GROWTH, CAPITAL AND GOVERNANCE:
THE CHALLENGE OF FINANCING RUSSIA’S INVESTMENT
REQUIREMENTS IN THE OIL SECTOR

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Abstract

Russia’s recent economic recovery has surprised most observers. However, in order to maintain the current momentum and achieve the government’s objective of doubling GDP within a decade, capital formation must increase substantially. It is estimated that in the oil industry alone $12 billion need to be invested every year over the next three decades. Representing a doubling from current levels, Russia’s investment requirements pose important challenges in terms of securing sufficient finance. While foreign direct investment could play an important role in this context, the paper argues that greater access to foreign savings will require bold corporate governance reforms. As important as Production Sharing Agreements as islands of stability may be, the paper counsels to put in place a wholesale transformation of Russia’s governance regime.

The views expressed in this paper are those of the author and do not necessarily reflect the views of the Royal Dutch/Shell Group of Companies
Non-technical summary

Russia’s recovery following the economic and financial crisis in 1998 has been impressive, which has encouraged the government to aim at doubling GDP by 2014. In order to attain this objective, the economy will need to continue to expand at the current rate for the next ten years. However, the Russian economy has remained heavily dependent on oil and gas. Its underlying trend output growth rate – the rate of output growth under constant oil prices – is estimated at 4 to 5 percent, making the government’s objective attainable only if investment rises substantially. Indeed, Russia’s investment requirements are huge. A substantial part of the economy’s capital stock is outdated, and in the energy sector massive investments are needed to meet a rapidly rising demand for oil and gas.

According to the International Energy Agency, total investment needs in the energy sector amount to more than $1 trillion in the first three decades of this century. In terms of GDP, this is by far the highest ratio among all individual regions, more than 5 times the global average. Russia’s oil sector alone, which has undergone substantially changes since the dissolution of the former Soviet Union, will require around $328 billion, or about $11 billion a year on average, over the period 2001-2030. Although total upstream investment by Russian oil companies has risen substantially in recent years, in 2003 it was just about half the amount projected to be required over the medium and long term. Unless investment picks up considerably, there is concern whether Russia can sustain its current production level of more than 9 million barrels per day.

Greater access to foreign savings could help meet Russia’s challenges to finance its huge investment needs. A critical precondition for more FDI is a sustained improvement in corporate governance. In any given country, the legal and institutional system helps set some corporate governance standards, with two companies with the same risk profile but domiciled in countries with contrasting legal, regulatory and market standards, presenting different risk profiles should their governance practices deteriorate. In assessing the quality of Russia’s corporate governance regime at the macro level, the paper employs survey data from the World Economic Forum’s executive opinion survey for the Global Competitiveness Report, emphasizing that there may exist an important gap between the “law on the books” and their enforcement. Specifically, this data set contains information about the perceived degree of independence of the judiciary, the protection of property rights, favoritism, the prevalence of organized crime, the protection of minority
shareholders, the quality of financial auditing, the effectiveness of the security exchanges and the role of mergers and acquisitions. On all these dimensions, Russia’s scores poorly.

In principle, it is conceivable that companies operating in weak country environments transcend local practice. Companies whose corporate governance standards are perceived to be high are generally seen as less risky than companies with low standards, irrespective of the country of domicile. In assessing whether Russian companies tend to pursue better practices than the quality of their corporate governance environment would suggest, the paper also uses data from the World Economic Forum’s executive survey. In particular, this assessment focuses on the perceived degree of corporate ethics, the efficacy of boards and the control by shareholders, and recruitment practices of senior management. According to the survey results, Russia’s corporate governance standards at the firm level are on average perceived to be somewhat better than the country’s framework conditions. However, this premium is relatively small, and while some companies may be “overachievers” in the sense that they pursue better practices relative to the legal and institutional framework they operate in, many others have yet to transcend national standards.

Against this background, it may not be surprising that FDI has remained relatively low. FDI in the energy sector has usually taken the form of Production Sharing Agreements (PSAs), which lock in tax regimes, clarify resource ownership, and guarantee payments in fungible exportable assets such as oil. In practice, PSAs have not eliminated the uncertainties that deter investors. Frequently, government-to-government contacts have played a role in the investment process, especially in cases where investors have found the existing PSA regime incapable of solving uncertainties about regulatory and tax treatment. The paper argues that while it is important to improve the current PSA regime, what is required to increase investment and achieve faster economic growth in the medium and long term is a wholesale transformation of the country’s corporate governance regime. Rather than aiming at establishing islands of stability, it is critical to put in place an improved framework for the entire country that is conducive to investment and private risk-taking.
INTRODUCTION

Russia’s recovery following the economic and financial crisis in 1998 has surprised even the greatest optimists. Amid a global economic slowdown, output expanded by around 6.7 percent per year between 1999 and 2003, and data for the first half of 2004 suggest that economic growth has even accelerated. Against this background, the Government has announced its objective to double GDP by 2014. In order to attain this objective, the economy will need to continue to expand at the current rate for the next ten years.

Standard theory tells us that sustained economic growth requires two things: capital deepening and technological progress. In order to meet these conditions, an environment is needed that is conducive to investment and risk-taking. In some areas, important macroeconomic and structural reforms are underway to put such a framework in place. In others, however, reform efforts have stalled, including reform of natural monopolies and public sector reforms in order to address the considerable government influence in the economy (IMF 2004b, p.47). Narrowing the reform gap between announced measures and their actual implementation represents an important precondition for a sustained increase in private investment.

To be sure, Russia’s investment requirements are huge. A substantial part of the economy’s capital stock is outdated, and in the energy sector massive investments are needed to meet a rapidly rising demand for oil and gas. Russia’s enormous investment requirements pose serious challenges with regard to the financiability of such investments and the diversification of the economy. These challenges are exacerbated by the projected increase in consumption as real disposable incomes continue to rise. In principle, greater access to foreign savings, especially in the form of foreign direct investment (FDI) might alleviate the financing requirements, but in the absence of a well-functioning legal and institutional framework foreign investors have remained cautious.

Against this background, this paper begins by analyzing recent economic trends and especially the extent to which high oil prices have contributed to Russia’s recovery. Then, the paper examines Russia’s investment requirements in the energy sector, and in particular the oil industry, over the long run. In discussing the possible contribution of FDI to the financing of the required investments, the paper then looks at corporate governance reform in Russia. First, it discusses the framework of corporate governance in Russia. Taking into
account that there remains an important gap between the “law on the books” and actual enforcement, this analysis is based on new evidence from the World Economic Forum’s Global Competitiveness Report. Finally, the paper evaluates the extent to which good corporate governance practices in individual companies might compensate for perceived weaknesses at the macro level. The paper concludes that the reform process needs to be deepened and accelerated if FDI is to play a crucial role in meeting Russia’s huge investment requirements. Rather than creating islands of stability through Product Sharing Agreements (PSAs) within an otherwise risky area, the paper argues for the continuation of a wholesale transformation of Russia’s governance structures to make the entire economy more predictable.

RECENT ECONOMIC TRENDS AND THE ROLE OF THE ENERGY SECTOR

Russia’s recent growth performance has been impressive. Having recovered remarkably well from the financial crisis in 1998, the Russian economy expanded by almost 40 percent between 1999 and 2003 – or around 6.7 percent per year on average. Output growth has remained strong at around 7.5 percent in the first half of 2004, and at the current rate, the government should be able to achieve its objective of doubling GDP by 2014.

Other macroeconomic indicators also appear favourable. The federal government budget registered a surplus of around 2.5 percent of GDP per year since the beginning of the decade. This has enabled the government to set up an oil stabilization fund, which currently holds around $10 billion. At the same time, disinflation has continued, with the rate of consumer price inflation having fallen from 86 percent in 1999 to 14 percent in 2003. Thanks to a rapid increase in exports, the current account registers a substantial surplus, allowing a continuing built-up of foreign exchange reserves. Encouraged by Russia’s progress in stabilising the economy and achieving rapid economic growth, Moody’s, the credit rating agency, upgraded Russia’s external debt rating to investment grade in October 2003.

The economy’s strong rebound after 1998 has occurred despite relatively low investment. Although gross fixed capital formation rose by around 10 percent per year between 1999 and 2003, in terms of GDP investment has remained considerably lower than in other emerging
market economies as well as the OECD. A comparison with China is particularly striking, with Russia’s investment ratio amounting to not even half of that in China (Table 1).

Looking at developments in the labour market, one would be tempted to attribute the recovery to strong growth in labour productivity. While employment started to grow immediately after the 1998 crisis – in fact for the first time since the dissolution of the former Soviet Union – it did not bounce back as decisively. Cumulative employment growth from the low point in 1998 until the end of 2002 was less than 4 percent, while the corresponding number for aggregate output is 29 percent. Moreover, employment gains where distributed unevenly across sectors, and whereas employment in the service sector grew throughout the post-crisis period, employment in industrial production did not.

Table 1. Investment Ratios (Investment to GDP, in percent)

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<tbody>
<tr>
<td>Russia</td>
<td>21.1</td>
<td>20.0</td>
<td>18.3</td>
<td>16.2</td>
<td>14.4</td>
<td>16.9</td>
<td>18.9</td>
<td>17.9</td>
</tr>
<tr>
<td>China</td>
<td>40.7</td>
<td>33.8</td>
<td>33.4</td>
<td>35.7</td>
<td>36.4</td>
<td>36.8</td>
<td>38.8</td>
<td>42.2</td>
</tr>
<tr>
<td>Hungary</td>
<td>20.0</td>
<td>21.4</td>
<td>22.2</td>
<td>23.6</td>
<td>23.9</td>
<td>24.1</td>
<td>23.6</td>
<td>22.3</td>
</tr>
<tr>
<td>Poland</td>
<td>18.6</td>
<td>20.7</td>
<td>23.5</td>
<td>25.1</td>
<td>25.5</td>
<td>23.9</td>
<td>20.9</td>
<td>19.1</td>
</tr>
<tr>
<td>OECD</td>
<td>21.0</td>
<td>21.7</td>
<td>22.3</td>
<td>22.8</td>
<td>22.5</td>
<td>22.5</td>
<td>22.0</td>
<td>21.0</td>
</tr>
</tbody>
</table>


As a result, labour productivity increased rapidly after the crisis. However, as the World Bank (2004a, p. 7) argues, these gains did not reflect genuine productivity advancements, resulting from re-allocating given factors of production, or what is generally labelled as “intensive growth”. Rather, growth in the early years after the crisis was greatly facilitated by the existence of huge spare capacity in capital and labour. Thus, the recovery was driven primarily by “extensive growth” in the sense of increasing utilisation rates rather than output capacity. At the same time, however, the economy has witnessed a rapid depreciation of its capital stock. Over the 1990s the share of investment relative to GDP nearly halved, and the mean age of Russian manufacturing equipment is estimated at 16 years, compared to international standards of 8-10 years (Deutsche Bank Research, 2003, p. 25). Much of Russia’s industrial base is outdated and competitive only thanks to subsidised energy prices. In many areas, infrastructure is at a breaking point, and as the output gap has continued to narrow due to higher utilization rates and the progressive depreciation of the capital stock, it
has become increasingly important to achieve intensive growth through efficiency gains by reallocating productive factors.

Underutilization can facilitate rapid economic growth, but in and of itself it does not represent a growth driver. In explaining Russia’s rapid recovery, researchers have generally pointed to the impact of hydrocarbon export prices, which began to rise substantially after the 1998 crisis. To be sure, the Russian economy has remained heavily dependent on oil and gas, with more than 50 percent of its export revenues and more than one-third of federal budget revenues generated by these sectors. Under plausible assumptions about the elasticity of GDP growth with respect to oil prices, the World Bank (2004a, pp. 10-11) estimates that nearly half of Russia’s output growth in the first half of 2003 can be attributed to the oil sector alone. Specifically, estimating that an increase of one percent in the average price of oil adds 0.07 percent to GDP growth, the World Bank calculates that more than 40 percent of the expansion of real activity during this period was due to higher oil prices. A sensitivity analysis suggests that higher oil prices would still have contributed almost one third to GDP growth even if the elasticity had been just 0.05 (Table 2).

<table>
<thead>
<tr>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elasticity of GDP growth rates With respect to oil prices</td>
<td>0.05</td>
<td>0.07</td>
</tr>
<tr>
<td>Oil price effect for H1 2003, %</td>
<td>2.2</td>
<td>3.0</td>
</tr>
<tr>
<td>GDP growth in H1 2003, %</td>
<td>7.2</td>
<td>7.2</td>
</tr>
<tr>
<td>GDP growth in H1, net oil effect, %</td>
<td>5.0</td>
<td>4.2</td>
</tr>
</tbody>
</table>


Similar results are obtained for different periods, suggesting that Russia has an underlying trend output growth rate – the rate of output growth under constant oil prices – of around 4 to 5 percent over the post-crisis period from 1999 to 2003. Although still considerable, at this rate the Government’s target of doubling GDP by 2014 would be unattainable. Rather, the Government’s pledge would need to be put back until at least 2020. Put differently, achieving a doubling of real output within the next decade appears feasible only if oil prices continue to rise, other things being equal.
Changes in oil prices have important fiscal implications. Currently, 37 percent of federal budget revenues originate from hydrocarbons, and every increase in the price of Ural crude by $1/bbl is estimated to raise federal budget revenues by 0.35 percent of GDP and consolidated budget revenues by 0.45 percent of GDP (World Bank, 2004a, p. 8; and Kwon, 2003). At a Urals oil price of $20/b, the general government would have run a deficit of 1¼ percent of GDP in 2003, compared with a recorded surplus (at the actual Urals oil price of $27/b) of 1 percent of GDP. As the IMF (2004c, p. 12) emphasises, this represents an underlying loosening, at constant prices, of 4 percent of GDP since 2000. In its World Economic Outlook in April 2003, the Fund (IMF, 2003, p. 42) had already warned that high oil prices were masking important fiscal weaknesses, with wage increases, increased spending on security, and the revenue losses related to the ongoing tax reform producing widening budget deficits in the non-hydrocarbon sector. Recently, the IMF (2004a, p. 44) reiterated its concern, counselling that a tighter fiscal policy stance was necessary to bring down inflation faster in line with the government’s disinflation objectives and stressed (IMF 2004c, p. 46) that any pressures to spend a proportion of oil revenues from the oil stabilization fund be resisted.1

For the economy to be launched on a steeper growth trajectory in a financially sustainable manner, two ingredients are essential: capital deepening through increased investment and technological change raising productivity. In its macroeconomic framework for the 2004 Article IV Consultation with the Russian Federation, the IMF (2004c) forecasts that real GDP growth averages 5.7 percent per year between 2004 and 2009 (Table 3). Note that this rate of expansion falls short of the government’s own objective. However, even at this more moderate growth path, Russia’s investment ratio would need to continue to increase from 20.6 percent of GDP in 2003 to 24.5 percent of GDP in 2009. However, with rising incomes consumption can be expected to increase. Thus, national savings are forecast to decline in relation to GDP, despite ongoing reforms in the financial sector. As a result, Russia’s savings-investment balance, and hence its current account, looks set to deteriorate over the

1 All revenues arising from oil prices above $20/b are currently saved in the stabilization fund. However, only half of such revenues are saved once the existing cap on the fund of Rb 500 billion (about 2 ¾ percent of GDP) is reached. Under the budget oil price assumption of $26/b this will happen by mid-2005, and much earlier if prices remain at current levels. The half that will be spent will be transferred to the pension fund to cover the gap left in the unified social tax. The other half will be saved outside the stabilization fund, and could be used for early repayment of debt (IMF 2004c).
medium term – in the IMF framework from an estimated surplus of 8.3 percent in 2003 to near balance by 2009.

The OECD (2004b, p. 45) has recently echoed these concerns, stressing that imports in recent years have tended to increase at least in line with disposable incomes. Given that Russia’s terms of trade are likely to deteriorate at some point in the future as oil prices ease, Russia will have to be able to sustain rapid export growth if it wants to sustain high economic growth. However, according to the OECD this raises an important dilemma: While a more diversified export structure is highly preferable in order to reduce Russia’s susceptibility to terms of trade shocks – and more generally the risk that Russia’s abundant endowment with natural resources becomes a curse rather than a blessing\(^2\) - the economy’s revealed comparative advantage has clearly been in natural resources, especially hydrocarbons, and energy-intensive manufactures, such as steel, aluminium, nickel and fertilisers.

**Table 3. Savings-Investment Balances (in percent of GDP)**

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
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<tr>
<td><strong>General Government</strong></td>
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<tr>
<td>Gross investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Net income from abroad</td>
<td>2.8</td>
<td>3.0</td>
<td>3.0</td>
<td>3.0</td>
<td>3.0</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>National savings</td>
<td>-0.8</td>
<td>-0.6</td>
<td>-0.5</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.2</td>
<td>-0.2</td>
</tr>
<tr>
<td>Savings-Investment</td>
<td>3.9</td>
<td>6.1</td>
<td>4.7</td>
<td>3.9</td>
<td>3.5</td>
<td>3.3</td>
<td>3.1</td>
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<tr>
<td></td>
<td>1.1</td>
<td>3.1</td>
<td>1.7</td>
<td>0.9</td>
<td>0.5</td>
<td>0.3</td>
<td>0.1</td>
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<tr>
<td><strong>Private Sector</strong></td>
<td></td>
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<tr>
<td>Gross Investment</td>
<td>17.8</td>
<td>17.8</td>
<td>18.9</td>
<td>20.0</td>
<td>20.6</td>
<td>21.0</td>
<td>21.5</td>
</tr>
<tr>
<td>Net income from abroad</td>
<td>-2.3</td>
<td>-2.5</td>
<td>-2.2</td>
<td>-2.2</td>
<td>-2.2</td>
<td>-2.2</td>
<td>-1.1</td>
</tr>
<tr>
<td>National Savings</td>
<td>25.0</td>
<td>23.1</td>
<td>22.0</td>
<td>21.5</td>
<td>21.4</td>
<td>21.4</td>
<td>21.6</td>
</tr>
<tr>
<td>Savings-Investment</td>
<td>7.2</td>
<td>5.2</td>
<td>3.1</td>
<td>1.5</td>
<td>0.9</td>
<td>0.4</td>
<td>0.1</td>
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<tr>
<td><strong>Overall economy</strong></td>
<td></td>
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<tr>
<td>Gross investment</td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Net income from abroad</td>
<td>20.6</td>
<td>20.8</td>
<td>21.9</td>
<td>23.6</td>
<td>24.0</td>
<td>24.0</td>
<td>24.5</td>
</tr>
<tr>
<td>National savings</td>
<td>-3.1</td>
<td>-3.1</td>
<td>-2.7</td>
<td>-2.5</td>
<td>-2.5</td>
<td>-2.5</td>
<td>-1.3</td>
</tr>
<tr>
<td>Savings-Investment</td>
<td>28.9</td>
<td>29.2</td>
<td>26.7</td>
<td>24.9</td>
<td>24.7</td>
<td>24.7</td>
<td>24.7</td>
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<tr>
<td>(= current account)</td>
<td>8.3</td>
<td>8.4</td>
<td>4.8</td>
<td>1.3</td>
<td>0.7</td>
<td>0.7</td>
<td>0.2</td>
</tr>
<tr>
<td>Real GDP Growth</td>
<td>7.3</td>
<td>7.3</td>
<td>6.4</td>
<td>5.5</td>
<td>5.0</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Change in GDP deflator (%)</td>
<td>14.2</td>
<td>12.9</td>
<td>7.4</td>
<td>5.1</td>
<td>4.3</td>
<td>3.6</td>
<td>2.9</td>
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\(^2\) In the literature on the risk for resource-rich countries to suffer from “resource curse,” six different channels are usually identified: (1) a long-term decline in the terms of trade; (2) revenue volatility; (3) “Dutch disease”; (4) crowding out effects; (5) an increasing role of the state; and (6) socio-cultural and political impacts (Stevens, 2003).
Under plausible assumption about Russia’s domestic savings – both private and public – the financing requirements will be challenging. In fact, as we discuss in the following section, Russia’s investment needs in the energy sector alone are huge, and meeting them will require a business environment that is conducive to private entrepreneurship and risk-taking – and to greater access to foreign savings that could alleviate the economy’s financing constraints.

**INVESTMENT REQUIREMENTS IN THE OIL SECTOR**

In its World Energy Investment Outlook, the International Energy Agency (IEA, 2003) estimates global investment needs in the energy sector at $16 trillion in the first three decades of this century. In absolute terms, North America faces by far the greatest investment needs, totaling $3.5 trillion. But in terms of the size of their economies the largest requirements are estimated to be in emerging market economies, many of which have only limited access to foreign capital. Critically, according to Goldman Sachs (2003 and 2004), over 70% of the top 120 new legacy projects in oil and gas lie in non-OECD economies.

Russia’s investment requirements are particularly challenging, with total investment needs in the energy sector estimated at more than $1 trillion. Russia’s oil sector alone, which has undergone substantially changes since the dissolution of the former Soviet Union (Box 1), will require around $328 billion, or about $11 billion a year on average, over the period 2001-2030. These investment requirements forecast by the IEA are based on a global supply/demand model, which takes into account both domestic and foreign consumption. With domestic demand projected to grow throughout the projection period at an average annual rate of 1.7%, driven mainly by rising transport demand, over 40 percent of the estimated investment needs will be in projects to supply OECD markets. Net exports as a share of total production are forecast to peak in 2010 as domestic consumption is expected to accelerate.

Russia’s huge investment needs reflect not only a considerable increase in expected domestic and foreign demand for crude oil, but also chronic under-investment over the last decade. True, production has seen impressive growth in recent years (chart 1), with Russian oil companies choosing different strategies for achieving their growth targets. Surgutneftegaz,
Tatneft, and Lukoil mainly opted to rely on in-house technologies and extensive drilling, while Yukos and Sibneft have turned much more rapidly towards the business model usually employed by western integrated oil companies – selectively retaining international oil service providers and applying state-of-the-art reservoir management. However, although total upstream investment by Russian oil companies has risen substantially, it was less than $5 billion in 2002, not even half the amount projected to be required over the medium and long term (Table 4). Unless investment picks up considerably, there is concern whether Russia can sustain its current production level of more than 9 million barrels per day (bpd). While this level makes Russia the world’s second largest producer (after Saudi Arabia) with a global market share of 11.4 percent, it is well below the peak of 11.5 million bpd in 1987.

Box 1. The Changing Structure of Russia’s Oil Industry

The dissolution of the former Soviet Union and Russia’s transition towards a market economy led to substantial changes in the country’s oil industry (for details regarding the 1990s see Moser and Oppenheimer, 2001; for more recent changes see Deutsche Bank, 2003; and UBS, 2004). The state monopoly was replaced by a number of vertically integrated oil companies, which were established following a Presidential decree in November 1992. The oil production monopoly was separated along geographic lines, combining regional oil production association with refineries and product distributors, and transforming them into integrated joint stock companies.

The first stage of privatization in 1992 was followed by the emergence of vertically integrated companies, after government stakes (generally 51 percent of voting shares) in various enterprises were consolidated to form individual holding companies. Many holdings were subsequently sold to financial/industrial groups, with control tending towards the owners of the holding companies at the expense of shareholders in the subsidiaries. The pace accelerated at the end of the decade when Surgutneftgaz, Sibneft and Yukos completed the consolidation of their subsidiaries and Lukoil acquired Komitek. State-owned Onako was sold in 2000 to TNK group, which merged with BP in 2003., while Slavneft was privatised in late 2002. Recently, Gazprom and Rosneft merged, and ConocoPhilippines acquired the government’s stake in LUKoil.

Key Events:
1992: First vertically integrated companies – LUKoil, Surgutneftgaz, Yukos and Rosneft.
1994-95: Slavneft, SIDANCO, VNK, ONACO, and TNK
1996: Creation of Sibneft. Yukos becomes first fully privatised Russian oil company.
1997: BP buys 10 percent stake in SIDANCO
2000: LUKoil buys Getty Pretroleum Marketing Inc
2002: BP announces increase of its shareholding in Sidanco to 25 percent plus one share.
2002: Slavneft privatisation – divided between TNK and Sibneft.
2004: Gazprom merges with Rosneft.
2004: ConocoPhillips purchases Russian government’s 7.9% stake in LUKoil.
Russia has the world’s seventh largest proved oil reserves, estimated at 9.5 billion tonnes, or 6 percent of the world’s total proved oil reserves. The bulk of Russian oil production is based in Western Siberia, which accounts for two-thirds of total production. The Volga-Urals is the oldest and most depleted oil region, producing sour crude. By contrast, Timan-Pechora in the Far North and Sakhalin in the Far East are more recent production centres and are still in the early stages of development. There are also relatively underdeveloped new regions with substantial potential in the Northern Caspian, Eastern Siberai and the Artic shelf.

**Chart 1. Russia: Oil Production**

Source: BP (2004); and UBS (2004)
Table 4. Upstream Capital Spending by Company (in USD million)

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<tr>
<td>Financial group owned</td>
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<td>Of which three largest:</td>
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<td>Yukos</td>
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<td>269</td>
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<td>1821</td>
<td>4143</td>
<td>6018</td>
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Source: OECD (2004), p.60

Given the mature field decline in Russia, which is exacerbated by under-investment in the 1990s, Russia’s investment requirements are expected to rise over time. While in the current decade average annual investment needs are estimated at around $10 billion, they rise to $11 billion in the coming decade and to $12 billion in 2021-30. This increase reflects more drilling in less mature areas, such as Timan-Pechora, and frontier provinces, such as east Siberia, the Pechora Sea, or the Russian sector of the Caspian, in order to replace ageing fields in the mature Siberian basins. Exploration and development account for over 90 percent of total investment needs.

There are two major uncertainties as to whether the increase in production projected by the IEA will actually be forthcoming. The first concern is of a more technical nature and will not be discussed in detail in this paper. Essentially, there is uncertainty as to the extent to which fields might have been damaged by long-standing practices such as quasi-systematic water injection to raise output as quickly as possible in order to meet aggressive planning targets.

An increasing share of proven reserves falls into the “difficult-to-recover category and over 70 percent of fields now in production yield such low flow rates that their operation is only marginally commercial. According to the IEA (2003, p. 148), around 55 percent of Russia’s total oil reserves now in development yield flow rates of 10 tonnes per well per day or less compared with average rates of nearly 250 tonnes in the Middle East and 140 tonnes in the North Sea. Thus, there is a considerable downside risk that investment requirements are higher than estimated by the IEA. Interestingly, the Government’s own projections of
investment requirements in the oil sector are higher than the IEA’s estimates. According to the new Russian Energy Strategy approved in September 2003, it is forecast that cumulative investment of $230-240 billion will be needed through to 2020. This is almost $14 billion per year and more than one-third higher than estimated by the IEA.

The second uncertainty concerns the financiability of Russia’s investment requirements. With Russia’s GDP estimated at $434 billion in 2003, around 2.5% of it should have flown into investments in the oil sector. However, in reality only around 1.5% of GDP was actually invested in that sector. As output expands over time, the percentage of required investment in terms of GDP decreases. Over the period from 2001 to 2030, Russia’s investment needs are estimated to average around 1.8 percent of GDP. This is nearly twice the estimated global investment requirements in the energy sector – not just the oil sector – during this period, relative to global output.

The picture is even more dramatic, if one takes into account investment needs in other parts of the energy sector, especially the gas and electricity sectors. Estimated at more than $1 trillion during the first three decades of this century, the required average annual investment ratio for Russia’s energy sector overall amounts to 5.5% of GDP. This is by far the highest ratio among all individual regions, more than 5 times the global average and around 80 percent higher than in the Middle East region relative to the respective incomes there (chart 2). In relation to Russia’s current investment ratio for the economy as a whole, nearly 40 percent of all investments would need to be in the energy sector if the IEA’s estimated requirements were to be satisfied. Clearly, such a distribution of investment funds would be incompatible with the authorities’ objective to diversify the economy.
So what is to be done to ensure that the required amounts of investment in the energy sector can actually be financed, while fostering the diversification of the Russian economy? In a simple macroeconomic framework, a sustained increase in national investment requires greater savings. First and foremost, a higher savings rate necessitates a well-functioning financial system, with banks, bond and equity markets serving as financial intermediaries. Thus, as stressed by the World Bank, the IMF, the OECD and others, financial sector reform should be given high priority on the reform agenda. These reforms need to be accompanied by reforms in other key areas in order to make the Russian economy more competitive (Malleret, Paua, and Cornelius, 2002), including taxation, labour markets, health, education, housing, public administration, natural monopolies – and the energy sector itself. While important measures have already been designed, in several areas the reform process has stalled. Putting the reform process back on track will be critical for the “reform gap” between reform announcements and their actual implementation to be narrowed and eventually be closed.

Deepening and broadening the reform process will not only help to raise domestic savings but can also be expected to facilitate access to foreign savings, especially in the form of foreign direct investment (FDI). In fact, greater capital inflows may be necessary to finance a
deteriorating current account, as an increase in investment could result in a worsening of Russia’s savings-investment balance. A critical precondition for more FDI is a sustained improvement in corporate governance, an issue we turn to in the following.

FOREIGN INVESTMENT AND THE FRAMEWORK OF CORPORATE GOVERNANCE

In the broadest sense, corporate governance can be defined as the stewardship responsibility of corporate directors to provide oversight for the goals and strategies of a company and to foster their implementation. Corporate governance may thus be perceived as the set of interlocking rules by which corporations, shareholders and management govern their behaviour. These rules refer to individual firm attributes and the factors that allow companies to maintain sound governance practices even where public institutions are relatively weak. Such factors may include a corporation’s ownership structure, its relationships with stakeholders, financial transparency and information disclosure practices as well as the configuration of its managing boards.

In any given country, the legal and institutional system helps set some corporate governance standards, with strong investor protection laws generally linked with broader and deeper capital markets, a more dispersed shareholder base, and a more efficient allocation of capital across firms. Defining the framework for corporate governance practice at the individual company level, legal, political, historical and cultural factors interact and help determine ownership structures, stakeholder priorities and fundamental attitudes towards the role of the firm in the economy (Dallas, 2004). Thus, assessing corporate governance risk at the company level requires analysing country risk factors. For example, two companies with the same risk profile but domiciled in countries with contrasting legal, regulatory and market standards, present different risk profiles should their governance practices deteriorate. In other words, in the event of deterioration in a specific company’s governance standards, investors and stakeholders are likely to receive better protection in a country with stronger and better enforced laws and regulations.

While absolute conformity of corporate governance systems is both unnecessary and unlikely to be very healthy, there is near universal recognition of the need to preserve investor confidence through transparency, accountability, fairness and responsibility.
This recognition has driven and continues to drive convergence on notions of governance and what constitutes best practice, despite differences in legal origins, regulatory systems, and governance models (Cornelius and Kogut, 2003). In fact, according to a recent survey among global investors in the energy and extraction industries (Lameed and Saeed, 2003), a well-functioning legal and institutional framework represents a key precondition for investments in emerging market economies. Top of the list is the guarantee of private property rights, whose absence is perceived as a “critical deal breaker.” Other factors of major importance include the independence of regulatory institutions from arbitrary interference, judicial independence, and regulations that clearly define and allow the exit for foreign investors (chart 3).

That there are standards that can apply across a broad range of legal, political and economic environments is at the core of the Principles of Corporate Governance developed by the OECD (2004a). First published in 1999, the original Principles focused on the rights of shareholders; their equitable treatment; the role of stakeholders in corporate governance; disclosure and transparency; and the responsibilities of the board. In April 2004, these Principles were revised. Specifically, the new principles encourage institutional investors to disclose their corporate governance policies; emphasize the need for strengthening the rights of investors, including their ability to remove board members; call for rating agencies and analysts to avoid conflicts of interest; make reference to the rights of stakeholders and advocates protection for whistleblowers; and clarify board responsibilities.
The OECD Principles provide thoughtful guidance to nations seeking to improve corporate governance and serve as the basis for numerous detailed corporate governance standards throughout the world. Emphasizing the importance of a regulatory framework in corporate governance that promotes efficient markets, the Principles recognize that capital is the essential factor in any growing economy: Nations compete for investment capital, and the assurances investors seek as they decide whether to provide that capital are universal. Investors ultimately choose to place their capital where they can understand the risks and believe their investment is most likely to be protected from fraud or other misuse.

Recent benchmarking attempts have encompassed a wide range of components, which are believed to determine the quality of corporate governance at the macro level. While some attempts focus on broader public governance issues, such as the World Bank’s
composite governance index (Kaufmann et al., 2003) and its assessment of the investment climate in individual countries more generally (World Bank, 2004b), Transparency International’s (2003) Corruption Perceptions Index and Kurtzman et al.’s Opacity Index (2004), other have focused more narrowly on specific corporate governance criteria, which can be divided into four categories: Market infrastructure, legal infrastructure, regulatory infrastructure, and informational infrastructure. Some of the criteria are objective in the sense that they reflect specific regulations and the “law on the books.” How regulations and laws are applied and enforced in practice is a different matter, however (Pistor and Berkowitz, 2003). Therefore, most attempts to measure the quality of public and corporate governance also include survey data.

In this regard, the World Economic Forum’s executive opinion survey for its Global Competitiveness Report (GCR) contains especially useful information as it covers a particularly large sample of countries and reflects the views of more than 7,500 senior executives. Working with a substantial number of local partner institutes, the World Economic Forum (2004) endeavours to ensure that the survey is representative with regard to the size of the firms of a country, the ownership structure and market orientation. Around two-thirds of the respondents are domestic investors, while the rest represent foreign companies. In the case of Russia, the sample size was 264.

Blending survey data with “hard” data (i.e., publicly available statistical data, such as GDP, inflation, budgetary balances etc), the Forum ranks more than 100 countries according to their competitiveness – defined as an economy’s ability to achieve sustained economic growth over the medium term. One of the sub-indexes that are used to calculate the overall rankings reflects the quality of the legal environment. Based solely on survey evidence, the Contracts and Law Index mirrors responses to four questions focusing on the independence of the judiciary, the protection of property rights, favoritism, and the prevalence of organized crime. In addition, the World Economic Forum introduced in last year’s survey several new questions on corporate governance, some dealing with institutional and legal issues (Box 2).
### Box 2. Global Competitiveness Report Questionnaire on Issues Pertaining to Corporate Governance at the Country Level

#### A. Contracts and Law Index

The judiciary in your country is independent from political influences of members of government, citizens, or firms (1 = no, heavily influenced, 7 = yes, entirely independent).

Financial assets and wealth (1 = are poorly delineated and not protected by law, 7 = are clearly delineated and well protected by law).

When deciding upon policies and contracts, government officials (1=usually favor well-connected firms and individuals, 7 = are neutral among firms and individuals)

Organized crime (e.g. mafia-oriented racketeering, extortion) in your country (1= imposes significant costs on businesses, 7=does not impose significant costs on business).

#### B. Survey Questions on Corporate Governance Framework

Law protection of minority shareholders’ interests in your country is
(1 = nonexistent and seldom recognized by majority shareholders, 7 = total and actively enforced).

Financial auditing and accounting standards in your country are
(1 = extremely weak, 7 = extremely strong, among the best in the world)

Access to reliable and timely information regarding company financial performance is
(1 = often insufficient, delayed, and difficult to obtain, 7 = regular and easy).

The regulation of securities exchanges in your country is (1 = nontransparent, ineffective, and subject to excessive industry and government influences,
7 = transparent, effective, and independent of excessive industry and government influences).

In your country, mergers and acquisitions—particularly hostile takeovers—are
(1 = rare and face serious legal impediments, 7 = common and allowed by law).

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On the Contracts and Law sub-index, Russia is ranked 91st out of 102 economies included in the Global Competitiveness Report. This poor overall ranking reflects perceived weaknesses across all dimensions of the sub-index. In the view of the survey respondents, the judiciary remains subject to important political influences (rank 81), property rights are perceived to be generally weak (rank 96), favoritism in decisions of government officials is perceived to be widespread (rank 81), and organized crime is prevalent (rank 87).

Similarly, the Global Competitiveness Report identifies key challenges in the domain of Russia’s corporate governance system. For instance, minority shareholders are perceived to be hardly protected by the law, with an overall ranking of 101 out of 102 economies
and a score of 1.4 on a 1-7 scale. With regard to financial auditing and accounting standards, Russia is ranked 89th, while the regulation of the security exchanges is perceived to be inappropriate (rank 93).

These findings are broadly consistent with other studies. For example, the World Bank’s *Doing Business in 2005* Report (World Bank, 2004b) calculates a disclosure index, which captures seven ways of enhancing disclosure: whether laws and regulations require reporting (i) family; (ii) indirect and (iii) beneficial ownership; (iv) disclosing information on voting agreements between shareholders; (v) audit committees to the board of directors; (vi) use of external auditors; and (vii) ownership and financial information is publicly available to all current and potential investors. Based on surveys among corporate and securities lawyers, the index varies between 0 and 7, with higher values indicating more disclosure. For Russia, an index value of 3 is calculated, which signals the need for important reforms to improve the protection of investors.

That serious weaknesses in Russia’s corporate governance structure exist is well recognized, and, encouragingly, the government has begun to address these challenges by implementing important reforms. In October 1991 President Putin stated that “(w)e understand that we have to solve questions pertaining to the protection of owners’ rights and the improvement of corporate governance and financial transparency in business in order to be integrated into world capital markets” (OECD, 2002, p.3). Several Corporate Governance Roundtables organized by the OECD since June 1999 culminated in a White Paper on Corporate Governance in Russia (OECD, 2002), which includes numerous recommendations for corporate governance reform based on the OECD Principles. The new Code of Corporate Behaviour was promulgated by the Federal Securities Commission in 2002 as a voluntary code rather than being legislated, although compliance with it is now required for companies listed on one of Russia’s major stock exchanges (for the evolution of the new Code, see Kostikov, 2003). Although largely based on the OECD Principles, the Russian code is unusually long and specific, reflecting the perceived need explicitly to rule out certain abusive practices that were prevalent in the 1990s. For instance, it was not uncommon for Russian companies to hold Annual General Meetings at 2am (OECD 2004a, p. 65) – a practice in response to which the new Code specifically requires meetings to be held not before 9am and after 10pm.
CAN GOOD CORPORATE GOVERNANCE AT THE COMPANY LEVEL COMPENSATE FOR WEAK GOVERNANCE AT THE COUNTRY LEVEL?

Whereas the preceding analysis has focused on the legal and institutional framework of corporate governance, investors are equally, if not more, interested in the quality of corporate governance of the company they plan to invest in. Firm-level corporate governance provisions matter especially in countries with weak legal environments, potentially compensating for ineffective laws and enforcement by providing credible investor protection (Klapper and Love, 2004). According to a recent survey by McKinsey among 200 institutional investors, well over 70 percent of the respondents in each region were willing to pay more for a well-governed company, all other things being equal (McKinsey, 2002). The McKinsey survey suggests that the quality of corporate governance at the firm level is most valuable to investors where the disclosure and legal framework protecting shareholders is perceived as weakest. In fact, the premium for Russian companies was particularly high, amounting to 38 percent.

In principle, it is conceivable that companies operating in weak country environments transcend local practice. Companies whose corporate governance standards are perceived to be high are generally seen as less risky than companies with low standards, irrespective of the country of domicile. However, whereas good corporate governance at the company level may compensate for weak framework conditions, the opposite is not true. While the country environment can influence the articulation and practical protection of ownership rights and the norms of transparency and disclosure, positive framework conditions are no guarantee that all companies in a given framework will demonstrate strong corporate governance standards. Thus, investors and rating agencies, such as Standard&Poors do not regard the quality of the macro framework of corporate governance as a floor (Standard&Poors, 2002).

Note that the underlying approach of risk assessments with regard to corporate governance deviates from credit risk assessments. In credit analysis, the concept of a sovereign ceiling implies that the credit rating of an individual company can be constrained by the credit rating of its country of domicile. As Dallas (2004) argues, however, applying the same principle in corporate governance analysis would be self-defeating: “Part of the logic of a governance rating system is to provide a positive
incentive structure for individual firm improvement. To imply that an individual firm in a weak country environment cannot have anything but weak corporate governance itself is not only wrong, but it could also have perverse implications. Namely, an artificial ceiling might de-motivate a firm from making positive improvements in its own governance standards if such improvements were not reflected in its standalone governance rating assessment” (Dallas, 2004, 149-150).

Many investors would welcome an index that rates companies according to their corporate governance practices. While the main benefit of such an index would be to provide a benchmark that can serve as a thumbnail sketch of a company, its construction is fraught with a number of practical difficulties. A key problem is that corporate governance is difficult to measure, especially at the firm level. There are many variable factors and many subjective areas, which are difficult to be incorporated into one single figure. And how does one create an international index when corporate governance standards, codes and rules vary from country to country?

In order to allow cross-country comparisons, a new corporate governance index developed by the Financial Times and Institutional Shareholder Services (ISS) limits the number of corporate governance factors to just five areas: board composition and independence; executive and director compensation; company ownership; audit independence; and takeover defences and shareholder rights. Based on the assessment of individual companies based on these criteria, the index then ranks countries according to the average governance ratings. Unfortunately, for the time being, the index will not be available for emerging market economies.

Luckily, the World Economic Forum’s executive survey also includes questions that focus on corporate governance practices at the company level, in addition to those that concentrate on the quality of corporate governance at the country level. Three questions are particularly relevant, dealing with corporate ethics, appointments of directors and insider control (Box 3).
Box 3. GCR Survey questions on firm-level governance

The corporate ethics (ethical behavior in interactions with public officials, politicians, and other enterprises) of your country’s firms in your industry are (1 = among the world’s worst, 7 = among the world’s best).

Senior management positions in your country are (1 = usually held by relatives, 7 = held by professional managers chosen based on superior qualification).

Corporate boards in your country are (1 = controlled by management, 7 = powerful and represent outside shareholders).

The survey evidence reveals considerable weaknesses at the company level, too. As regards the efficacy of boards, Russian companies on average are given a 4.2 on a 1-7 scale, indicating that their boards are often dominated by management, with relatively little control by shareholders. This score puts Russian companies on the 69th rank of the 102 economies included in the survey. Worse, senior management is perceived to be frequently chosen based on personal relationships rather than professional qualifications (rank 77), and respondents see substantial room for improving companies’ ethical behaviour in interactions with public officials and other firms (rank 87).

With an unweighted average of 78, Russia’s corporate governance standards at the firm level are on average perceived to be somewhat better than the country’s framework conditions. However, this premium is relatively small, and while some companies may be “overachievers” (Dallas, 2004) in the sense that they pursue better practices relative to the legal and institutional framework they operate in, many others have yet to transcend national standards.

The quality of corporate governance may have an important effect on the mode of foreign investment. Firms are in themselves substitutes for the market and will extent their borders whenever they encounter missing or inefficient markets (Williamson, 1985). Foreign companies dealing with such markets will want to have hierarchical control in those environments where transaction costs are high due to inadequate contract enforcement, poor protection of property rights or inappropriate board procedures. Markets may be attractive for other reasons, for example, because of a rapidly expanding consumer base or natural resource endowments. But whereas a poor macroeconomic
governance infrastructure may deter foreign investment altogether, weak corporate governance standards may discourage portfolio investors to a relatively larger extent. By comparison, foreign investors who acquire a controlling stake in a foreign company or undertake greenfield investment tend to be less affected. A high share of foreign direct investment (FDI) may thus signal poor, rather than good, corporate governance (Hausmann and Fernández-Arias, 2000).

While for the majority of emerging market countries empirical support for the Hausmann/Fernández-Arias-hypothesis can be found (Cornelius, 2004), for Russia this is not true. Rather, portfolio investment (i.e., acquisitions of up to 10 percent of the share capital) represents a comparatively high share in total capital inflows to Russia, despite relatively poor corporate governance standards both at the company and country levels. However, the importance of portfolio investment relative to FDI (acquisitions of more than 10 percent or greenfield investments) is not explained by high portfolio inflows in absolute terms. Rather, FDI in Russia has remained very small, with the total inward stock at end-2002 estimated at $22.5 billion (UNCTAD, 2004, Annex table B3). In terms of GDP, Russia’s inward stock at the end of 2002 amounted to 6.5 percent, substantially lower than in many hydrocarbon rich countries as well as other key emerging market economies (chart 4). The low inward stock of FDI reflects relatively small inflows in the past. Although they picked up after the 1998 crisis, at just around 6 percent of gross capital formation in 2000-2003, FDI inflows in Russia still contribute significantly less to building up the country’s capital stock than in many other emerging market economies.

3 Estimates of the inward stock of FDI should be considered with caution. Some FDI investments, such as the deal between BP and TNK in 2003 was recorded offshore and did not show up in the balance of payments data (IMF 2004d, p. 8).
While FDI in the energy sector has usually taken the form of Production Sharing Agreements (PSAs), these do not really provide an enclave of stability. Typical PSAs lock in tax regimes, clarify resource ownership, and guarantee payments in fungible exportable assets such as oil. As Victor and Victor (2003) argue, however, in practice PSAs have not eliminated the uncertainties that deter investors. Potentially, PSAs seem particularly important for new projects in the Artic and the far eastern parts of the country, such as those off Sakhalin Island, where the fields are “green” and technological advantages are useful. Frequently, however, government-to-government contacts have played a role in the investment process, especially in cases where investors have found the existing PSA regime incapable of solving uncertainties about regulatory and tax treatment (Victor and Victor, 2003, p. 56).

Improving the current PSA regime is important. However, what is required to increase investment and achieve faster economic growth in the medium and long term is a wholesale transformation of the country’s corporate governance regime. Rather than aiming at establishing islands of stability, it is critical to put in place an improved framework for the entire country that is conducive to investment and private risk-taking. Many important reforms are already underway to unleash Russia’s growth potential. Provided that these reforms are further deepened and broadened, Russia should be able
to meet its extraordinary investment requirements in the energy and diversify its economy.

**CONCLUSIONS**

The starting point for this paper was the spectacular turnaround of Russia’s economy after the financial and economic crisis in 1998. Although impressive, the economy’s rapid output growth has benefited substantially from exogenous factors, especially high oil prices, and the country’s high dependence on the hydrocarbon sector casts doubts about the sustainability of the recovery. In reducing the economy’s high concentration on hydrocarbons, the government faces an important dilemma: While a more diversified economy is highly desirable to reduce its susceptibility to exogenous shocks, Russia’s comparative advantages lie in natural resources and energy-intensive manufactures. Solving this dilemma requires substantial investments in both the energy and non-energy sectors. Although investment has picked up, Russia’s national investment ratio with regard to GDP remains low by international standards.

As the paper discussed in greater detail, investment requirements in Russia’s oil sector alone are massive and bring about important challenges in terms of their ability to secure sufficient financing. Russia’s challenges appear even more dramatic if one takes into account other parts of the energy sector, especially electricity and gas. Foreign investment, which has remained very low, could alleviate these challenges, but this would require removing important impediments to greater capital inflows. First and foremost, as the paper argued, there is an important need to continue to improve Russia’s legal and institutional framework as well as corporate governance practices at the company level. On both dimensions, significant deficiencies were found on the basis on new survey evidence from the Global Competitiveness Report.

These deficiencies need to be addressed if access to foreign savings in the form of direct investment is to be increased. Foreign investment can help alleviate the financial requirements for more investment. But for foreign capital to play an important role in the development process, it is not enough just to create islands of stability through PSAs or other arrangements. Rather, a wholesale transformation is needed in order to provide framework conditions that are conducive to entrepreneurship and risk-taking.
This transformation should be accompanied by the further liberalisation of Russia’s FDI regime. Gazprom’s recent merger with Rosneft, which is 100 percent owned by the government, will play a particularly critical role in this regard. At present, foreign investors are not allowed to buy Gazprom’s domestic shares, and are only allowed to hold the company’s more expensive American Depository Receipts (ADRs). With the government holding 51 percent of Gazprom-Rosneft, the merger could pave the way for the long-awaited liberalisation of the remaining 49 percent, without the government loosing its controlling stake in the country’s most powerful energy company. As Gazprom itself emphasised (Financial Times, September 21, 2004), getting rid of the ring-fence would entice Gazprom-Rosneft towards a full listing on both Russian and international stock exchanges, making the company more accountable to shareholders.

Combined with other structural measures, the way the Gazprom-Rosneft merger is handled will be an important signal for investors concerning the government’s seriousness about economic reforms. Gaining investors’ confidence represents a prerequisite for raising and modernizing the economy’s outdated capital stock and maintaining the current growth momentum. The government’s objective to double GDP within ten years is no doubt ambitious. With the right policies it can be attained.
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