

THE POLITICS OF REGULATORY REFORM IN A PETRO-STATE

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Sebastian Junger published a best-seller called *The Perfect Storm*, in which he described how two massive storms, the kind that happen once in a decade, occurred on the same day, on different sides of the Atlantic, and converged on each other, with devastating consequences for vessels trapped between.

Something similar has happened to the Russian economy over the past few years. It finds itself trapped between several dilemmas which have different origins but which are growing together in a deadly embrace.

The three main storms bearing down on the Russian ship are:

- 1) **the resource curse** – the economy (and government's) heavy dependence on energy reserves.
- 2) **the natural monopoly problem** – the need to devise an ownership structure and regulatory framework to deal with the monopolies which dominate key sectors of the Russian economy - some natural, and some artificial creations inherited from the Soviet system.
- 3) **the oligarchs**. A decade of partial reform saw the emergence of powerful oligarchs with a vested interest in preserving the current less than socially optimal status quo. The transition from socialism has proved to be highly path dependent: its course is heavily shaped by initial conditions and early choices.

Unfortunately in order to maintain the transition to a market economy the political leadership of Boris Yeltsin struck a Faustian bargain with a narrow group of old (and new) insiders, resulting in an economy whose commanding heights are in the hands of a small group of oligarchs. One can argue whether this was or was not a wise choice, but one cannot argue that this is the choice that was in fact made.¹

This paper will review these triple dilemmas in search of an answer to two questions: what help if any are Western theories of political economy in trying to understand the likely outcomes of this "perfect storm;" and what are the political circumstances under which further reform is likely to occur?

Western experience shows that there is no magic wand which will guarantee a solution to any of these problems – still less to all three of them together. The most positive aspect to emerge from the literature is the hope for efficiency gains if regulators are able to implement incentive structures that encourage investment, growth and cost-effectiveness. The challenge is to attract investors without exploiting customers. Policy-makers should shift the focus away from controversies about distribution of the existing pie (rent-seeking by incumbent managers, corruption and tax evasion, ownership battles between rival groups, etc.) and look towards efficiency savings that will grow rather than re-divide the pie. Unfortunately most political commentators focus on issues of corruption and not the politics of effective regulatory regimes: they are more concerned with morality than efficiency.

Now that the external IMF pressure for further liberalization has been lifted, what are the political circumstances under which further reform is likely to occur? The short answer to this question is that it is unlikely that one will see a breakthrough in the next few years – given the technical difficulties to be overcome (lack of a reliable regulatory institutions, uncertainties about cost conditions, etc.) and the political risks of embarking on such a strategy.

Previous efforts to tackle these problems by increasing domestic energy prices (most notably in the spring of 1997) were defeated by opposition from a broad spectrum of domestic constituencies. The immediate

¹ Shleifer and Treisman 1999, Rutland 2001.

losers from such a policy outnumber the more diffuse long-term winners. The oil and gas industry itself would benefit from higher domestic energy prices, but they seem willing to trade this off in return for other special favors from the national government and from regional governors. So the political economy of regulation reform seems trapped in the status quo. All one can reasonably expect is incremental change: the slow development of legal and administrative institutions that will create the infrastructure for a more effective regulatory regime in the future.

Russia as a petro-state

One feature which has emerged with stark clarity since 1998 is Russia's character as a petro-state. The Russian economy in general and federal government revenue in particular is highly dependent on earnings from exports of energy and energy-intensive products like metals and chemicals. The petro-sector broadly understood accounts for about 60% of exports, 40% of federal government revenues, and 15-25% of GDP.² Russia is the world's third largest oil producer and second largest exporter, accounting for 12% of global oil exports. It has 33% of the world's natural gas reserves and provides 40% of Europe's natural gas needs. Russia's prominence as an international power rests increasingly on its role as an energy provider. This was evidenced by the September 2001 invitation to attend OPEC meetings, and to coordinate in the reduction of global production.

Many Russians, for reasons of national pride, resist accepting the fact that Russia suffers from the "resource curse." Even though presidential advisor Andrei Illarionov sees the resource curse as the central feature of the Russian economy, he does not seem to have any concrete suggestion for how to escape from this fate.³ Similarly, in the West this characteristic of the Russian economy was largely overlooked by the advocates of rapid liberalization who dominated Western thinking about the Russian transition prior to 1998. The market was supposed to work its magic irrespective of the sectoral strengths of any given economy. Only recently have Western analysts turned their attention to this question.⁴

Prior to 1998, it seemed as if the only people who seriously discussed Russia's growing emergence as a petro-state were the political opposition (especially the Communists), who thought that the "Kuwaitization" of Russia was a bad thing.⁵ They wanted Russia to hang on to its role as an exporter of advanced technology industrial manufactured goods, such as weapons, ships, aircraft and nuclear power generators. But they refused to acknowledge that Russia's capacity to sell such items had been closely tied to its military superpower role and to the network of allies and client states who bought these technologies at low and subsidized prices.

The negative features of the "resource curse" are well-known. They are both economic and political. Other things being equal, dependence on resource extraction tends to slow growth, increase inequality, and inhibit democracy.⁶ It boosts the exchange rate and drives up the cost of capital, making other forms of industrial activity unprofitable (the "Dutch disease"). It makes the economy dependent on fluctuations in world markets and deteriorating terms of trade. The availability of high rents, generated in a few regions by a relatively small number of workers, encourages the concentration of wealth and power in a few hands, who can use sticks and carrots to keep the majority in check. Resource wealth generates a moral hazard: the society (and its leaders) starts to think that it is richer than it really is, and fritters away the energy rents in excessive consumption or infrastructural investment. Social inequality and political instability tends to increase.

However, it's important to avoid an over-deterministic approach. Not all societies fall prey to the resource curse to the same degree or in the same way. For example, petro-states around the world exhibit a broad variety of political forms, including liberal democracy (Norway), unstable democracy (Venezuela), military dictatorship (Algeria, Iraq), Islamic autocracy (Saudi Arabia), and Islamic revolution (Iran). Thus it is hard to predict what sort of political system will emerge in a Russian petro-state. But a common feature of all these regimes is intense competition for the large rents that accrue from energy exports, and the development of an intimate and unhealthy relationship between this sector and the state.

² Ignatova 2001.

³ Smirnov, 2001, Miraev, 2001.

⁴ Bosquet, 2002; Luong Jones and Weinthal, 2001.

⁵ For a non-communist critique, see Delyagin 2001.

⁶ Bonjean, 1999; Ross 1999, Ross 2001.

The main oil and gas producers – Gazprom, Lukoil and the other oil barons – are the major beneficiaries from Russia's resource dependency. Ten firms alone account for 40% of Russia's exports.⁷ But the energy barons have also been expected to do cross-subsidization of domestic and CIS customers, enough to buy political support in times of crisis – a role which tends to be negotiated directly with top government leaders. The main vehicle for cross-subsidization is the maintenance of artificially low prices of domestic consumers of gas and electricity (refined oil products have generally been allowed to rise to near world-market levels).

The federal government is another major beneficiary of Russia's status as a petro-state, and since the fall of 1998 it has been doing a better job of getting its share through hiking oil and gas excise taxes. Still, tax rates on energy exports still seem rather modest, accounting for about 25% of the oil export price and 16% of the natural gas price.⁸ A larger proportion of the rents (42% of oil potential receipts and 66% of gas) are distributed to energy consumers – half of them inside Russia and (surprisingly) half of them in the CIS.

The top beneficiaries from the "resource curse" are few in number and physically concentrated – in the Moscow beltway and a couple of other locations (Tyumen, Tatarstan). The losers from the "resource curse" are numerous (the majority of consumers and workers) and geographically dispersed. One of the main asymmetries in the distribution of costs and benefits is temporal short-term benefits (rich energy barons, no sharp price increases for consumers) versus long-term costs (slower growth). The main losers are future generations of Russian citizens who will live and work in an economy that is smaller and less efficient. Mancur Olson's collective action theory tells us that it will be easier for the small number of immediate beneficiaries to coordinate among themselves and realize their common interests than for more numerous latent beneficiaries to do (especially those yet to be born).

One key variable in playing out the "resource curse" is the exchange rate.

The surge in export earnings from commodity exports boosts the exchange rate. For reasons of inertia and prestige the government tries to maintain a relatively fixed nominal ruble exchange rate against the dollar. However, optimism about their ability to control domestic inflation leads to creeping real appreciation of the ruble. One can also argue that an over-valued ruble benefits certain domestic constituencies, such as import-buying urban consumers. This process of creeping over-valuation of the ruble played out in the period of the ruble corridor 1995-98, and again since then. Over the period December 1999 to October 2001 the ruble slid from 27 to 29 rubles to the dollar, although domestic inflation was running at 20% a year, meaning real appreciation of the ruble of about 12% a year. This makes imports more competitive and will tend to erode the trade surplus, meaning that a financial crisis may eventually ensue, leading to a correction in the exchange rate.⁹ This was exactly the sequence of events which led to the investor flight from the ruble in August 1998.¹⁰ (Some suggest that statistic gathering as of 2001 is no longer as reliable as it used to be, given the weakening of IMF monitoring, so the inflation situation may actually be even worse than current data suggest.)

If previous experience is any guide, only an exogenous shock – a dip in export earnings, or a panic among foreign lenders – will jolt the government from its complacency and force the devaluation needed to keep the ruble at a competitive level. It is possible that such a shock could be administered by a future external debt crisis. Although Russia in 2001 once again began meeting its debt obligations, the prospects for future years look daunting. In 2003 alone interest and repayments will amount to \$19 billion, a sizeable sum for a government whose annual budget revenue is about \$22 billion.¹¹ The key figure to watch is the oil price. If that slips below \$20 a barrel, as well it might, the federal budget and Russia's capacity to meet its debt obligations, will be in trouble. (Over the past ten years, the average oil price has been \$18.40 a barrel.¹²)

This exogenous factor – the vulnerability of the exchange rate – has proved to be one of the major factors driving change in the inertia of economic policy in Russia (and not just Russia) – and this may well happen in the future

⁷ Startseva 2001.

⁸ Bosquet, 2002.

⁹ Goskomstat, August 2001. The Economic Expert Group estimates that real appreciation EEG was 30% in 1999, 4.3% in 2000, and 4.3% in first 9 months 2001. On web at www.internetsecurities.com

¹⁰ Popov 1998.

¹¹ Lakoza 2001.

¹² *Nezavisimaya gazeta*, 15 June 2001.

The challenge of monopoly regulation

Even mature capitalist economies face difficult problems in devising policies to regulate monopolies, especially "natural monopolies."¹³ A natural monopoly is a sector where for technical reasons it is most efficient to have a single provider, and where demand is fairly price inelastic due to lack of close substitutes. Privatization will not by itself solve the problem of monopoly, since in the "natural monopolies" it will be technically impossible to break up the industry in such a way as to ensure that all economic rents are competed away and all firms in that sector enjoy only normal profits.

In Russia the 1995 law on natural monopolies regards the pipeline distribution networks of the oil and gas industries as natural monopolies, as are the railways, telecom and airports. Privatization was quite rapid and deep in most of these sectors. Oil production was split into more than a dozen entities, now mostly private corporations, while the pipelines were separated into the Transneft corporation.¹⁴ Gazprom was privatized as a vertically integrated concern controlling 95% of gas generation and the long-distance and local distribution pipeline systems. The railroads remained under state ownership, but were split into 16 regional monopolies.

The goal of regulatory policy according to economic theory should be to promote efficiency, both static allocative efficiency and long-term competitive efficiency, and to capture or reduce monopoly rents.¹⁵ Additional political goals creep in along the way – paying off powerful lobbies, placating certain consumers, or more broadly keeping down inflation.

There is quite a body of economic theory which discusses the question of regulatory regimes, calling for transparency, long-term credibility, and clear incentive structures that will encourage investment and cost-reduction. In dealing with monopolies regulators face the challenge of uncovering the true pattern of production costs not only in the present but also the future. With respect to the present, one has to deal with the inherited asset infrastructure, which may include massive inefficiencies. With respect to the future, one wants to encourage investment and innovation, and make some guesses about the trajectory of efficiency gains it is reasonable to expect.

The main policy choices facing regulators are the following:

a) *Price cap*: where the regulators allow the utility to raise prices in future years at a rate tied to the retail price index (such as RPI-1%). The advantage of this approach is that it gives an incentive for the firm to cut costs, promoting more efficient use of existing assets and encouraging new investment. The disadvantage is that if regulators underestimate the extent of efficiency gains and/or future demand, allowing super-profits to accrue to the monopoly, there will be pressure to claw back some of the gains through expropriatory windfall taxes. If on the other hand regulators overestimate the efficiency gains and future demand, the monopoly will be driven into bankruptcy.

b) *Fixed rate of return*, where the regulators allow price increases on a cost-plus basis, guaranteeing a certain return on capital. This has the advantage of being fairly simple to administer, and suits sectors (like distribution grids) where technological change is slow. The disadvantage is that it locks in existing inefficiencies and gives no incentive to cut costs. It may encourage (even over-encourage) investment in future capacity. The rate of return approach, which was prevalent in the US until the 1980s, prioritizes protection of existing utilities over potential efficiency gains.

c) *Restructuring*, to try to promote more market competition. One feature of most natural monopolies is that they bundle together potentially competitive activities along with their "natural monopoly" operations. Even if a natural gas pipeline or railtrack network is a natural monopoly which would be prohibitive to duplicate, in practice one finds that the operator of these networks also carries out other activities which are not natural monopolies – such as drilling for gas or running train services, or even totally unrelated activities such as

¹³ Beesley 1997; Slay 1996.

¹⁴ Kryukov, 2001.

¹⁵ Beasley, 1997.

building houses and running hospitals.¹⁶ So unbundling the potentially competitive operations from the natural monopoly could generate efficiency gains.

Both Britain and the US have run into problems in trying to privatize natural monopolies. In Britain there was growing social discontent with windfall profits enjoyed by privatized electricity, gas and water utilities, and a real crisis in the railway system where it proved very difficult (and dangerous) to separate railtrack maintenance from the companies running train services along those tracks.¹⁷ In the US, the California energy crisis in the summer of 2000 was a sobering experience.¹⁸ Retail price caps were optimistically set lower than the prices wholesalers found themselves forced to pay, and an unexpected surge in demand drove the wholesalers into bankruptcy. An additional problem was that California regulators could not control the prices and quantities of energy which utilities sold outside the state.

Such risks are intrinsic to the deregulation exercise, since one is dealing with essentially unknowable future variables and a fluid, dynamic environment peopled by economic actors who react in response to regulator behavior.

How much more of an obstacle does deregulation face in the Russian case. Over the past decade Russia's political economy has entrenched severe deviations from the price mechanism when it comes to the production, sale and consumption of energy. Second, institution-building of the sort needed to create and police a regulatory framework has moved forward with only glacial slowness.

The Russian case

The Russian energy system is a complex and unwieldy pyramid of economic self-interest and political bargaining. The drastic and chaotic introduction of market reforms in the first half of the 1990s left Russia with a dual economy. On one side are transactions taking place at more or less competitive prices. On the other side there are large tracts of the economy which are still conducted in state-regulated prices – much of housing, transport and the energy infrastructure. The energy sector has been used by the government to buffer the impact of market transition by providing cheap energy to households and to industrial customers.

Looking just at the oil and gas sector, Benoit (2002) estimates that the sum of rents (potential revenues in excess of costs) was \$9 billion in 1999, rising to more than \$15 billion in 2000, or about 18 percent of consolidated tax revenues. The rent on oil was about \$95 a ton, of which 25% was captured in taxes, and 42% went in effective subsidies – half to CIS customers. Natural gas yielded rent of \$45 per 1000 cu.m., only 16% of which was directly captured in taxes.

This situation has left the energy sector facing some perverse incentives. Energy companies have incentives to expand the export infrastructure (and they are doing so), but not to expand domestic production. It is easier for them to divert supplies from domestic to foreign buyers than to expand output. The persisting uncertainty over the future division of rents gives them less incentive to expand the size of the rents in the immediate term. Hence oil output fell from 591 mn tons in 1987 (12 mn bd) to 301 mn tons in 1996.

The pivotal actor in this drama of non-reform is the electricity monopoly RAO EES, headed since 1999 by Anatolii Chubais. It is ironic that in this energy-driven economy the electricity generating and transmitting monopoly has been one of the main casualties. Electricity prices charged to domestic consumers have been held down, to the level of 2 cents per kilowatt/hour (0.56 rubles, as of April 2002).¹⁹ This is half the price that Ukraine or Georgia is willing to pay, let alone consumers in richer countries.²⁰

EES claims that the selling price is below the cost of production, although it is hard to say whether this is true, given the high proportion of sunk costs in electricity production. They also argue that it has been held down below the rate of domestic inflation (true); and is below the level needed to generate investment needed to replace capacity which has reached the end of its lifespan (also true). EES has to pay close to market prices for many of its inputs (gas, fuel oil, coal, rail transport) but faces strict price controls over its sales to industrial and domestic consumers.

¹⁶ Belousova, 2002.

¹⁷ On UK electricity, see Loreda 2000, on telecom, Dnes 1999, on gas, Weir 1999.

¹⁸ Borenstein, 2002, Woo 2001.

¹⁹ Vlasova, 2002.

²⁰ Kozyrev 2001, Rudchenko 2002.

A further irony is that when the economic recovery got under way in 1999 the situation of EES actually got worse rather than better. Given that EES was selling at below production cost, increased demand for electricity as industrial output expanded mean a widening subsidy gap for EES, and more pressure on its already exhausted physical capacity. So, like in California 2000, economic growth can actually make this problem worse rather than better.

EES has been left in a critical condition by the market transition because it does not have much in the way of export earnings of its own, and bears the whole burden of the scissors between domestic and export energy prices. It is hard for EES to discriminate between worthy recipients of subsidies and profitable firms. If you discriminate by allowing the farms to run up arrears, then it is hard to stop profitable firms such as the aluminum smelters from following suit. Political pressure prevents EES from cutting off electricity to large categories of non-payers such as communal housing services and military installations. The only other major player in as dire a situation as EES is the nuclear power industry – which also has very limited access to dollar export earnings, and which has to sell most of its electricity at fixed prices to EES.²¹

Gazprom is better placed than EES given that it exports 30% of its output and thus generates hard cash earnings – earnings that are taxed at a modest rate. However, Gazprom complains that they have been forced to bear the burden of balancing the federal budget and keeping other economic sectors afloat.²² In August 1993 the government started indexing gas prices to CPI on a monthly basis, in February 1996 the increase was cut to 0.8 of the general inflation rate. In June 1996 responsibility was shifted to the newly-created Federal Energy Commission (FEK), which effectively froze prices from October 1996 to November 1999. Thus from 1991-2001 the domestic gas price rose 18 times while oil price rose 54 times and industrial prices on average rose 32 fold. The August 1998 devaluation caused the domestic gas price to fall from \$45 to \$15 by 2001. Gazprom estimates its losses from domestic sales to have risen from \$1.2 bn in 2000 to \$1.9 bn in 2001. As a result Gazprom investment fell from \$6.5 bn in 1996 to \$3.2 bn in 2000, while gas output fell from 565 bn in 1996 to 511 in 2001. Gazprom in turn has been criticized for shadowy dealings with subsidiaries and intermediaries, most notably the Itera concern. In its annual report released in June 2001, Gazprom acknowledged for the first time that it provided \$2.7 billion in loan guarantees to other companies last year, including Itera.

The railways ministry is another important player – they have been able to hike freight prices to extract rent from coal and metals producers, who need the railways to secure their own export earnings, and the railway has been using these earnings to subsidize passenger travel. The November 2001 firing of rail minister Nikolai Aksenenko could threaten the railways' cosy monopoly.

The regulatory history began back in 1990-91 with the passage of a law on monopoly, the main issue being the battle with price inflation across a broad range of industries.²³ A monopoly was defined as any firm with a 35% market share, and some 2,000 companies were listed as monopolies. Once the general market transition had settled down, attention turned to the natural monopolies. A February 1995 presidential decree no. 220 started setting up regulatory commissions, and the August 1995 law no. 147 "On natural monopolies" provided the legal framework. In 1995-96 the national FOREM power and capacity market established, but most industry users (including the railways) do not take part in FOREM, they want their payments to go to regional utilities. Regional commissions set local rates. Formerly they were under the jurisdiction of regional governments, now most have legal status. February 1997 saw a new law on federal regulation of electricity and heat tariffs. A 1999 effort to put FEC under MAP failed. After that MAREC (Inter-regional association of Regional Utility Commissions) was created. Prior to August 1998 tariffs were reviewed every three months, using a formula of costs plus reasonable rate of return. Since then the reviews have been more infrequent, and based on political bargaining.

²¹ Arkhanel'skaya, 2002, says EES pays atomic stations 18% less than thermal stations.

²² Kozyrev 2001, Yarkin 2002.

²³ Slay 1998; Evans 2000.

The overall result of these faltering institutional developments is a situation where "all basic economic tariffs in Russia are set by different bodies and on the basis of different principles" and "The Federal Energy Commission does not know the first thing about market methods of regulation of tariffs."²⁴

Tariff levels are highly distorted. Differences between regional rates run as high as 10 to one. Kamchatka rates were 16 times higher than those in Irkutsk in 2000 (up from eight times in 1990). In addition some individual "beneficiary consumers" receive special rates. Public housing pays below production cost. Only in 1998 was a discount introduced for industrial night use (30%). The same year a presidential decree introduced a 50% discount for cash payments. After Chubais took over cash payments increased, hitting 100% by June 2000.²⁵

Recent developments

After August 1998 in a bid to assuage popular discontent the state held down utility prices. The relative prices of gas, transport, and electricity dropped by 20%, 23% and 39% respectively (calculated vis-à-vis the industrial producer price index on an end-year basis) during 1998-2000.²⁶

Utility tariffs are now routinely set through face-to-face bargaining between energy barons and government leaders. At its January 2002 meeting the government set a 35% ceiling for all utility rate increases for 2002, broken down for electricity (17.9%), railways (16%, plus elimination of different rates for domestic/foreign freight), and gas 20%.²⁷ The government had previously reviewed Gazprom's \$5 bn. investment program, said it was over-ambitious, and encouraged the corporation to sell off 9 non-core businesses hopefully raising \$700 mn.²⁸ Similarly, the 2002 railroad investment plan was cut from R160 to 115 bn. Controversial presidential advisor Andrei Illarionov accuses the utilities of profiteering, paying themselves higher salaries than average and absorbing an ever-larger share of investment resources. He claims "As calculations show, the rates for electricity and rail transport are 40% overpriced on average."²⁹ He has many vocal opponents in the so-called "high tariff party" such as leading economist Yevgenny Yasin.³⁰ The most immediate casualties of a tariff increase are the metallurgy industries, which are facing an acute profits squeeze due to declining world market prices, not to mention US import quotas.

The Putin administration has dithered over what to do about the financial crisis at RAO EES and the price scissors between domestic and international energy prices. Putin angered much of the opposition by allowing the controversial Anatolii Chubais to stay on as head of RAO EES. In spring of 2000 Chubais came up with a plan for raising money by privatization some of EES's more lucrative regional producers to the highest bidder. This angered foreign investors who already held some 20% of EES stock and they were able to derail the reform plan. They feared that all of the profitable segments of the company would be sold off, leaving only the money-losing operations in the hands of the national company. The lucky recipients of the privatized assets would presumably be Chubais' political cronies (as in the 1995 loans-for-shares deals), such as Oleg Deripaska, the head of the powerful aluminum conglomerate Rusal.³¹

A compromise that will allow limited privatization was struck in July 2001.³² The first draft of electricity bill ran into a bureaucratic stonewall, but was pushed through by vice premier Viktor Khristenko. Presidential advisor Illarionov opposed the Chubais plan, saying it was "a case of privatization when Cabinet officials are 'privatized' by private companies and corporations."³³ In the first stage, up to 2004, EES's hydropower and fossil fuel power-generating capacity will be restructured into five to seven generation companies, or gencos. These will be owned by EES until 2004, when they will be spun off as independent

²⁴ Novoprudskii, 2001.

²⁵ Yakovlev, 2001.

²⁶ Slay 2001.

²⁷ Zhelenin, 2002.

²⁸ "Pravitel'stvo otpravilo Gazprom na pereeksamenonku," lenta.ru, 20 December 2001.

²⁹ Sivkova, 2002.

³⁰ Guriev, 2002, Sivakova, 2002.

³¹ Whalen 2001.

³² Energy Information Administration, 2001; Guriev 2002; Happy New RAO EES, 2001.

³³ Smirnov, 2001.

companies and a wholesale market introduced. In March 2002, the board of EES approved a revised plan that stipulates that all shareholders will receive proportional representation of their stakes in the new companies. Prices should rise 100% by 2005, then the market will be liberalized. The Federalnaya Setevaya Kompaniya, currently a subsidiary of RAO EES, will be returned to state ownership, as will the dispatcher service TsDU.

Prospects for change from outside

One important lever in introducing competitiveness to energy markets is the arrival of foreign management and foreign investment. However, neither the Russian energy barons nor the government has shown much interest in opening the door to foreign oil majors. British Petroleum took the lead, sinking \$500 mn into a 10% share of Sidanko in 1997. What happened next scared off any investors were inclined to follow their lead. In 1999 Sidanko went into bankruptcy proceedings, during which TNK managed to gain control of Sidanko's prize Chernogerneft operating unit at expense of BP. In the summer of 2001, Alfa Group, TNK's parent company, acquired a 44% stake in Sidanko from Interros, bringing its total holding in Sidanko to 84%.³⁴ A second obstacle to foreign investment is the lack of working Production Sharing Agreement structure which can insulate investors from changes in the domestic tax regime. Only three PSAs are operating at the moment, all were signed before the PSA law was approved by Russian parliament in 1995, and two of them are located on remote Sakhalin island.

A major factor stimulating earlier waves of reform was external pressure – from the IMF, from the US government. Since the August 1998 crash however there has been a paradigm shift in Western attitudes towards Russian economic reform. The former heady optimism of high hopes for Russian economic reform has been replaced by a sense of weary resignation and sober pragmatism.

The “Washington Consensus,” while still intact, is less confident that liberalization can work quickly in all countries, irrespective of their initial conditions. This means that the international community is more tolerant of countries that deviate from liberal orthodoxy.

Second, there has been a profound shift in US government policy towards Russia. The Clinton administration shaped its foreign policy around the promotion of democracy and market reform, with Russia being the prime pupil. This provides strong financial and political incentives for the adoption of reform by the Yeltsin government. US enthusiasm for this policy sharply eroded after August 1998, and dropped completely with the arrival of George W. Bush. The initial intent of the Bush administration was downgrade relations with Russia to that of other mid-ranked countries, and to drop the pretence that the US could seriously contribute to the development of competitive markets or liberal democracy in Russia.

There are still some divisions in American opinion over the status of the Russian economy. Some see the August crisis as a turning point, a useful crisis that brought about some necessary corrections in Russian economic policy – adjusting the exchange rate downwards, puncturing the power of the oligarchs, and shaking out the more corrupt and inefficient commercial banks (which was nearly all the private banks). The most powerful argument in their favor is the fact that the economy started growing in the wake of the August crisis – 8% in the first year, and 5% per year thereafter. Living standards too have started to rise, and by some accounts have clawed back to a level roughly equivalent to that of 1990.³⁵

In contrast the pessimists still argue no real reforms have been introduced since 1995. The agenda of urgent structural reform remains unfulfilled, and the leverage of the international community is now much weaker. The doomsayers contend that the post-1998 growth surge is a temporary phenomenon, caused by the devaluation shock and the surge in world oil prices, neither of which will be sustained for much longer.

³⁴ Energy Information Administration, 2002.

³⁵ Vodyanova and Konstantin Danov 2001.

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