Energy Investment and the Moscow G8 Energy Ministerial

*by Lise Weis and Isabel Murray**

The first 100 days of Prime Minister Kiriyenko's term in office have not been easy ones and it doesn't look like it will get any easier soon - from increasingly difficult financial problems, pressure on the ruble due to investor cooling in the wake of Asian financial turmoil worsened by the continuing non-payment problems, international debt servicing pressures and the impact of low oil prices on a country given that oil and gas still account for almost half of Russia's hard-currency export revenue, to the crack down on tax collection and tax evaders, the formulation of a package of crisis measures and pressure on the Duma to adopt them and the recent passage in third reading by the Duma of PSA related legislation. This ongoing flurry of news and events began during the week leading up to the G8 Energy Ministerial in Moscow. At the end of March, President Yeltsin surprised the world with the decree dissolving his cabinet and if the other G8 government representatives needed a reminder of the lack of a stable investment climate in Russia, they got it in the form of the term "acting" before the titles of each of their Russian counterparts. The new government has provided solid leadership since it was given its mandate with the energy sector and investment a key focus. This was made clear by then "acting" Prime Minister Kiriyenko in his opening address to the G8 Energy Ministers. Having stepped into these shoes from his portfolio as Minister of Energy, Kiriyenko understands all too well how vital this sector is to Russia, especially now.

The International Energy Agency (IEA) jointly with the Energy Charter Secretariat (ECS) prepared a background paper for Energy Ministers on Energy Investment for the G8 Energy Ministerial in Moscow April 1, 1998. In it the IEA and the ECS assessed future energy investment needs and the benefits which national economies could gain from private sector energy investments. The paper identified the policies needed to attract private sector investment, whether domestic or foreign. G8 Energy Ministers were invited to widen awareness of the importance of energy investments for world economic growth and trade by bringing the conclusions, and recommendations based on this paper to the attention of other governments.

In general, the paper covered:

- ***Growing need for energy investment:*** All countries will need to assure a supportive climate for investment to meet their energy needs, enhance efficiency and improve environmental quality. Energy investment requirements will amount to 3 or 4 percent of world GDP over the next two decades. As a percent of GDP, the needs will be higher still in the transition economies, because of the need to replace or modernise obsolete and inefficient plants and infrastructure.
- ***Investment competition:*** There is no shortage of capital for global energy investment - the problem lies in how to mobilise it. Energy projects will be in competition with other investment opportunities in both domestic and international markets.
- ***Socio-economic benefits:*** Investments in the energy sector provide a range of socio-economic benefits in the regions and countries where they are made. These include job creation, increased tax revenues and competitiveness, as well as infrastructure, transfer of modern technology and managerial techniques, improved efficiency and the ability to reallocate government spending.
- ***Meeting energy investment needs depends on competitiveness:*** Countries' ability to mobilise enough capital for their energy investment needs will depend on the quality of their investment, fiscal and regulatory policies. This in turn will crucially affect the rate of economic growth and living standards in those countries.
- ***Thorough assessment of market, financial and legal risks:*** One of the most important considerations for potential investors will be a country's political and economic stability. Companies will also evaluate other market, financial and legal risks. The main areas will be market access, including market structure, discrimination and bureaucracy and market operation, including the legal framework, the financial environment and market conditions.
- ***Excessive bureaucracy or discrimination hinder market access:*** Companies will want to know that they can obtain any consent needed for new investments through procedures based on clear and consistent criteria and avoid bureaucratic complexities and delays. Foreign investors will be particularly deterred if there is discrimination on nationality grounds.
- ***Attractive market structure:*** Traditionally, in many countries, the scope for private sector activity in the energy field has been limited by the involvement of government and State enterprises. There is now widespread recognition that liberalisation, including privatisations and reduction of monopolies yields major benefits for the efficient operation of energy markets. Governments need to ensure fair competition, including control of monopoly behaviour, and avoid distortions in energy prices.
- ***A stable and effective legal environment:*** Companies will always look closely at the overall legal and administrative framework in a particular country. They want to be sure that they can, if necessary, protect their investments by recourse to law. This matters most in cases where agreements they have entered into are not being complied with by other parties, or where customers have defaulted on payments. Dispute resolution is an important aspect of this issue, including, whenever necessary, access to international arbitration. In a wider sense companies will want to feel protected against crime and corruption.
- ***Pattern of legal and fiscal stability is needed:*** In countries where appropriate legal and/or fiscal regimes are still being developed or have not long been in place, governments will need to take positive action to create investor confidence through strong and stable legal guarantees. International treaties can provide a broadly-based, secure

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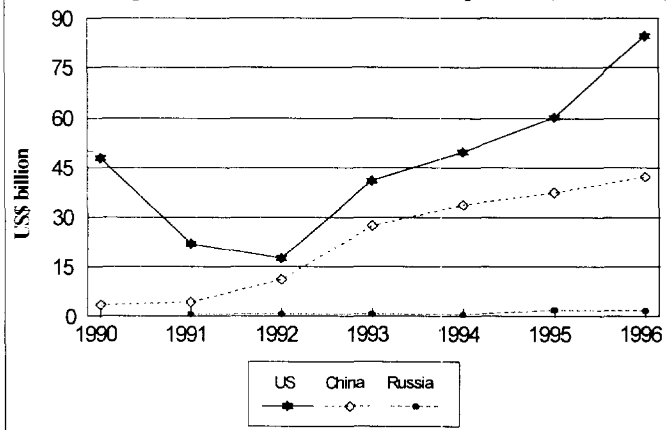
and stable foundation for large-scale investments with long pay-back periods. Examples are the Energy Charter Treaty (ECT) and its future extensions, a Multilateral Agreement on Investment being negotiated under the OECD, bilateral investment treaties and production sharing agreements in upstream oil and gas investments.

- ***Proper taxation rules:*** The viability of an energy investment will depend crucially on the relevant tax regime. Experience has shown that an unstable or unbalanced tax system can be the single most important factor in deterring investors. This has been particularly true where taxation is based on gross revenues rather than on profits, with allowance for incurred costs. A system which favours short-term government revenues can jeopardise long-term investment benefits.
- ***Access to energy transport systems and trade:*** Companies will want to know whether they can move their future production to domestic or international markets. They will ask for secure access on fair terms to local and national energy transport systems, such as pipeline networks or electricity grids. They will also be sensitive to any likely restrictions on their ability to export or import energy, or on their purchases of energy equipment or services from abroad. A regime which follows World Trade Organization Rules will provide companies with considerable assurance in this regard.
- ***Energy efficiency and the environment:*** Governments should ensure that attention is also given to investments in energy efficiency and in energy-related environmental projects, along with investments in energy supply.

Energy is vital to prosperity in developed countries, countries with economies in transition and developing countries. But the sector faces a fundamental challenge: to attract investment in today's fiercely competitive financial markets, now that the system of state management has disappeared. Energy investment projects compete with other investment opportunities across the domestic economy and internationally as well. In the area of new power generation capacity alone, the World Bank estimates that Asia would require about $30 billion/year and Latin America about $15 billion/year and estimates the gap between savings and investment needs by 2005 at about $50 billion/year in both Asia and Latin America. In Russia and Eastern Europe the World Bank estimates this gap at about $10-15 billion/year. The crux of the issue is whether these countries will be able to attract enough private domestic and/or foreign investment to meet their energy needs.

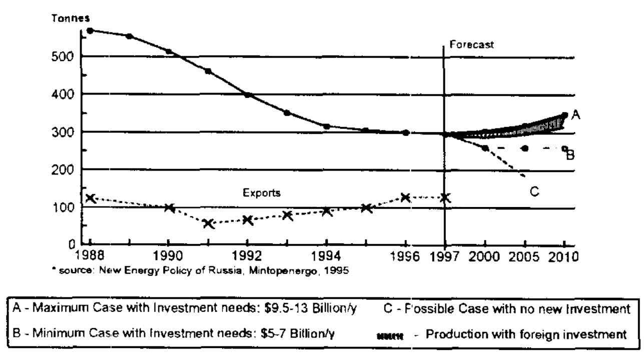
Foreign direct investment acts as a supplement to domestic savings. The following chart compares the different levels of foreign direct investment inflows over the last 15 years in the United States, China and Russia. The United States attracts more foreign investment than any other country; U.S companies are also actively investing abroad and giving the United States its position as the largest source of foreign direct investment. Since 1990, China has created an investment environment which is increasingly attracting foreign direct investment to promote and help sustain its high GDP growth rates. The comparison between Russia and China is striking, with China attracting over $42 billion in 1996 compared to less than $2 billion in Russia. (In 1997, preliminary estimates show foreign direct investment to China and Russia at $32 billion and $3 billion, respectively).

Foreign Direct Investment Inflow Comparison ($US billion)



In Russia, oil production has at last stabilised and recently started to grow slightly. But, according to a statement by the Russian Ministry of Fuel and Energy in 1996, there could be a further decline to levels below 200 MT/y by 2005, unless significant investments are made to increase recovery in existing fields and, more importantly, to develop new fields. As shown in the graph below, Russia's annual investment needs are estimated at a minimum of $5 to $7 billion and a maximum of $9 to $13 billion.

<u>Russian Oil Production and Exports</u>
<u>History and Forecast Dependent on Investment</u>



Three conditions are crucial to meeting that challenge. And they are particularly relevant for Russia and other economies in transition in continuing the work of establishing a favourable investment climate. They are:

- the establishment of an efficient market,
- the sanctity of contracts under the rule of law,
- the application of non-discriminatory, profit-based taxation.

None of these conditions is sufficient in itself to attract investment; all three need to be fulfilled.

Current energy policy in most of the economies in transition remains characterised by non-payment, discretionary and often discriminatory decisions on allocation of export permits, cross-subsidization and a substantial differential between domestic and export price. The ability to access the

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most lucrative markets determines the profitability of the investment. Price differential combined with limited and selective access to the most lucrative markets almost "invite" crime and corruption. This situation is significantly worsened by the non-payment problem. This fundamental market failure undermines competition. It undermines the security necessary to promote any private investment. A fundamental attribute of a functioning market is that it is underpinned by a culture and a legal system which makes selling and buying a real process, a process followed by a transaction. Without a functioning market, reasonable and even investor-friendly legislative reforms alone are not sufficient to stimulate investments in a sector.

The best way to encourage competition is to work towards elimination of discretionary measures. This will give private investors, domestic as well as foreign, the necessary signal that a frame of economically viable terms for investments is seriously contemplated. Where the price of the products is not determined by the market - driven by supply and demand - there is an overwhelming danger that the most efficient allocation of resources is not achieved.

Future investment demands the security of international market practice and the allocation of resources to profitable and cost-efficient projects. Non-discriminatory access and the eventual elimination of price differentials are primary objectives in this process. They are supported by the binding provisions of the Energy Charter Treaty. For formerly centrally planned economies, the transition to competitive markets will take time. Recent and current experience of deregulation in Western Europe provides many lessons in this respect, and it is one of the central working objectives following the Treaty's entry into force.

The rule of law and sanctity of contracts within a free-market are basic needs for investors. One of the worst fears for investors is the possibility of fundamental changes to the legal regime governing an investment which would undermine the fiscal or contractual undertakings that formed the basis of original investment decision. Delay in developing an adequate legal regime or reliance on piece-meal regulation also heighten investor uncertainty. This is a significant issue for transition economies where there is no "track record" regarding sanctity of contracts. It will take time to develop one. These economies need to move more quickly to put in place comprehensive systems of legal regulation which will provide strong assurances to investors making large-scale long-term energy investments.

There are immediate and relatively low-cost measures that governments can take to promote investor confidence, such as becoming party to international treaties, bilateral and multilateral, which provide for basic guarantees required by investors: enforceable contracts backed by sound and stable domestic legislation and legally enforceable international agreements, including access to international arbitration. Obvious examples are the Washington Convention on the Settlement of Investment Disputes, the Energy Charter Treaty and a future OECD Multilateral Agreement on Investment (MAI) which is currently under discussion in the OECD.

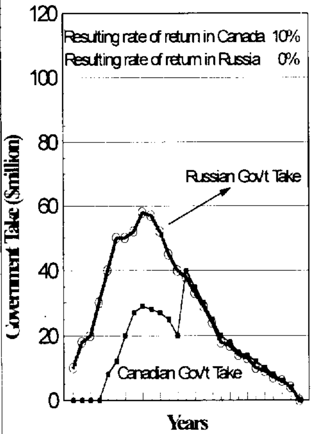
Experience in many countries has shown that investors regard Production Sharing Agreements (PSAs) as an alternative mechanism on which to base major investments especially while an overall tax regime is being drafted and put into place. The recent boom in investment in Azerbaijan shows how legal and fiscal arrangement for PSAs can attract investment, especially when it is underpinned by strong treaty obligations. Azerbaijan was among the first countries to ratify the ECT. It has signed PSAs involving total investment of over $30 billion since September 1994. In Russia, the Sakhalin I and Sakhalin II PSA projects are already underway. They are expected to bring the Sakhalin region more than $40 billion in investment over the next 10 to 15 years. Although Russia enacted a PSA Law in 1996, many domestic and foreign investors continue to wait while the Russian State Duma considers amendments to it and passage of related legislation for the PSA Law to become fully effective. Resolution of the PSA issue would provide a boost to investor and lender confidence in Russia generally.

Finally, risk of fiscal change is a major concern to investors making large upfront investments, especially in regions with little or no history of fiscal stability. Frequent tax changes are due in part to the nature of gross-revenue based regimes where governments need to make adjustments to benefit from changes in prices or costs. Profit-based systems are more self-adjusting and give a better basis for investors to assess the fiscal impact over the life of their investment project. Such systems do not impose a heavy tax burden in the early years of production which would negatively affect projected rate of return. This can be seen in the following chart, which compares the impact on project rate of return and the tax revenues over the life of the same oil project under the Canadian tax system (a representative of profit-sensitive tax regimes) and under the current Russian tax system, which is essentially based on gross revenues. Taxation which aims to maximise short-term government revenue may jeopardise the long-term economic goals of attracting investments, providing long-term employment, income and a widening of the tax base. Finding the right tax structure is of particular importance to Russia given the state's heavy reliance on oil-related revenues. In 1997 about two-thirds of the income from oil sales went to fund federal and regional budgets in the form of royalty, taxes and other contributions to various funds. The impact of low prices in 1998 is putting an obvious squeeze on budgets and at the same time making it clear that the taxation of the oil industry must shift away from its predominantly gross-revenue base to a profit based regime.

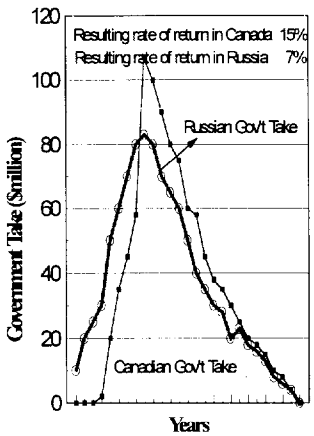
Passage of the presently proposed Russian Tax Code would introduce provisions for hydrocarbon taxation which are more profit-sensitive. This important step towards conformity with OECD countries in the area of taxation will need to be combined with a sound and professionally run public and private audit system. That system should be based on generally accepted accounting principles, for purposes of checking and monitoring tax compliance under a much more complex tax system. This should in turn reduce the perceived need to set norms to control maximum allowable business costs, thereby reducing still further the differences between Russian and OECD systems of taxation. This could lessen or remove altogether investor concerns about double taxation or problems with tax credit in home countries. Implementation of an effective Tax Code will be a key component to build and strengthen the ongoing process of reform to a market economy.

Comparison of Government Take and Impact of Fiscal Systems on Project Rate of Return

Low Oil Price Case ($102/Tonne)



Average Oil Price ($131/Tonne)



Much of the above are extracts from the IEA/ECS G8 Energy Investment paper. Also, in this paper, the IEA and the ECS presented several basic recommendations which were noted at the April 1st G8 Energy Ministerial meeting. Given the situation in Russia since then, the recommendations to Ministers listed below have only gained in importance and urgency in the Russian context.

Recommendations to Governments on Energy Investment

1. Governments should address the need for attracting higher levels of private sector investment by liberalising energy markets and ensuring fair competition, including control of monopoly behaviour.
2. Procedures for granting investment rights should be reasonable, practical, transparent and based on published criteria.
3. Where investment opportunities are generally available, the scope for private sector investment should be maximised by giving companies equal access to those opportunities without discrimination by nationality or on other subjective grounds. The national economic benefits arising from a particular investment will not be determined by the nationality of the investing company.
4. Privatisation opportunities should, except in very limited cases of clearly defined national interest, be open to companies without discrimination on grounds of nationality. There should be no constraints on subsequent resale and purchase of shareholdings or other assets after privatisation.
5. Investment prospects should be enhanced by a stable and comprehensive framework of national law, properly implemented at all levels of administration, including enforceability of contracts, debt recovery mechanisms and recourse to effective national and international dispute settlement procedures. The respective responsibilities of national, regional and local authorities should be clearly defined. Investors should receive effective protection from crime and corruption.
6. In countries where the legal framework for upstream oil and gas investments and the relevant taxation rules do not yet provide sufficient confidence to investors, governments should include effective alternative options such as Production Sharing Agreements into their policies.
7. Taxation systems should be clear, stable, non-discriminatory and based mainly on profits rather than on gross revenues or production.
8. No constraints should be placed on international financial transfers relating to energy activities, or on access to capital funding.
9. To enable resources to be allocated efficiently, Governments should allow energy prices to reflect market conditions.
10. In accordance with international standards, there should be no discrimination in the operation of national energy markets.
11. Governments should have legal regimes ensuring access to energy transport systems on fair terms, under rules applied by operationally independent regulatory authorities.
12. Companies should be free to sell their production in foreign markets through the full application by governments of World Trade Organization (WTO) Rules. Consistent with WTO Rules, there should be no barriers to purchases of energy equipment, services or technology from the most economic source, whether that source is within the country concerned or abroad. Government policies in this area should acknowledge the benefits of transfers of modern technologies.
13. As well as energy supply projects, investments in energy efficiency and environmental quality should be given high attention in energy investment policies.
14. The governments concerned should continue to pursue, as a matter of priority, ratification of the 1994 Energy Charter Treaty. The Treaty remains open for accession by other countries.

The recommendations of the G8 Energy Ministers were endorsed at the G8 Summit in Birmingham. Below is the relevant extract from its Communiqué.

"A crucial factor in ensuring sustainable development and global growth is an efficient energy market. We therefore endorse the results of our Energy Ministers' Meeting in Moscow in April. We shall continue co-operation on energy matters in the G8 framework. We recognise the importance of soundly based political and economic stability in the regions of energy production and transit. With the objective of ensuring reliable, economic, safe and environmentally sound energy supplies to meet the projected increase in demand, we commit ourselves to encourage the development of energy markets. Liberalisation and restructuring to encourage efficiency and a competitive environment should be supported by transparent and non-discriminatory national legislative and regulatory frameworks with a view to establishing equitable treatment for both government and private sectors as well as domestic and foreign entities. These are essential to attract the new investment which our energy sectors need. We also recognise the importance of international co-operation to develop economically viable international energy transmission networks. We shall pursue this co-operation bilaterally and multilaterally, including within the framework and principles of the Energy Charter Treaty."

The Energy Charter Treaty offers a sound and effective

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