices in the 1970s.

There were at least two additional sources of resistance to oil price liberalization in Russia. First, complete price reform depended—and still depends—on the unrestricted access of Russian oil to world markets. Domestic policymakers have expressed concern over the social and political consequences of a diversion of crude oil supplies away from the domestic market in favor of exports. Second, any significant difference between domestic and world price levels translates into a favorable environment for arbitrage and establishes vested interests in blocking reform.

These considerations prevented oil from being included in Russia's general price liberalization of January 1992. Nevertheless, a process of steady reform got under way. Within 18 months, all administrative controls, limitations on profit margins, and sales allocations for the domestic market were largely ended. Once prices had been liberalized on the domestic market, the reformers turned their attention to trade liberalization. Oil export quotas were abolished in early 1995, and oil export duties,

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Oil sector reform involves many participants

Price reform	Tax reform	Legal reform	Enterprise reform	Foreign direct investment
President's office	President's office	President's office	President's office	President's office
Ministry of Fuel and Power	Ministry of Fuel and Power	Ministry of Fuel and Power	Ministry of Fuel and Power	Ministry of Fuel and Power
Ministry of Finance	Ministry of Finance	State Committee on Geology	Ministry of Economy	State Committee on Geology
Ministry of Economy	Ministry of Economy	Ministry of Environment and Natural Resources	State Property Agency	Regional government
Ministry of Foreign Economic Relations	Duma Economic Policy Committee	Duma Industry and Energy Committee	Regional government	Producers
Duma Economic Policy Committee	Regional government	Duma Ecology and Natural Resources Committee	Producers	World Bank and IMF
Regional government	Producers	Duma Economic Policy Committee	World Bank and IMF	Bilateral lenders
Producers	World Bank and IMF	Federation Council		
Consumers	Bilateral lenders	Regional government		
World Bank and IMF		Producers		
Bilateral lenders		World Bank and IMF		
		Bilateral lenders		

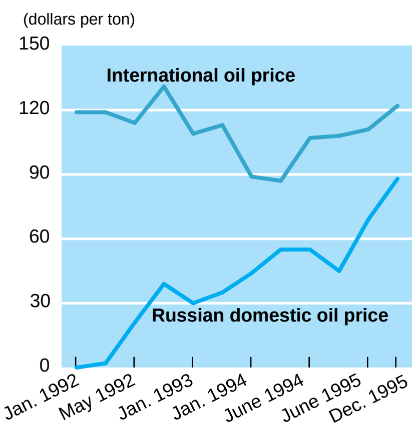
Source: World Bank.

which were driving a wedge between domestic and international prices, were reduced. By the end of 1995, domestic prices were at parity with international prices, net of the export duty, and were equivalent to 70 percent of world prices in absolute terms (Chart 1). The government announced a 50 percent reduction in the oil export duty, effective April 1, 1996, and has made a commitment to abolish the remaining duty by July 1, 1996.

Although offset to a degree by parallel tax increases, higher domestic prices have improved the industry's cash flow and incentives, and contributed to some renewed rehabilitation of low-cost production facilities. Domestic consumption of oil and oil products has declined sharply, not only because of industrial restructuring and declining incomes but also, in part, because of the price increases.

Chart 1

Russian crude oil prices converging to world levels [1]



Source: World Bank.
[1] Crude oil price at border.

Oil taxation

Tax reform remains one of the most pressing oil sector policy issues. The heart of the debate lies in the tension between the urgent need for revenue to reduce the budget deficit and the equally compelling concern that increased oil taxation not "kill the goose that lays the golden eggs." It should be possible to reconcile these two objectives by putting in place a tax system that is flexible enough to encourage a wide range of oil production and development projects, while collecting a significant and progressive share of the economic rents from the sector.

Russia's present oil tax system attempts to satisfy both fiscal and incentive objectives by varying the incidence of an excise tax and certain revenue taxes as a function of the estimated profitability or cost of an oil producer's operations. The government has experienced problems with the application of this system, however, and a critical review of its efficiency is planned.

Russia is already well on its way toward introducing new tax arrangements for major oil development projects that are now pending. To get such projects off the ground, the government has negotiated a series of production sharing agreements (PSAs) with foreign and domestic investors on an individual project basis. These agreements contain attractive, "state-of-the-art" fiscal provisions and will become effective when acceptable enabling legislation is enacted. The PSA formula is relatively simple, calling for a modest royalty or revenue tax, a corporate profits tax, and an additional profits-based tax (or production share) that would escalate with the actual profitability of a project.

The formula will apply only to projects to be carried out under PSAs. There is no reason, however, why the same concept, with some modification, should not be more generally applied. A shift in this direction is one of the options the government is likely to explore over the next 12 to 18 months.

One of the advantages of the new system is its greater reliance on profits-based—as opposed to revenue-based—taxation. The principal concern of the government in assessing any possible change to the existing system is that the fiscal contribution of the oil sector might be jeopardized. In parallel with its review of tax design, the government is committed to taking much-needed steps to strengthen administration and enhance tax compliance.

Legislation

A legal framework setting out clearly the rights and duties of the government and contractors, and covering key issues such as ownership and taxation is a *sine qua non* for investment in the oil sector of any major oil-producing region. While some saw the urgency of establishing such a framework, many Russians, including leaders in the oil industry, did not at first recognize the importance of the necessary legislation. During the Soviet era, the industry had operated through administrative fiat and the lobbying of powerful contacts. Now, acceptable framework legislation is widely regarded as essential, but questions remain concerning what form the legislation should take:

• Should legislation cover all resources, or focus specifically on petroleum?

• Should the legal regime be license-based, raising the specter of unilateral withdrawal or revision of licenses by the government, or should it be a contract-based regime that is mutually binding on the government and the investor?

• Should the parliament approve all contracts and amendments, or should reasonable authority be delegated to the government?

• How should federal and regional interests and authority be balanced in such difficult areas as approving licenses and contracts, controlling operations, safeguarding the environment, and sharing tax revenues?

• What special privileges, if any, should be granted to foreign investors?

These conceptual issues and most of the standard provisions of petroleum legislation and contracts represented largely uncharted water for the Russian reformers. Not surprisingly, progress has come in fits and starts. Overlapping and sometimes competing legal drafting initiatives were common, as were serious inconsistencies and conflicts among the laws and drafts affecting petroleum operations.

An omnibus law, the Law on Underground Resources, covering all natural resources was enacted in 1992, but it contained no specific provisions for petroleum and established a license-based, rather than a contract-based, regime. During 1992–95, considerable effort was made to draft more than half a dozen laws or regulatory packages, involving several government ministries, parliamentary committees, and industry lobbies, and some coherence began to emerge. Over the same period, foreign and domestic investors made great strides in negotiating PSAs containing provisions that were standard internationally for the petroleum industry. The Law on PSAs, enacted in December 1995, represents a very important step toward an acceptable legal framework for major PSA investments in the oil sector. Several key issues relating to assurances of a contract-based regime, contract stability, governing law, and arbitration, are still unresolved, but the government is working actively to address them, drafting clarifying regulations and, as required, legislative amendments.

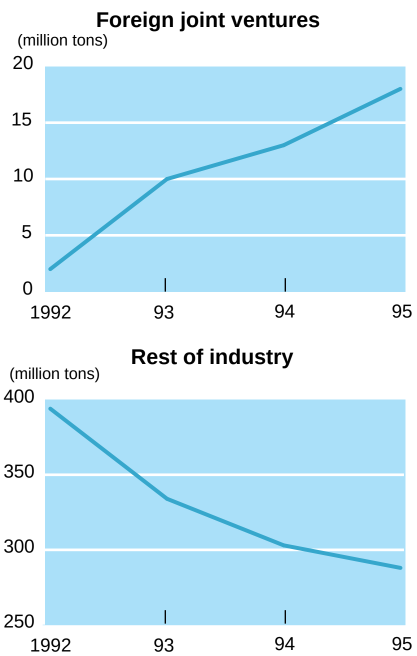
Enterprise reform

Viewed against the background of the legacy of central planning and a complete absence of accountability, transparency, and competition, Russia's achievements in the areas of institutional and enterprise reform in the oil sector have been considerable. Legislation and decrees have, with reasonable clarity, defined the roles of government at both the national (Moscow) and regional levels. The government has increasingly distanced itself from interference in the commercial operations of the oil industry and recently decided against the creation of a national oil company.

As early as November 1992, a presidential decree established a blueprint for enterprise reform: all oil enterprises were to be given independent legal (joint stock company) status as quickly as possible; up to 12 vertically integrated oil companies would be formed; and the government's controlling shareholdings would be sold off in three years. These goals have all been largely met. The one cloud still hanging over this chapter of the reform story is the lack of transparency and the haste with which major oil enterprise privatizations were handled in late 1995. It is generally accepted that with more careful management, and more openness and time, these sales could have realized much larger revenues for the government and attracted more experienced, market-oriented investors.

Chart 2

Russian-foreign joint ventures have performed well [1]



Source: World Bank.
[1] Crude oil production.

With independent legal status and the prospect of privatization, enterprises have begun to restructure, to put their operations on a commercial basis. The need to gain access to international capital markets and to attract share capital has led most companies to conduct independent legal, financial, tax, and reserve audits, thereby promoting good corporate governance. Recent gains notwithstanding, tax arrears are a major, urgent problem for companies and the government alike.

Finally, competition, supported by legislation, appears to be developing well at the producing level and even at the refining and distribution levels of the "oil chain." Local monopolies are likely to be short-lived. Natural monopolies in oil pipeline transport are still state-owned and will be subject to regulation of rates and rules of access. The potential for private ownership of new transport projects is being seriously discussed.

Foreign direct investment

Foreign private investment is playing, and will continue to play, a critical role in achieving stabilization and recovery in the oil sector. What it will take to attract foreign capital is largely reflected in the reform agenda discussed above: international prices, export access, an internationally competitive tax and legal framework, restricted government intervention, and well-run, financially sound Russian counterpart companies. Attracting foreign capital will also depend on a welcoming or accommodating Russian attitude toward such investment.

Russians have generally been deeply skeptical of foreign involvement in their economy. In good part, this is due to nationalist sentiments, which have deep historical roots, as well as to professional pride. Foreign direct investment has been viewed as a necessary evil, providing essential bridge finance during economic transition, at the expense of giving away part of the national heritage. In fact, Russia stands to gain a great deal from the involvement of foreign capital, as do other major oil regions in the world. These gains include shared financial and technical risk, accelerated development, and shared technical and managerial ideas and practices. These advantages have become increasingly apparent to the larger Russian firms that have now been exposed to major international firms for several years. Their foreign partners hold an average of less than

45 percent of international deals because they recognize the benefits of joint ventures.

Through 1995, approximately $1 billion has been invested in foreign joint-venture projects in Russia under special incentive schemes providing exemptions from the more onerous features of the existing tax system. These projects have performed well relative to the rest of the sector (Chart 2), but, because they have been limited in scope and number, represent only a small fraction of total production.

Russian focus has now shifted to the negotiation of megadeals with foreign investors in the context of PSAs. As part of this process, many important issues between the government and foreign investors, and between Russian and foreign joint ventures, have been resolved or at least clearly identified. Ten of these projects, worth an estimated $60 billion in new investments, have been negotiated with 14 different international companies. Their implementation depends on the completion of an enabling legal framework. Once these projects are fully operational and the benefits of cooperation become more tangible, Russian resistance to foreign investment, at least in the oil sector, could erode rapidly.

Next steps

Given the difficult circumstances, Russian progress on oil sector reform has been substantial. Prices have risen from less than 5 percent of world levels to 70 percent; an acceptable tax package has been developed, which was negotiated in the context of PSAs; and the government has committed itself to seriously considering broader tax reform. Competing drafts of petroleum legislation have begun to coalesce, and there is growing consensus on the required legal reforms. The recently enacted Law on PSAs was a major achievement. A rational institutional framework for the oil sector now exists, with minimal state interference, and enterprises have rapidly become more commercial. Despite the fact that many Russians remain ambivalent about foreign investment in the oil sector, truly world-scale projects are now pending on a foreign joint-venture basis, and more are planned.

These achievements notwithstanding, a number of critical obstacles to reform remain: export duties need to be abolished in order to complete price reform; PSA fiscal provisions should be further defined and confirmed by legislation; broader tax reform for the oil sector needs to be urgently addressed; regulations and legislative amendments will be required to complement the PSA law and unlock the billions of dollars in pending PSA investments; and further progress on commercialization, audits, and tax compliance is required to bring oil sector enterprises up to international standards.

The Russian reform context remains very complex and, if anything, this complexity is increasing as the number of active participants grows. Nevertheless, the potential payoff to reform is enormous. F&D