

ТН-И

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

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Г-ну Е.Т. Гайдару
Директору Института
экономических проблем
в переходный период
Москва, Газетный пер., 5

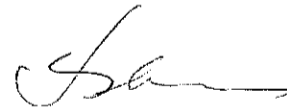
Уважаемый Егор Тимурович!

Направляем Вам Памятную записку, подготовленную миссией Всемирного Банка на основе встреч с представителями Правительства Российской Федерации в период с 29 сентября по 10 октября 1997 года. Целью работы миссии было: (а) рассмотрение ряда вопросов, относящихся к программе реформ Министерства топлива и энергетики; и (б) изучение вопроса о возможном проекте в области нефтепроводного транспорта.

В краткой форме основные положения Памятной записки можно изложить в следующем виде:

- Всемирный Банк согласен с мнением министерств о том, что целый ряд высокоприоритетных направлений работы должен финансироваться из средств компонентов технического содействия в рамках двух существующих энергетических займов (согласно оценкам, объём имеющихся средств составляет от 3 до 5 миллионов долларов США). Всемирный Банк надеется, что Министерство топлива и энергетики представит конкретные предложения по этому вопросу.
- Всемирный Банк также согласен с тем, что создание Центра стратегического развития и реформирования топливно-энергетического сектора стало бы благоприятным фактором для осуществления предлагаемых реформ. Работа Центра потребует дополнительного финансирования, и Всемирный Банк будет рад рассмотреть официальный запрос Правительства Российской Федерации о предоставлении такового.
- Всемирный Банк представил российской стороне копии недавно законченного "Исследования вопросов российского нефтепроводного транспорта и экспорта нефти" и с нетерпением ожидает продолжения диалога с Правительством Российской Федерации по возможному проекту в области нефтепроводного транспорта.

С наилучшими пожеланиями,



Вадим Воронин
Заместитель Руководителя
Московского представительства
Всемирного Банка

Russian Federation

Energy Sector Reform Technical Assistance Project and Oil Transportation

Aide Memoire

1. A World Bank mission comprised of Messrs./Mme. Thomson, Craig, McPherson, Porter, Pease, Stuggins, Manuel and Voronin visited representatives of the Russian Government during the period from September 29 to October 10. As stated in the mission's terms of reference, dated September 24, 1997, the purpose of the mission was two-fold. First, to respond to the request of the Ministry of Fuel and Energy (MoFE) that the Bank review a number of issues related to the Ministry's reform agenda and, second, to address the issue of a possible oil transportation project. The mission would like to express its appreciation for the assistance provided by the Ministry and by the Federal Energy Commission (FEC) and, in particular, would like to thank Mrs. Telegina and Mr. I. Lozhevsky for their help in facilitating the mission's efforts. A listing of the people and organizations the mission met is given in Attachment 1.

2. **Mission's Conclusions.** The mission noted that there was a broad consensus on the immediate need to take key steps to improve the investment climate in the energy sector and that, within this context, assistance is required in preparing and implementing tax legislation, legislation related to production sharing agreements and a legal and regulatory framework for oil transportation. Financing for these and certain other key initiatives is available from existing Bank loans, and the Government agreed to forward its request to the Bank to support these initiatives. The Government expressed its concern about the lack of qualified staff, within the Ministry and the Federal Energy Commission, who would advance, develop, coordinate and implement policy recommendations related to the Government's reform agenda in the energy sector. Currently, government procedures make it difficult to attract and retain staff with the required skills to provide the necessary degree of sustained analytical capacity to support its reform agenda. To address this concern, the Government has requested support for the creation of a separate body to develop, coordinate and implement policy reform recommendations. The mission agreed that the Bank would react favorably to a formal request from the Government to provide funding for the creation of the Strategic Energy Development and Reform Center.

3. The Bank's Russian Oil Transport and Export Study was distributed by the mission and discussed with Government, Transneft and industry representatives. The principal conclusions of the study were broadly endorsed, including the emphasis on private sector participation in any export expansion project and the need to put in place a legal and contractual framework to attract private sector finance. It was agreed that the Government and the Bank would give further careful consideration to the possibility of Bank Group support to export expansion projects. Options for detailed examination include: (a) the first phase of the proposed Baltic pipeline system; (b) expansion of

pipeline capacity between Atyrau and Samara, linking to and extending Druzhba export capacity into Central Europe; and (c) selected crude oil pipeline quality bank and segregation projects.

4. **The Investment Climate.** Responding to the Government's request for assistance in advancing its reform agenda, the mission met with Government officials, as well as, representatives from local and foreign companies active in the energy sector. The following summarizes the issues and concerns raised by these parties.

5. During the course of the discussions, it was noted that a key objective of the MoFE is to create a climate that supports increased investment in the energy sector and, in particular, in the upstream oil sector. It was further noted that the Government is particularly anxious to reverse the decline in oil production levels. Concern about the current investment climate in the oil sector was expressed by representatives of both the Russian producers and by the international oil companies operating in Russia. The companies indicated that some clear demonstration of the Government's intent to improve the investment climate in the sector would be extremely helpful in improving perceptions related to the outlook for the sector.

6. Representatives of both the Russian producers and the international oil companies cited a number of areas where evidence of a clear Government commitment to reform would be most helpful:

- Cleaning up the tax code through the passage of legislation that provides a level playing field for all participants and a focus on profits based taxes rather than revenue based taxes.
- Passing enabling legislation to support the Production Sharing Agreement legislation and ensuring that other legislation that supports investment in the oil sector is passed (e.g. the List Law.) This is of interest to both the Russian producers who are potential partners in PSA arrangements and to the international oil companies.
- Establishing a solid, legally based, framework for oil transportation. This would include passage of a pipeline law, introduction of a transparent tariff calculation methodology, development of clear, non-discriminatory guidelines for pipeline access and for the construction of new pipeline facilities, and progress on the establishment of a quality bank.
- Ensuring Government compliance with established contractual arrangements with both Russian and international producers.

7. One other item of concern that was cited is the fact that the drafts of both a law on investment activities and amendments to the Foreign Investment Law (which have passed their first readings) are perceived as potential impediments to investment in the oil sector

as well as many other sectors. Any efforts undertaken within the Government to address the concerns associated with these proposed laws would be well received by both domestic and international investors.

8. **The Reform Agenda.** In its request to the Bank, the Ministry attached a concept paper outlining a number of activities whose contribution to the reform agenda would benefit from access to additional funding. The mission, in its discussions with the Government has reviewed these activities in an effort to establish priorities. The mission has also reviewed the availability of funds that could be allocated to these activities.

9. Two existing loans include a technical assistance component with some funds that could be allocated to support certain of these priority requirements. Oil Rehabilitation 1 has approximately US\$3 million available for allocation. Energy Efficiency includes a TA component that has already been assigned. Certain of the identified studies, however, have not yet been initiated. Consequently, should the Ministry wish to revise the allocation of tasks associated with this loan, up to \$2 million in additional funds could be made available. In addition, approximately \$10 million remains undisbursed from the Project Finance Center component of the Portfolio Development Loan that is handled by the Ministry of Economy.

10. Between \$3 and \$5 million is potentially available as “quick-release” funding that the MoFE could allocate to support its reform agenda. It appears that the following activities warrant high-priority attention:

- Consulting services to support the implementation of new tax legislation.
- Training to ensure the effective application of the new tax code once the new tax legislation is passed.
- Consulting services to complete the drafting and to support the introduction of legislation related to production sharing agreements (PSAs).
- Consulting services to analyze the existing PSAs and develop recommendations as to how best to address concerns that have arisen with regard to these agreements.
- Training of lawyers and economists to assist the MoFE with the administration of current and future PSA agreements.
- Funding to enable the FEC to establish a set of rule setting documents for oil transportation.
- Additional computers and other office equipment for the MoFE.

11. The available “quick release” funds should be adequate to support these activities for the next 12 to 18 months and, thereby, make significant advances in achieving the Ministry’s reform agenda. In order to progress this effort, however, it will be necessary for the Ministry (and the FEC, as appropriate) to develop terms of reference (TORs) for each activity. The Bank would be happy to provide guidance to the Ministry and the FEC in the preparation of such TORs.

12. It is possible that the Ministry may be able to obtain some grant funding to support some of these activities (e.g. training) and the Bank would be happy to work with the Ministry in exploring such options. In addition, it is the mission's view that the Russian and international producers would likely be willing to assist with some of the training requirements associated with developing an enhanced understanding of the economic drivers associated with the oil industry.

13. In its request to the Bank, the Ministry also proposed the establishment of a "Strategic Energy Development and Reform Center". The primary function of this Center would be to provide the analytical and coordination capability to enable the MoFE and the FEC to develop and implement policies to support the country's reform agenda in the energy sector. It would also recommend changes to eliminate barriers to creating a business environment that would attract private sector investment while protecting the public interest. The proposed Center would have some similarity to other units established to assist the Government in progressing its reform agenda, for example, the Bureau of Economic Analysis, which is financed under a Bank loan, and the UES support group, established with assistance from the IFC and the UK Know How Fund.

14. The mission acknowledges the need of the MoFE and the FEC for additional analytical and coordination support and recognizes that, in order to attract the people capable of providing such support, an independent entity such as the proposed Center will have to be established. The mission has prepared a brief concept paper addressing the structure, organization and objectives of the proposed Center (Attachment 2). The "quick release" funds, however, would not be sufficient to support the establishment of the Center. Consequently, if the Bank is to finance this effort, the Government will need to submit a request for new funding. This funding could take the form of a new loan. Alternatively, it may be possible to provide financing through a supplemental loan to the TA component of the Oil Rehabilitation I Project.

15. In order to progress the establishment of the Center, additional work will be required to develop detailed terms of reference for the Center, to identify an inventory of tasks and studies that it will handle and to define the funding requirements. In order to initiate this effort, therefore, it is recommended that the Ministry make an application for initial funding from the Project Finance Center which receives funding from the Portfolio Development Loan. This funding would be sufficient to cover the cost of preparing the project, including drafting a charter for the Center, identifying staffing and funding needs, and developing implementation and procurement plans for the proposed project.

16. Certain other loans have technical assistance components to support the energy sector (e.g. coal and power). Both within the MoFE/FEC and within the Bank, care must be taken to ensure that technical assistance activities funded through these loans are coordinated with the activities funded under the Oil Rehabilitation I and the Energy Efficiency loans and the new loan that may be established to support the Center.

17. **Oil Transport Options.** Key findings of the Bank's Russian Oil and Transport

Study include: (a) a highly uncertain need for significant investment in new Russian oil export capacity; (b) extremely competitive markets for regional exports from or through Russia; and (c) the existence of a wide variety of options for expansion of export capacity, ranging from policy initiatives to major capital expenditures. The Study recommends expansion strategies which: (a) first explore low cost opportunities; (b) are phased or incremental; and (c) to the maximum extent possible, shift risks to the private sector. An array of legal, contractual and regulatory initiatives, many of which have been launched by the MoFE and the FEC, will be required to attract private sector finance and shippers to new projects. Projects identified for further detailed review and possible Bank Group support include the Baltic Pipeline System (BPS), expansion of Atyrau-Samara capacity and Druzhba extensions into Europe and selected quality bank/crude oil segregation projects.

18. Phase 1 of the BPS would add approximate 15 million tons of annual export capacity, delivering crude from Tyumen Pechura and West Siberia to Porvoo in Finland. The benefits of the project would be significant, including, in addition to incremental export capacity, promotion of field development in a new oil province of Russia, the environmental benefits of a more secure pipeline system in Tyumen Pechura, and the favorable competitive impact of a new export option. The need for financing for this project, however, is at least 9 to 12 months distant and is dependent on the completion of a detailed feasibility study, partially financed by the Bank, and completion of commercial and legal arrangements among current and potential future project sponsors. In the Bank's view, the addition to the BPS of an export terminal at Primorsk in Russia is not, at present, commercially viable and, if selected by Russia as being of strategic importance, would have to be funded directly by Government, an action that should be carefully assessed, given the risks involved.

19. The second possible project would expand capacity from Atyrau to Samara, rehabilitate, as necessary, the Druzhba system from Samara and consider its possible further extension into Central European markets. Russian and Kazak transit exports could be increased by approximately 15 million tons annually by the project. Unit costs of transport through the under-utilized core Transneft system would be reduced, encouraging the development of new production. In addition, pressure on strained Black Sea export routes would be relieved. As with the BPS, development of a new or enhanced export option would bring competitive benefits. One of the most challenging aspects of the Atyrau-Samara-Druzhba extension project will be the negotiation of inter country transit arrangements and tariffs and of the conditions to ensure stability of these arrangements. This is an area where the Bank may be comparatively advantaged in being able to offer assistance.

20. Both of the above projects would afford possibilities to put in place a pipeline quality bank and/or crude oil segregation mechanisms which can be expected to enhance the value of the crude oil export streams from and through Russia. Such mechanisms would also provide incentives for more efficient production and market allocation of crude oil in the region. In particular, they offer the opportunity to improve the efficiency

of the refining sector.

21. The oil transportation projects provide ample opportunity for the participation of, or financing from the private sector. The Bank's role would be limited to providing only such support as might be required to obtain such private sector participation. The Bank's private sector affiliate, the International Finance Corporation, could play a key role in this regard.

22. **Next Steps (Energy Sector Reform Technical Assistance Project)**

By the Government:

- Confirm that the MoFE wishes to allocate funding from existing loans to a set of high-priority projects and provide the specific priority listing. The confirmation should include identification of the proposed source of funding (e.g., Oil Rehabilitation 1 Loan, Gas Efficiency Loan).
- Forward draft terms of reference for these projects to the Bank, including proposed implementation and procurement arrangements.
- Confirm its request for the preparation of a project to establish the Strategic Energy Development and Reform Center and finance high-priority studies to support the ongoing reform agenda.

By the Bank:

- Upon receipt of the Government's request, review and respond to the proposed initiatives.
- Agree on the proposed components for Bank financing and on the funding needs.
- Work with Russian counterparts on the implementation and procurement arrangements for the initiatives.
- Seek grant financing from suitable donors.

22. **Next Steps (Oil Transportation)**

By the Government:

- Confirm the request for an oil transport project and advise on priorities for possible Bank Group support among several oil export expansion options.
- Identify and confirm a counterpart team for further development of a possible project.

By the Bank:

- On receipt of the Government's request, work with Russian counterparts to identify, in detail, a project for Bank Group support including definition of the Bank Group's role.

October 10, 1997

The Strategic Energy Development and Reform Center

A Draft Concept

The primary function of the Strategic Energy Development and Reform Center (SEDRC) is to provide the analytical and coordination capability to enable the Ministry of Fuel and Energy (MoFE) and the Federal Energy Commission (FEC) to develop and implement policies to support the country's reform agenda in the energy sector. It will also recommend changes directed at eliminating barriers to creating an environment conducive to private investment while protecting the public interest. The proposed structure, organization and objectives of the SEDRC are as follows:

Structure

The SEDRC should be established as a separate legal entity governed by a Supervisory Board of Directors and a Steering Committee and financed by the Russian Government. Since most of the SEDRC's activity will support the MoFE, the Center should report through the Ministry. The Center will also be active in supporting the FEC. Consequently, it should have a close relationship with the FEC. The Center should also maintain close contacts with the Ministries of Finance and Economy.

Organization

The governance structure of the SEDRC would be comprised of (a) the Supervisory Board of Directors, chaired by First Deputy Prime Minister Nemtsov; (b) the Steering Committee chaired by First Deputy Minister Kirienko; and (c) the Director General. The Supervisory Board of Directors and the Steering Committee would include appropriate representation from the MoFE, the FEC and the Ministries of Finance and Economy.

Rather than organize the Center along sectoral lines (i.e. oil, gas and power) it is proposed that the Center be organized along functional lines. The initial organization would, therefore, include the following functional units:

- Legislation;
- Taxation;
- Regulatory Research;
- Environment;
- Training Coordination;
- Policy Coordination;
- Financial Analysis and Coordination.

The policy and financial analysis coordination units would include a subset of responsibilities. The Policy Coordination unit would have oil and gas specialists, a power specialist and a coal specialist. These specialists would be responsible for addressing issues such as industry structure, competition and relationships with

companies active in the sector. In addition they would be responsible for handling issues identified as requiring a particular level of expertise or attention. For example, the oil and gas area would have specific responsibility to cover PSAs and tenders of petroleum assets.

The Financial Analysis and Coordination unit would have specialists covering three areas: - project/study analysis and preparation, financial markets' analysis and macroeconomic coordination. The macroeconomic coordination specialist would be responsible for coordinating review of energy policy proposals with the Bureau of Economic Analysis and/or the macroeconomic unit in the Ministry of Finance to ensure that macroeconomic implications and social issues associated with such proposals are fully identified.

While all the functions cited above need to be covered by the Center, the Center should avoid the establishment of a rigid hierarchical structure. Rather, what is contemplated is that the organization should establish a core of knowledgeable staff (regular employees, long term consultants and short-term consultants on retainer), but should contract out all major study activities and certain of the ongoing functional activities (e.g. tax and legal.) The Center will also bring in individuals from the MoFE, the FEC and other ministries on secondments or rotational assignments to participate in efforts to address specific tasks.

Much of the work of the Center would be handled through the establishment of task teams to address particular issues, with the team leader being held accountable for delivering the required product. The numbers and composition of the core staff group will likely need to change to reflect the evolving requirements of the Government. Consequently, it is important that the Center retain the ability to adjust its core staffing mix. This will likely most easily be accomplished by changing the consultant mix. It is, therefore, contemplated that the core professional staff group would initially be limited to no more than 10 professionals (regular staff plus long term consultants) with the possibility that this number could increase to 15 to 20 as the level of activity increases. This group would, however, be responsible for supervising a substantial amount of contracted study activity.

Objectives

The Government recognizes that Russia's near-term capital requirements for the energy sector are significant if it is to reverse the decline in oil production and increase the economic viability of other activities in the sector. Therefore, the primary objectives that the MoFE and the FEC intend to address in establishing the SEDRC are:

1. To create a business climate that attracts private investment to the energy sector and, in particular, in the upstream oil sector.
2. To complete the restructuring efforts that have been initiated within the energy sector. (These restructuring efforts include the implementation of enterprise reform within the sector to eliminate or turn around the performance of loss making enterprises.

The efforts should also update the relative roles and responsibilities at the federal and regional levels within the country.)

3. To regulate the activities of the natural monopolies within the sector. This involves the development and implementation of regulatory policies to address the key activities of these monopolies.

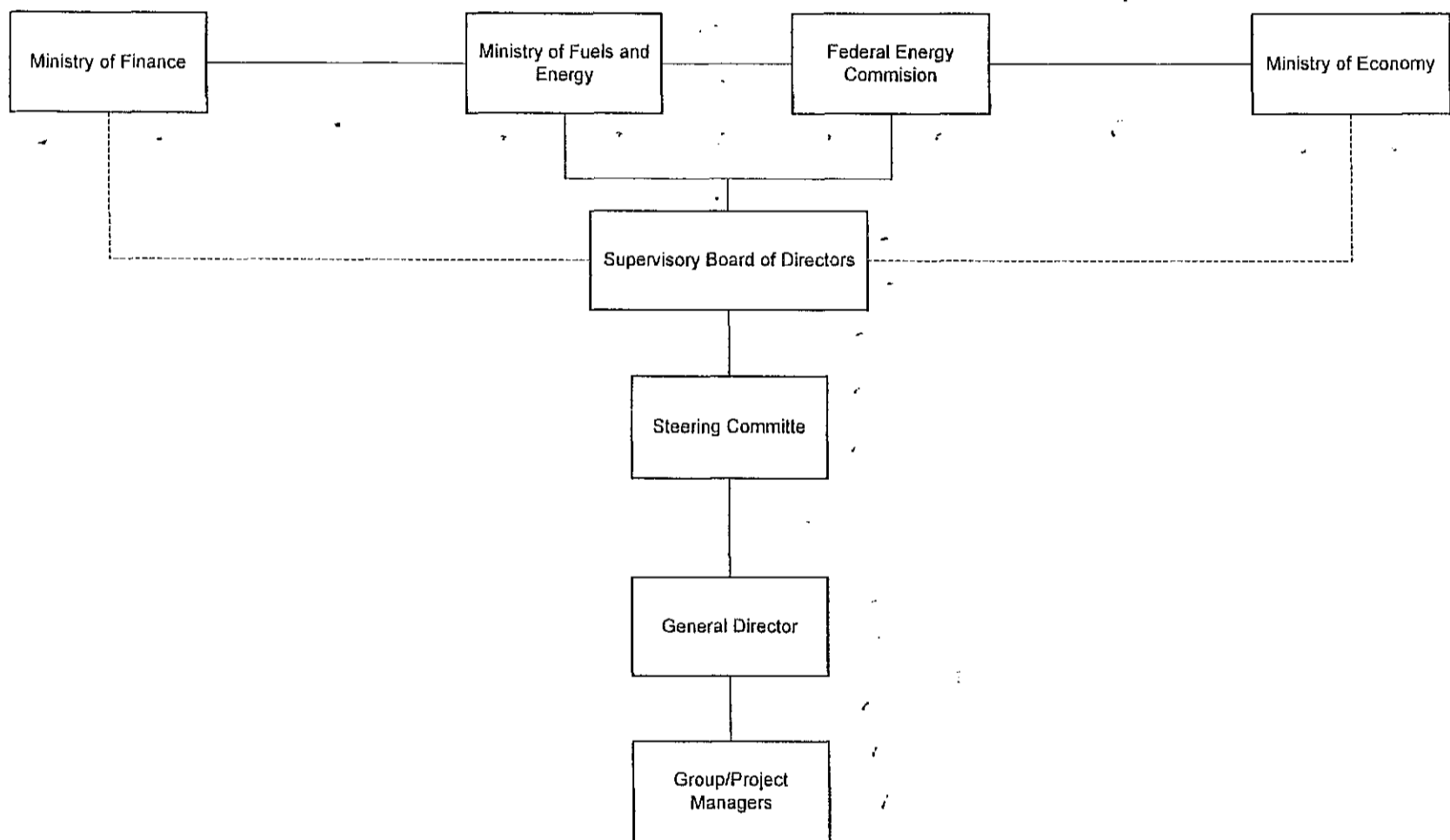
The Center will play a key role in helping to fulfill these objectives. The Government has identified a number of high priority initiatives that will support its objectives. These include:

- Efforts to support the implementation of new tax legislation;
- Efforts to complete the drafting and to support the introduction of legislation related to production sharing agreements;
- Institutional strengthening of the FEC;
- Funding to enable the FEC to establish rule setting documents;
- Restructuring within the coal sector;
- Energy efficiency initiatives;
- Establishing enhanced data base capabilities;
- Enhancing safety inspection capabilities.

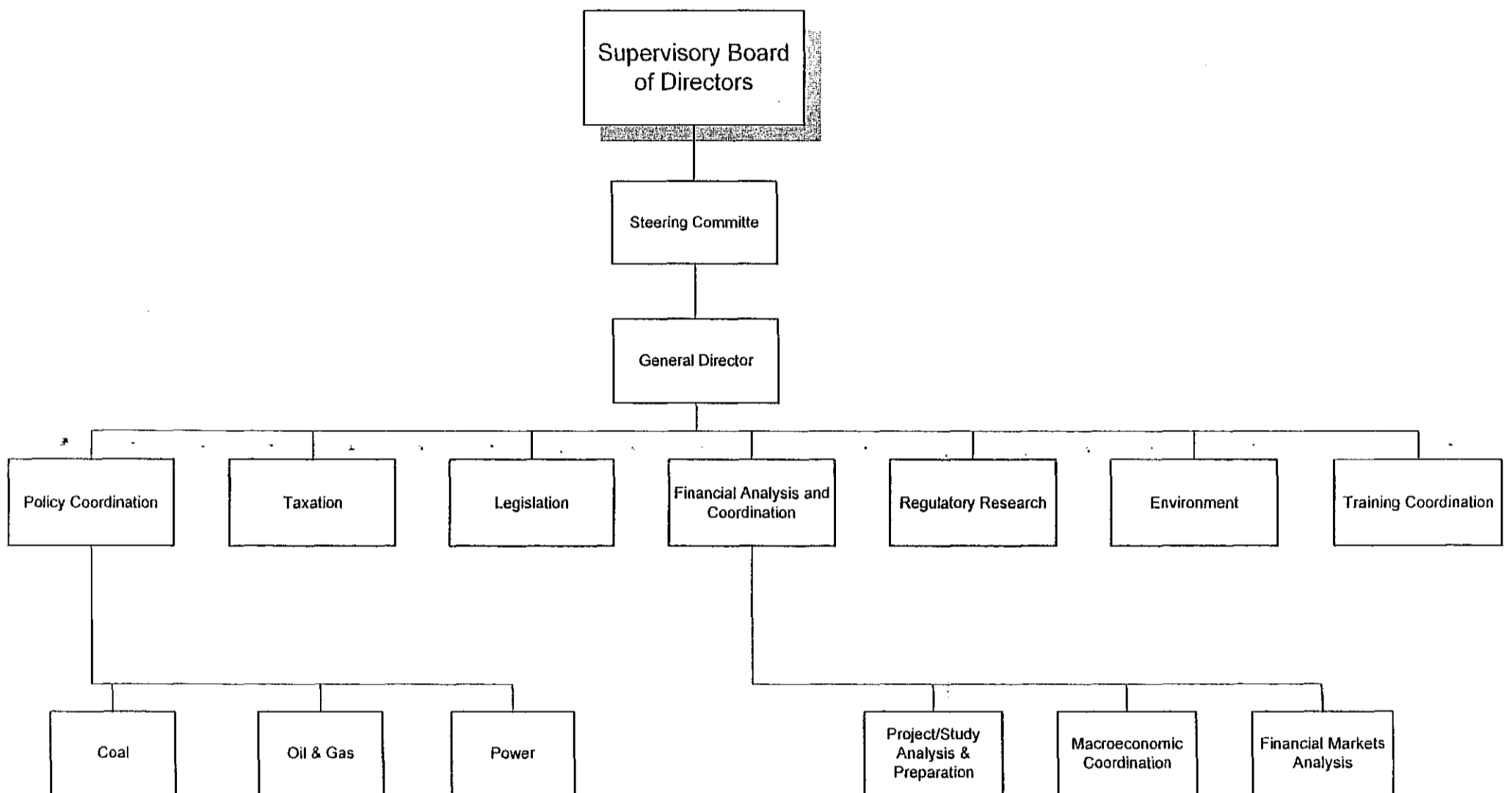
Funding for some of these activities will be provided before the Center is established. It is assumed, however, that such studies will be assigned to the Center once it is established and that the Center will take on responsibility for coordination and oversight of the remaining study requirements and such new requirements as may be identified.

The Center will also have the role of helping to ensure that both the MoFE and the FEC develop the analytical capabilities to enable them to become completely self-reliant in dealing with the energy sector. Within this context, the Center will be responsible for ensuring the routine transfer to the MoFE and the FEC of knowledge acquired in resolving the problems of the energy sector.

Strategic Energy Development & Reform Center



Strategic Energy Development & Reform Center



Individuals and Organizations the Mission Met

Ministry of Fuel and Energy:

Mr. S.V. Kiryenko First Deputy Minister
Ms. Y.A. Telegina
Mr. S. Novikov
Mr. I. Moskaev
Mr. V.M. Duma
Mr. Khemelitsky
Mr. A.V. Sannikov
Mr. V.V. Ratnikov
Mr. V. Bourov

Federal Energy Commission:

Mr. A.F. Zadernuk Chairman
Mr. N. Borisov
Mr. Ustyuzhanin
Plus various FEC Staff Members

Transneft:

Mr. S. Ter-Tsarkisants
Mr. S.A. Zemlyansky
Mr. A.A. Bezverkhov

Others:

Mr. S.E. Don Member of the State Duma
Mr. E. Grushevenko The Russian Petroleum Club
Mr. S.V. Generalov Vice-Chairman, Bank Menatep
Dr. N. A. Volynskaya Director, Independent Fuel-Energy Institute
Dr. A.A. Konoplyanik Executive Director, RBRD
Dr. M.A. Subbotin Consultant, The State Duma
Members of the Petroleum Advisory Forum
Consultants to the Gaidar Institute