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**Working Paper**

## Regulatory Reform in the Energy Industry of Post-Soviet Countries: Same Name, Different Content

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# **DIW** Diskussionspapiere

## **Discussion Papers**

Discussion Paper Nr. 155

**Regulatory Reform in the Energy Industry of Post-Soviet Countries :  
Same Name, Different Content**

by

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Berlin, November 1997

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## **Abstract**

This paper analyses the issues of regulatory reform in the energy industry of post-Soviet countries. We identify the characteristics of the transformation that these countries go through: it is the introduction of a) a new legal culture and b) a capitalist rationality of production in societies embedded in a post-Soviet institutional context. We identify existing models to which these countries' regulations could adhere. Though the industries claim to adopt an Anglo-Saxon approach, one observes in reality the emergence of a specific, post-Soviet regulatory model, characterized by the legalisation of the quasi-propiertorial rights factually enjoyed by new political and economic elites. We review some specific aspects of regulatory reform in the energy sector in Russia, Ukraine, Kazakstan and Azerbaijan. We conclude that foreign investors, politicians and advisors have to adjust to the post-Soviet reality if they want to have a lasting impact.

JEL-classifications: P52, Q4, K23

key words: regulatory reform; energy; post-Soviet countries

## **Zusammenfassung**

Das Papier untersucht den Reformprozeß des Energiesektors in post-sowjetischen Transformationsländern, insbesondere die Entstehung neuer Regulierungssysteme. Diese Länder sind gekennzeichnet durch die Einführung a) einer neuen Rechtskultur und b) kapitalistisch-marktwirtschaftlichen Produktionskriterien; der institutionelle Rahmen hingegen ist weitgehend post-sowjetisch geblieben. Für die Reform des Energiesektors stehen vier Regulierungsmodelle bereit, die charakterisiert werden: das angelsächsische, das französische, das deutsche und das mittel-/osteuropäische. Zwar haben die post-sowjetischen Staaten formell das angelsächsische Modell angenommen, welches rasche Unternehmisierung und Einführung von Wettbewerb vorsieht. In der Praxis ist jedoch ein Regulierungssystem entstanden, welches die Verfügungsrechte an Energieunternehmen für die alten und neuen Eliten ex-post rechtlich festzuschreiben versucht. Der Fortschritt der Energiereformen wird für vier Länder dargestellt: Rußland, die Ukraine, Kasakstan und Aserbaidshan. Im Gegensatz zur vorherrschenden Einschätzung einer „Transition“ bestehender Wirtschaftsordnungen beobachtet man vielmehr eine zunehmende Divergenz zwischen den Entwicklungspfaden ostmitteleuropäischer Länder und der GUS-Staaten.

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## **Introduction: the reform of the energy sector in post-Soviet countries**

The energy sector in most post-Soviet countries is one of the major, if not the major industry. Not only does it provide people and industries with essential energy supplies, it generates (for example in Russia, through the gas and oil industry) a major part of export and tax revenues. The situation is similar in other significant oil & gas producers : Kazakhstan, Azerbaijan, Turkmenistan and Uzbekistan. In the other CIS-countries which are net importers of energy, a reform of the energy sector (comprising oil, gas nuclear, coal and electricity generation, transport and distribution) is essential, if overall economic reform is to be successful. Energy is also a highly politicised business: Government performance everywhere is seen to fail if energy for heating and lighting homes, running factories and fuelling transportation is not always readily available. Payment for energy often consumes the major part of the minimal pensions and regular salaries paid in post-Soviet countries. The energy industries (particularly oil, gas and coal extraction as well as integrated electricity supply) in the former Soviet Union were formed by well established, proud and cohesive social groups (workers; management and technical staff; research institutions and their extensive staff). Bureaucracies which tend to resist change, defend their vested interest and carry political clout, both in regional and central governments.

Reforming the energy sector in the countries of the former Soviet Union is a major legal and economic challenge. Seven years after the breaking-up of the Soviet Union, very different countries and situations have emerged in this area of the world. They have nothing in common with the dominant idea formulated in 1991, i.e. a “transition“ or convergence toward one “best“ model of legal and economic systems. The “energy-rich” Soviet Union has been transformed into rather “energy-poor” post-Soviet Republics, at least judged by their output decline and the disappointing results of foreign investment. Regulatory reform and structural change are required if these countries want to live up to their own and to international expectations.

In this paper we provide an overview of the issues of regulatory reform in the energy industries in post-Soviet countries, i.e. the CIS-countries emerging from the break-up of the Soviet Union. The very specificities of these countries is that while at Soviet

times there existed neither law nor economics, today the countries have to deal with new legal and economic cultures. Our thesis is that in this peculiar context, it is unreasonable to expect the post-Soviet countries to implement a Western-type of regulatory reform. There can be not on “best” reform process, copied from other countries, and transplanted into the post-Soviet reality. Instead, these countries are about to create their own, post-Soviet model. While working with foreign concepts and institutional building stones, they will set up a system that will express their own specific history, culture, class relations, tempered only by the capitalist logic and international technical progress. Our analysis is based on extensive hands-on experience in almost all post-Soviet countries.

The plan of the paper is as follows: section 1 identifies the point of departure of the reform process in post-Soviet countries, characterized by the absence of law and economics. In section 2 we explain what the move from socialist Soviet Union to independent Republics means, i.e. nothing less than the introduction of a legal culture and an economic rationality. The “formal“ implementation of legal codes and privatisation on paper were insufficient to kick-start a sustainable reform process. In a very Confucian vein, we identify common misunderstandings on key words used in the two worlds, but for which post-Soviet and Western societies have different meanings (e.g. legislation, contract, money, state). Section 3 discusses the options of regulatory reform at the light of the four existing “models”, e.g. the Anglo-Saxon, French, German and Eastern European ones. Section four lays out the decisions to make in regulatory reform.

In section 5, we review empirical evidence on post-Soviet energy developments and performance so far (Russia, Ukraine, Kazakstan, Azerbaijan). Whereas all claim to have introduced Anglo-Saxon type of deregulation, none has done so in reality, preferring to maintain highly politicised and non-monetary energy sectors; foreign investment was not seriously sought. Section 6 offers an explanation why Western models can not be transplanted into the reality of post-Soviet economies. We conclude that the CIS-countries are about to define their very own, “post Soviet” mode of development, not easily accessible to foreigners, but which investors, consultants and researchers will have to adjust to.

## **1) Point of departure: the energy sector under Soviet socialism: absence of law and economics**

One needs to recall and reflect on the legacy of the Soviet era organisation of the energy sector: The socialist character meant that individual units of industry were virtually non-existent.<sup>3</sup> The general set up, management and staff were not trained to operate according to monetary (or: capitalist) criteria. Instead, they were run as links in the hierarchical organisation, dominated by the Communist Party. In the absence of money, economic criteria (such as costs, reserves, profit, etc.) could not play any role. Political criteria such as integration of the political space of the Soviet Union played an important part (for instance when oil equipment industries were located in Azerbaijan to supply extractive industries in Western Siberia). Transport was essentially provided for free. Locational decision therefore could not reflect costs of transport, which - once priced at costs and under constraints of a capitalist market economy - would have made many operations uneconomic. Similarly, extraction was not based on economic criteria, but rather on technical criteria so that energy fuels (coal, oil and gas) were often produced through costly investment, which in a capitalist environment would not have been feasible.<sup>4</sup> Energy efficiency was no priority, the practice made this more evident, since there was no incentive for energy producers, distributors or consumers to save on energy: Hence the huge losses of energy in production, transport (pipeline leakage), distribution (town heating losses) and consumption (e.g. regulation of temperature by opening and closing windows).

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<sup>3</sup> Cf. Hirschhausen, Christian v.: *Du combinat socialiste à l'entreprise capitaliste - une analyse des reformes industrielles en Europe de l'Est*, Paris; L'Harmattan, 1996. An overview in English: Hirschhausen, Christian v., 1996, "Lessons from Five Years of Industrial Reform in Post-socialist Central and Eastern Europe", in: *DIW-Vierteljahreshefte zur Wirtschaftsforschung- DIW Quarterly Journal of Economic Research*, Heft 1, 65. Jahrgang, pp. 45-56.

<sup>4</sup> It is unfortunate, therefore, that even today, reserve estimates of post-Soviet countries are still based upon the socialist, i.e. purely physical, definition of "reserves" (cf. BP: 1997: *Statistical Review of World Energy*, estimating Russian gas reserves as high as 49 trn. m<sup>3</sup>, which corresponds to the socialist "reserve" categories A-C1).

The transformation of post-Soviet governments and energy industries is infinitely complex.<sup>5</sup> Reforming such industries is very much a matter of legislative reform<sup>6</sup> and enterprise restructuring. Both have received little attention in the last five years. The importance of legislative and general legal reform for the transformation process has not been appreciated for two basic reasons: First, law as a stable system of legally and judicially protected entitling “rights” - different from temporary and volatile governmental commands - was unknown in socialism. Legislation is still very much seen as a government directive rather than as a system of rights and obligations which are relatively immune from instantaneous government intervention.<sup>7</sup> Since the socialist

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<sup>5</sup> We have to bear in mind that the European Union has in four decades since the signature of the Treaty of Rome, not succeeded in giving effect to Community laws on economic integration and competition in the energy sector and has so utterly failed in either enforcing its primary Community laws against the nationally segregated and closed energy industries of major countries or in getting its draft directives for opening up the European electricity and gas markets accepted. cf: Ruediger Dohms, Die Entwicklung eines wettbewerblichen Europaeischen Elektrizitaetsbinnenmarktes (The development of a competitive European energy market) in Ob. Oe. Kraftwaerke AG Ed., Aktuelle Rechtsprobleme der Elektizitaetswirtschaft 1995, Universitatetsverlag Rudolf Trammer, Linz 1995; Peter Faross, Neuordnung des Wettbewerbs auf den Energiemaerkten, in: VIK-Mitteilungen 2 (1996) 32. If one considers the political clout of the German coal mining industry, which has resisted the application of standard EC law on state aids, competition and freedom of importation or the French electricity and gas monopolies which have equally resisted the application of EC law on freedom of cross-border trade and investment, then one may develop some idea of the political underpinning of existing structures in these very heavy industries. The most recent judgment of the European Court of Justice (Case C-159/94) in the matter upholds the specific French energy monopolies though in clear contravention to the integration articles 30, 34 and 37 of the EC Treaty as such monopolies were necessary to maintain the very French type of very specific public services provided by Electricite de France and Gaz de France. This important judgment affirming the French energy monopolies after 40 years of efforts at creating an integrated single energy market indicate the political strength of entrenched energy power structures. The judgment and commentary are likely to be published in the J. of Energy/Nat. Resources Law, Int'l Legal Materials and other European Law Journals in the near future.

<sup>6</sup> Legislative Reform in the Transition Economies (with J. Gunderson) in 43 Int'l & Comp L.Q. Vol. 43, April 1994, pp. 347 - 379; (forthcoming): Robert & Ann Seidman, Thomas Waelde, Legislative Reform (An edited book planned for 1998 with contributions from Bogumila Puchalska-Tych (Some cultural and legal issues of the property law reform in Poland); R. Knieper/M. Boguslavski, Robert Seidman, B. Tamanaha, D. Webb and others.

<sup>7</sup> This point had already been made in the early phase of post-socialism, but had passed largely unheard, cf. for example Svindland, Eirik, 1992, Bulgaria. in: Stevens, Christopher, and Jane Kennan: Reforming in Eastern Europe and the Developing Country Dimension, London, Overseas Development Institute. It was only after a consensus had emerged on the “transformation crisis“ that institutional approaches gained more publicity, see the review of Streit, Manfred and Uwe Mummert (1996): Grundprobleme der Systemtransformation aus



state and the people subject thereunder did not have or know the rule of law (“Rechtsstaatlichkeit”) as it normally operates in a civil society, the importance of creating a system, institutions and culture encapsulating the rule of law naturally was not understood. Western advisers were mainly theoretical economists hired by the Western international financial and aid agencies. In their thinking and formation, the emphasis was on privatisation and the creation of markets, but there only a very limited appreciation that real markets (as contrasted to markets in economic models) operate within a very dense framework of laws, legal institutions and very specific and distinct professional cultures.<sup>8</sup> This very fact is only now being brought home as the economic reforms recommended and implemented have not produced *per se* the market economy features familiar in Western countries.

Second, the importance of structural change and enterprise reorganisation was also not fully understood in the early post-socialist phase. The error was to consider socialism to have been a “state capitalism“ and thus to reduce structural change to ownership questions (from state to private). Instead, the socialist industrial structures did not have anything to do with what one would call capitalist in the Western sense. Indeed, in the absence of money, capitalism, characterized by a separation between an economic sphere (in which individuals try to optimise capital accumulation) and a “state” (representing the institutional infrastructure) could not at all exist in socialism. Thus the pure transfer of ownership of former socialist combines to “private” factories could not resolve the fundamental problem of enterprizing the post-socialist industrial “ruins” according to capitalist criteria. Neither was macroeconomic stabilisation, often obtained at the expense of plummeting production and unpaid wages, a sufficient condition for economic recovery.

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institutionenökonomischer Perspektive, Jena, Max-Planck-Institute for Research into Economic Systems, Discussion Paper 09-96.

<sup>8</sup> This also reflects the positive understanding of law in post-Soviet societies, where each and every action has to be permitted by decree; the Western understanding of law is by contrast negative, i.e. everything can be done that is not forbidden by law.

## **2) What does transformation from socialism to capitalism mean?**

### **2.1 Introduction of law and economics**

Right from the beginning of the onerous debate on “transition”, we have argued that this very concept is not only a misnomer of the real issues at stake, but that it deliberately leads to false policy implications.<sup>9</sup> Indeed whereas few people have really tried to understand what socialism was all about, even less are today able to say what “transition” means, and where it would lead to. Experience in post-Soviet countries imply that these countries will certainly not converge towards a Western-typo of “market economy“. Indeed, seven years into post-socialism, the advanced reforming countries of Central and Eastern Europe (e.g. Poland, Czech Republic, Estonia) have already ended their “transformation” process, and adopted the basic institutions of a capitalist market economy. By contrast, it has become evident that the post-Soviet countries will not emulate the Western model, but adopt a very different system of co-ordinating state and economic activity.

In the early days, the normal response to the challenge of transformation has been to introduce - on paper - private property and property law (which is in the process of implementation through the enactment of civil codes), and to create autonomous business actors, i.e. corporations (which is being achieved through organisational restructuring, corporatisation and sometimes privatisation of former state owned business units). Also, it was attempted to promote the evolution of markets in which these new autonomous commercial actor trade, to introduce competition (by freeing markets from price control, production commands and by introducing competition laws), to set up bankruptcy as a sanction for business failure, to introduce modern systems of direct and indirect taxation. The functioning of these organisational mechanisms was to be facilitated by providing training and know-how in business management, accounting and tax administration. The new system, it was thought, should replace the hierarchical commands used in the Soviet era for co-ordinating economic actors by a system of monetarized, contract relationships.

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<sup>9</sup> cf Hirschhausen, 1996, Du combinat ..., op cit.; similarly: Waelde/Gunderson, op.cit. supra.

It has been easy to carry out the “formal” part of economic reform, helped by a large influx of foreign advisers who are in essence (though not always formally) selected and imposed by the multilateral and bilateral Western finance and aid institutions. There has been a lot of activity in terms of organisational restructuring and legislation in all post-Soviet economies, in some (mainly East European e.g. Poland) much faster and in others (e.g. Ukraine, and some Central Asian States) much slower. It should have been clear at the beginning of this largely unplanned and quite spontaneous activity of advice, restructuring and legislation that there is more to a functioning capitalist market economy than merely producing organigrammes and legislation on paper and for the books:

- first, that it is necessary to instil vitality and life to legislation, to create and make institutions which function as envisaged and to support the emergence of the culture of a civil society and in particular of a legal or perhaps better a professional lawyers’ culture (as also a culture of business management, civil service and of professional services);

- second, that it is necessary to set up independent, profit-oriented enterprises, acting according to capitalist criteria in a monetarized environment; this process is now referred to as “enterprization”.<sup>10</sup> Indeed, as long as enterprisation is not finished, hierarchical relations will easily dominate over business relations.

In the post-Soviet countries, both developments are still very much at its beginning. The influence of foreign advisers has been quite enormous in terms of production of “formal” governmental action - typically more so in countries such as Russia where the size of the country and the number of the parties involved and forces usually eventually lead very much to domestically created *sui generis* solutions. However, their contributions to the emergence of effective socially and economically active and effective institutions and culture is more limited.

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<sup>10</sup> Cf. Bomsel et al. (1995): “Enjeux industriels du post-socialisme“, in: Revue d’Economie Industrielle

## 2.2 Same words, different meanings

We have identified a number of “misunderstandings”, in the sense of different meanings attributed to similar or identical terms, which may explain the large gap which still exists and is likely to continue existing, for an extended time between the only formally marketised post-Soviet societies and the “real” capitalist market economies of the West:

Legislation : Means in the Western capitalist market economies mainly protection of proprietary and personal rights, enforcement of contracts and providing a service of impartial dispute settlement for autonomous commercial actors; regulating abuse of power. In post-Soviet countries it is still seen mainly as the allocation of bureaucratic powers among competing organisations of the state. Such allocation can be easily changed - and so is the expectation.

Contract : The Western meaning is a definitive commitment, to consider carefully, to negotiate in detail, something to stick with, to take risk with - and largely immune from bureaucratic or political intervention. The importance of the sanctity of contract in Western market economics reflects not only the law, but also a culture of trust and of moral and legal commitment.<sup>11</sup> This social culture, reflected in and reinforced by legal culture, is the basis for long-term commercial commitments transcending the instantaneous give-and-take of short-term trading in lawless cultures, the latter being very much the current feature of the post-Soviet economies. In the post-Soviet countries, contract seems to mean rather a temporary instrument indicating intentions in a protocol or communiqué, i.e. something that from a moral, pragmatic and legal perspective, can easily be revoked or changed if the configuration of interests and bargaining power changes. A contract is also seen as similar to the familiar previous

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<sup>11</sup> Francis Fukuyama, Trust, The Social Virtues and the Creation of Prosperity, Hamish Hamilton, 1995; see also on the importance of property and commitment to encourage private investment: Investment policies and Investment Promotion in the Mineral Industries, in: 7 ICSID-Rev/Foreign Investment Law Journal, (1992) 94-113; reprinted in: Bruce Mc Kern (Ed) Transnational Corporations and the Exploitation of Natural Resources, Vol. 1o of the UN Library on Transnational Corporations (General Editor: John Dunning), Routledge, London, 1993, 340-363; T. Waelde /G. Ndi, Stabilising international investment commitments, in: 31 Texas Int’lJ 215-268 (1996). Every Western visitor to the CIS relying on contracts will soon find out that they are castles built in sand.

planning instruments, that is subject to sudden and unpredictable revocation and modification by the government.

Money: in capitalism, money is the central concept around which the rest of the economic turns (it is not too farfetched to think of the biblical dance around the holy cow). Money is a universal equivalent of value, measuring all productive activities, including labour. Indeed, capitalism, which is a societal consensus on the maximisation of the accumulation of money, can not work without money. On the micro-level, money is also an objective criteria of evaluation: if an enterprise runs out of money (bankruptcy), it means it will have to close, also leading to a disqualification and discrediting of its senior executives. In capitalism, money is carefully guarded, monitored, audited and accounted for; there is even a special professional and academic discipline (accountancy), solely dealing with money. By contrast, in socialism, money did not exist as a universal equivalent of value.<sup>12</sup> Money was only introduced in the former Soviet Union in January 1992, making capital constraints and the existence of accumulation possible. In other words, since January 1992 exist the necessary, though not sufficient condition for capitalism. However, since then, money has not been sufficiently developed to facilitate transactions; instead, barter is the dominant mechanism of exchange. The monetization (=M2/GDP) of post-Soviet economies is extremely low, at about 10-20% (in developed capitalist economies, it is about 40-50%). Where real money is used, it is mainly USDollars. In post-Soviet countries, there is little confidence and much less sense of seriousness attached to the various modes of acquiring, having and disposing of domestic money both in government, business and private life.

Property : Western society and culture, law and business revolves around property, in all its forms; traditional tangible ones (things; land) and intangible (intellectual property); individual and corporate. Economic activity is focused on the acquisition of

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<sup>12</sup> Ludwig van Mises, Max Weber and Sylvain Lazarus have shown that this implies the absence of any economic rationality in socialism; cf. Mises, Ludwig von (1922/1981): *Socialism*. Indianapolis, Liberty Class (Translation of the 1922 edition); Weber, Max (1921): *Wirtschaft und Gesellschaft (Grundriss der Sozialoekonomik)*, vol III; Tuebingen; Lazarus, Sylvain (1992): *Chercher ailleurs et autrement - Sur la doctrine des lieux, l'economie, l'effondrement du socialisme*. Paris; Les Conferences du Perroquet, No. 35.

or the profitable trade in property. Property in post-Soviet countries is a much thinner concept. Apart from personal belongings, “property“ in the Western sense, did not exist in socialism. Things were in fact owned by no one in particular and often subject to control and use by way of political and bureaucratic fiat, without certainty, stability and clarity. In addition, there is a large reservoir of distrust against commercially used property.<sup>13</sup> Industrial and commercial property has been subject to vilification as exploitative in the over 70 years of Communism in the Soviet Union.

The State : Means in Western countries a largely positive force with restricted powers whose basic role it is to provide a framework for economic activity. Its mandate is to protect its citizens’ right, provide authority to enforce their private economic dealings, ensure public order and security and step in as a regulating force where the market itself can not provide an adequate solution for functions desired by the people (e.g. health, education, welfare, competition, environmental protection). In post-Soviet countries, there is not yet an institutionalised separation between the state and individual economic activity. The association with the state is that of a pervasive organisation interfering without restraint into commercial and private dealings, weak and corrupt at its interfaces with the people. It is also the large, though very imperfect provider of all that is necessary for social life: jobs, income, housing, food, education and culture - and certainly: secure energy supplies.

It is within these cultural and institutional context that the reform of the energy sector, on the surface very much propelled by foreign advisers, has been taking place throughout post-Soviet economies. Instead of “transition“ towards one single model of economic life, one observes on the contrary a growing diversification of idealtypes of a civil society.

### **3) Tasks, Challenges and Options for Regulatory Reform in the Energy Sectors**

The ultimate goal is to create an energy sector that produces, provides and if possible exports energy in economical and competitive mode, in step with international

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<sup>13</sup> See, in particular, Bogumila Puchalska-Tych, in : Seidman/Waelde, op. cit.

conditions. This requires that socialist, non-monetary relations be replaced by horizontal, monetarized contractual relations; that the “true” costs of investment and operations are used for investment, operating and sales activities, that companies operate under commercial and financial - and not political - criteria and that the government and the consumers (industrial, distribution companies and households) see energy supply as a purchase of products/services - for which they have to pay. It also requires that apart from the business sector, methods of governance are established which take a national perspective, identify and deal with market failure and exercise roles of monitoring, policy formulation and policy implementation. In other words, a separation has to be introduced between the commercial, capitalist sphere consisting of largely autonomous companies and the state sphere consisting of a smaller, but more effective government service watching over and ensuring the proper functioning of the energy industries.

### **3.1 Idealtypes of Western regulatory models**

Regulatory and institutional reform usually, and particularly so in the post-Soviet situation, consists in identifying suitable models from abroad and then trying to emulate them effectively at home. The particular domestic model then emerges in the way the transplant grows root and operates in its own way in the domestic context. The capitalist market economies provide at least four different models:<sup>14</sup>

The Anglo-Saxon Model as it is emerging under the impact of the Thatcher privatisation in Britain and now replicated in Australia, New Zealand, Canada, several US states, South America and the Scandinavian countries - pursues the approach of privatisation, enterprization and competition. It creates wherever technically possible a series of independent companies on the level of power generation and power distribution, exposed to competition from each other and from newly emerging

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<sup>14</sup> We simplify more complex structures; for a survey of European models: Eugene Cross, *Electric Utility Regulation in the European Union: A Country by country guide*, Wiley:1966, Chichester; Leigh Hancher, *EC Electricity Law*, Chancer, London: 1992; Christian Egenhofer/Georg Goy, *Europäische Energiepolitik vor der Regierungskonferenz 1996/97*, in: *Vierteljahreshefte zur Wirtschaftsforschung*, Vol. 65, 368 (1996). Janne Haaland Matlary, *Energy Policy in the European Union*, Macmillan, London:1997.

independent power producers. Transportation - where still necessarily a natural monopoly - is opened up by third-party access of competitors to electricity grids or gas pipelines which are owned either by private companies or by publicly owned companies exercising only a transportation function (e.g. the UK National Grid Company). Under the influence of independent regulatory agencies, competition develops or is promoted by the regulators and sometimes by competition authorities. The logic of the UK model leads to competition on the level of retail electricity and gas distribution as well as power generation and gas extraction and trading. While originally doubted by supporters of established structures, it can no longer be denied that this model works - i.e. supplies energy to consumers reliably, but also that it is accompanied by substantially lower energy prices, in particular for large consumers able to negotiate on their own.<sup>15</sup>

The French Model relies, in the electricity sector, on integrated monopolies (i.e. Electricity de France, Gaz de France), protected against competition from outside, operating with some forms of supervision/planning exercised by the competent central government ministry. Electricity in France is available everywhere, at very equalised conditions. The sector appears very well managed and most French (apart from some large-scale industrial consumers) seem to be reasonably content with this state of affairs<sup>16</sup>.

The German Model - sometimes characterised as corporatist - may be viewed as a mid-road approach. It consists of mainly privately owned companies on the level of generation, transport and distribution, but competition is largely excluded by a system of distribution monopolies created by publicly issued franchises. Competition is also curtailed on the transportation and generation/extraction/import level by considerable

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<sup>15</sup> Thomas Waelde, Die Regelung der Britischen Energiewirtschaft nach der Privatisierung (Regulation of the British Energy Industries Post Privatisation), in P. Tettinger (Hrsg), Strukturen der Versorgungswirtschaft in Europa, Bd. 23, Boorberg: Stuttgart 1996.

<sup>16</sup> The political support of the French model is so strong that it is able to survive legal challenges based on the 1957 EC Treaty's key provisions on reciprocal opening, economic integration and EC-wide competition even in a 1997-based judgment of the otherwise, normally and traditionally very integration-oriented European Court of Justice, see the supra cited judgment of the ECJ of 23 October 1997.



difficulties for competitors to gain access to existing gas pipelines or electricity grids to transport energy to prospective customers.<sup>17</sup> There is no real national regulator in the German system and regulatory and policy-formulation is split between the Federal Ministry of Economics, state ministries of economics and the German competition agency (with a very limited remit over energy). The German model is accompanied by the highest energy prices within the EU.

In the Central/Eastern European model (e.g. Poland, Czech and Slovak Republic, Hungary, , Estonia) governments were able to implement coherent strategies, energy companies have been set up that operate according to established legal and economic criteria, and a certain separation between them and the state was institutionalised.<sup>18</sup> Thus Central and Eastern European countries, some of which are about EU-members, can also be classified as capitalist market economies. The Eastern European model is characterized by a replacement of the fully-integrated socialist structures by disintegrated enterprises, though state ownership remains dominant. Most privatisation and enterprization has taken place on the distribution level (gas and electricity), including a massive inflow of foreign direct investment; production and transmission remain state-dependent. But none of the national grid operators was privatised, nor committed to grant, so far, comprehensive and obligatory third-party-access<sup>19</sup>.

### **3.2 Post-Soviet simulations of the Anglo-Saxon model**

At first sight, one would assume that the natural tendency of the post-Soviet economies would be to look towards the French model at least for electricity and gas.

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<sup>17</sup> Friedrich von Burchard/Lutz Eckert, *Natural Gas and EU Energy Law*, Nomos, Baden-Baden, 1995 (from a gas company perspective); Peter Cameron, *Gas Regulation in Europe : From Monopoly to Competition*, FT Energy Publishing, London 1995; Hans Jarass, *Europaisches Energierecht*, Duncker & Humblot, 1996 p. 32 - 62; also: E. Cross and L. Hancher, *op.cit. supra*.

<sup>18</sup> Anita Ronne, *The Road to a competitive energy market: The Polish Draft Energy Law*, in: 14 JENRL 99-107(1996); eadem, *Alternative approaches to regulatory agency structures and powers*, 15 JENRL (1997); regular reporting: *Russian Petroleum Investor*; FT *East European Energy Report*; on Poland: Michael Davies, *Energy law reform in Poland*, in: *J. of Energy & Nat. Resources Law* (forthcoming).

<sup>19</sup> So this may be changing in the case of the more liberal East European countries, e.g. Poland.

This successful system should have recommended itself since it appears to be closest in terms of structure, organisation and attitude to the integrated energy monopoly, protected against competition and outside influences. Emphasis on central planning and co-ordination, on large-scale “grands projets” (including nuclear power), the concept of energy supply as a public service that should and can only be provided by a state entity - all this indicate areas of affinity which should have determined the selection of the French model. However, most surprisingly as it seems developments have been largely based on the Anglo-Saxon model.

Was it the original attraction of Anglo-Saxon economic thought to the young Soviet economists grouped in GOSPLAN and the main economic research institutes in Moscow which propelled the often very theoretical foreign economic policy advisers into the receptive arms of their Russian counterparts which were the only ones who were able to formulate a sense of direction for economic reform<sup>20</sup> with their opponents locked into a defensive and passive attitude? Was it the appreciation that at this time the Anglo-Saxon model looks clearly superior over the mercantilist model as embodied by France or the corporatist model embodied by the Germanic countries in terms of wealth generation, innovativeness in modern technologies and flexibility of economic responses? The latter response would attribute to the decision-makers and opinion-creators in the transition economies an insight that is as yet not generally shared even in Europe, where economic policy debate is at present dominated by the clash of quite rigid traditionalism with the Anglo-Saxon challenge.

There is, though, a third line of explanation which taking a more classical political economy approach - looking rather at the economic interests of the elite in the post-Soviet economies: The surprising enthusiasm in almost all post-Soviet countries for Margaret Thatcher’s energy market model must have benefited those who were in control of the energy industries. Under the socialist system the control was politically and bureaucratically based, and not protected by legal property rights. Today, the difference is that subsequent to “privatisation“ and the introduction of property rights

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<sup>20</sup> On the comparable enthusiasm for the Thatcher philosophy in Poland, See B. Puchalska-Tych with several references in, Seidman/Waelde op. cit.

such bureaucratic control was transformed into property rights compatible with, and protected by, the new legal system of the post-Soviet economy.

In other words, one way of viewing the readiness to accept avantgardist models of the energy industries is to view them as “legalisation of the quasi-propiertorial rights factually enjoyed by the new political and economic elites”<sup>21</sup>. Thus, the introduction of the market economy models of Anglo-Saxon origin proposed by Western theoretical market economists provided a convenient cover for the pre-existing or newly emerging ruling classes to convert the source of their power and influence into legal titles - i.e. it facilitated a smooth transformation for the previous ruling classes. Ruling class it was and remains, but its source of legitimacy was reformulated - from nomenclature to the bourgeois owners of the means of production. This interpretation would explain why the formal process of enterprization of energy industries seemed so relatively easy, while it is so much more difficult to move to a competitive energy market: The former holders of bureaucratic control would have had all the interest to transform bureaucratic control into legalised property, but not the interest to expose their property to the risks of competition.

#### **4) Policy Choices in the Regulatory Reform of Energy in post-Soviet Economies**

Independently whether they “choose“ a model or not, post-Soviet countries had to, and will continue to, confront crucial reform questions such as, inter alia:

- enterprization or maintenance of post-Soviet industry structures ? The fundamental question to be answered is whether the energy sector should be enterprised and independent, profit-oriented enterprises be created ? This would imply the end of the “public good” character of energy. The alternative is to maintain the inherited “politonomic” industry structures, without any distinction between politics and economics;

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<sup>21</sup> B. Puchalska-Tych, op. cit., p.2. Take the most striking example of the Ukrainian electricity “market“, in which the Ministry for Energy reserved itself the right to levy a 6% margin that it disposed of freely.

- maintenance of integrated companies or disintegration into separate companies which deal with the various stages involved in the supply of energy (extraction/generation/transport/distribution); reorganisation of the previous all-industry Ministry (Soviet style combination of industrial operations plus governmental supervisory roles) into either a policy-setting and monitoring Ministry or establishment of independent regulatory agencies; privatisation or continuation of state-ownership of energy activities: oil, gas, coal, nuclear; extraction/generation; transport; distribution;
- entire energy sector regulation including, oil, gas, nuclear, coal, electricity; or regulatory agencies for specific stages such as extraction/generation, transport and distribution; allocation of powers between specific energy regulatory agencies and general competition authorities; location of policy-making and implementation for environmental matters: inside the energy regulatory agency or in a separate agency?;<sup>22</sup> choice between competitive or closed (industry-wide or area-wide) monopoly systems; unbundling of natural monopoly functions (in particular transportation) from generation/production and provision for open access;
- management of the non-payment cycle (consumers vis-à-vis energy suppliers; national energy companies vis-à-vis foreign energy importers; energy companies vis-à-vis national tax authorities etc.).

Apart from such policy issues specific to the energy industries, there are also wider issues of foreign investment policy. Foreign investment promises a rapid inflow of capital, up-to-date technology and market-economy style of management. It also challenges and thereby encourages the modernisation of the domestic industry. On the other hand, foreign investors are less burdened by the heavy social charges traditionally incumbent on the domestic energy industry. This makes them more efficient and competitive, but also much more resented. To the extent they pay most of their taxes to the central government, they are unlikely to build up the necessary domestic political constituency necessary to be politically and socially accepted on the regional (oblast)

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<sup>22</sup> One should note that these issues for policy decisions are very much also part of the regulatory policy debate in Europe and all are currently influenced by the British model and its appraisal.

level. Ideological tradition and local resistance create serious political and administrative obstacles to foreign investors, which general governmental policy expressed in foreign investment laws and specific sector laws (like the oil production-sharing law in Russia and in other CIS-countries) have not yet overcome the above problem.

Foreign investment furthermore severely tests the capability of a government to introduce tangible reforms. Domestic companies can continue to survive in a context of non-payment, government interference and politicised energy supply conditions; by contrast, foreign companies as a rule, require stable and predictable investment conditions. This includes, licenses in the form of contracts safeguarded under (national and international) law and supply tariffs which are sufficient to recoup investment and the required rate of return. All these conditions are unfamiliar to the post-Soviet governments and often go against the natural instincts of politicians and bureaucrats therefore posing serious political risks. It is therefore not surprising that foreign investment has, so far, only taken place to a meaningful extent in the areas of oil & gas extraction in a few CIS and East European countries (mainly Kazakhstan, Azerbaijan, Romania and to some extent Russia).

### **5) Key Developments, Appraisal and Performance So Far<sup>23</sup>**

In Russia, the oil&gas sector has been corporatised with a large stake remaining with the government, another large stake with corporate management and employees and a

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<sup>23</sup> For an overview and relevant references : Andrew Seck, Financing Upstream Oil & Gas Ventures in the Transitional Economies of the Former Soviet Union : A Study of Foreign Investment and Associated Risks; PHD thesis, Dundee, 1997; Waelde, Thomas (1996): Internationale Investitionen im Energiesektor der früheren Sowjetunion: Zwischen wirtschaftspolitischem und rechtlichem Anspruch und der chaotischen Wirklichkeit jenseits des Kommunismus, Publication Nr. 359, 1997, Europainstitut, Universitaet Saarbruecken.;idem, The Russian Oil&Gas Industry and Foreign Investment, Opec-Bulletin, 25 (July 1994) 16-2; Engerer, Hella: Russische Energiewirtschaft: Zögerliche Neuorientierung, DIW-Wochenbericht 26/94, idem: Ukrainische Energiewirtschaft. Beschwerlicher Weg in die Eigenständigkeit; DIW-Wochenbericht 17/96; Beyreuther, Ursula (1997a) 'Energy in the FSU - the "great game" of the 21st century?' in: Deutsche Morgan Grenfell: Focus Eastern Europe, July. Forthcoming; Giuditta Cordero Mossa, The Russian Production-Sharing Law, in: Journal of Energy/Natural Resources Law (1998).

small percentage -without effective influence - available at a higher price for foreign portfolio investors. Licensing of upstream exploration and extraction is handled by the Ministry of Natural Resources (the former State Committee on Geology) based on the 1992/95 Subsoil law. Such licensing co-exists very uneasily with the 1996 Production-sharing law which vests the negotiation of production-sharing agreements for oil&gas in the Ministry of Fuel & Energy (Mintopenergo), with an ambiguous direct role of the Duma as well. Russian oil& pipelines are now owned by Transneft, with supervisory powers vested in a pipeline monitoring committee. Foreign petroleum investors complain about the difficulty of access at reasonable rates to this pipeline system. While a large number of oil companies was created, Gazprom still constitutes the Russian gas monopoly and has resisted, so far, all efforts at break-up and competition. A similar development has taken place in the electricity sector. A law on natural monopoly was passed which provides for government supervision of abusive practices. Recently, a Federal Energy Commission was created, the task of which is to assume regulatory powers similar to the US Federal Energy Commission over in particular electricity generation, transport and distribution. Its powers are as yet not very clear and it has not yet started its operations. The Russian industry and legislative reform reflects mainly influence from the UK and the US (enterprisation; setting up of a special industry regulatory commission).

In Ukraine, energy reform has moved more slowly, reflecting the general policy inertia in the first six years after independence.<sup>24</sup> Considered as an “energy-rich” country at socialist times, Ukrainian politicians and the public are not (yet) willing to give up the idea of energy as a free good for all. Payment ratios are as low as 33% (for gas, 1995); the state continues to prescribe annual “Plans” for production and consumption; breathtaking growth rates of domestic energy production are calculated without any reference to reality, and little is done to decrease energy intensity (which is among the highest in the world and rising). With international organisation increasing pressure,

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<sup>24</sup> For a survey cf. IEA/OECD (1996): Energy Policies of Ukraine - 1996 Survey. Paris; also: Hirschhausen, Christian v., Inna Lunina und Tatjana Vachnenko (1997): Die Energiewirtschaft der Ukraine - Bestandsaufnahme und Reformbedarf zur Unternehmisierung. in: Hoffmann, Lutz, und Axel Siedenberg “Aufbruch in die Marktwirtschaft - Reformen in der Ukraine von innen betrachtet“, Frankfurt am Main, New York, Campus.

energy reforms have accelerated since 1996. One step has been the preparation of restructuring of the electricity sector, resulting in a number of separate power generators and distributors, with a publicly owned distribution network.<sup>25</sup> A regulatory agency has been set up and a draft electricity law is in the legislative process. The implementation of a similar scheme in the gas sector is so far resisted by the gas industrialists (transport, regional distribution monopolists); it will require additional pressure from highest-level politicians to enterprising the gas sector, which is the “Achilles’-heel” of Ukrainian economic recovery. Because of the ticking “time-bomb” which constitutes the Chernobyl nuclear power station still in operation, nuclear power has attracted the most international assistance. Yet it remains unclear whether industry lobbyists and local politicians will really put at work the closure of the remaining blocks, that the Ukrainian government has promised in a memorandum of understanding with the G7 (see above on the different concepts of “contract” between East and West).

Kazakhstan had fuelled hopes on an early successful pilot-investment project, the Tengizchevroil-contract. Yet it had to bow to the rules of the geopolitical “Great Game” instead. The development of the supposedly large oil field now more depends on foreign policy strategies of Russia, the U.S., Turkey, and China than on international law and economics. Kazakhstan is also a good example that domestic politicians do not have the same understanding of “investment” as their Western business counterparts: in February 1996, Minister Daukeyev still considered Kazakh investment needs for oil&gas at about 600 bn. USD<sup>26</sup>. This bears no relation to the real investment volumes to date, not exceeding 3 bn. USD for all post-Soviet countries. As concerns electricity, it seems unlikely that Kazakhstan invent a different reform model from Russia’s in which it is still integrated. Gas will not play an important role

Azerbaijan, the peculiar Caucasian Republic where the Soviet oil&gas dreams originated in the early 20th century, may be considered as the most unconventional, yet pragmatic country. Though it has not introduced neither energy reforms nor FDI-

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<sup>25</sup> See Helen Ryding, *The Process of Legal Reform in the Ukraine*, Draft July 1997.

<sup>26</sup> Cf. Interfax Petroleum Report, 2-9 February, 1996.

legislation, Azerbaijan has obtained the best international “reputation” for pushing through energy projects. Thus, contrary to other post-Soviet Republics, it has attracted international investors’ interest for several investment projects. If any, the project on the “early oil” and corresponding pipeline developments can be considered one of the most successful oil&gas projects in the region. Azerbaijan deliberately chooses to ignore international “conventions” on legislation and economic issues. Instead, it considers each investment project as an ad-hoc individual case requiring an individual political approach. Cases are then handled on the highest political level, including case-by-case legislation and Parliamentary approval.<sup>27</sup> Whether this is a sustainable strategy is to be seen.

In all these countries (except Azerbaijan), reform has, in a conceptual sense, been guided by mainly the UK model.<sup>28</sup> In no country, however, have these concepts so far gone further than at most legislation setting up a formal system. The real system operates very differently, in an informal, non-monetized manner. While there may be a formal independence of the regulatory commissions, much resisted by the ministerial bureaucracies, in reality “independence” is subject to constant political interference and has not attained the independence quality of, say, the UK regulators (OFFER, OFGAS) or the US Federal Energy Commission. Apart from the upstream oil sector and some investment in refineries, in none of the countries mentioned has there been any substantive foreign investment (as, e.g. is very heavily the case in UK power distribution, in power generation of power and gas transportation or distribution).

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<sup>27</sup> Cf. Waelde, Thomas, 1996, op cit. (Saarbrücken European Institute) and the case study by Andrew Seck: Azerbaijan - Country Review. Dundee.

<sup>28</sup> I.e. privatisation, establishment of an independent regulatory commission for licensing operations and ensuring that a universal energy supply service is provided properly as well as for promoting competition, opening up (in a legal sense) existing monopolies over, first, transport and later distribution by removing legally effective exclusive franchises and instituting third-party access rights, unbundling of gas/electricity transportation from extraction/generation on one hand and distribution on the other and establishment of a wholesale market in electricity in gas.



## **6) Why Western models can not be transplanted into the reality of post-Soviet economies?**

The survey of issues and reform elements in the energy industries of post-Soviet economies raises questions about the relationship between formal elements of energy policy reform, identified as key in the UK energy sector reform and underlying, not clearly visible nor well understood, cultural and institutional foundations. Transplants and copying from another country, mainly a country seen as very successful, have been throughout history very frequent in policy, institutional and legislative reform.<sup>29</sup> It is natural for a country's elite seeking - usually in response to a crisis and the perception of systemic failure - to look for models abroad. The sense of urgency and pragmatic reasons (resources, time pressure) often do not allow a careful process of comparative law and policy to distil from international experiences what an ideal model could be that would work in a domestic context. The experience, though, with legislative and institutional copying is that institutional and social models tend to work often very differently in the host context than in the original home context.<sup>30</sup> This insight has, helped by modern institutional economics, now also been grasped in the discussion on regulatory economics,<sup>31</sup> where the relationship of newly created elements of regulatory policy/legislation to other, "general" characteristic traits of the respective society is newly identified.

Why can the Anglo-Saxon model not be directly transplanted to post-Soviet countries? In order to answer this question, we have to identify the non-technical or "general" factors of society which seem necessary for the - so far - successful functioning of the UK-model:

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<sup>29</sup> See Alan Watson, *Society and Legal Change*, Scottish Academic Press, Edinburgh 1977; Critically: Ann Seidman/Robert Seidman, *State and Law in the Development Process, Problem Solving and Institutional Change in the Third World*, St. Martin's Press, New York, 1994;/ Macmillan Press, London 1994; and T. Waelde/J. Gunderson, *op. cit.*; For a pragmatic view: B. Tamanaha in Seidman/Waelde, *op. cit.*

<sup>30</sup> T. Waelde/J. Gunderson, *op. cit.*, with several examples, notably from German and Japanese borrowing of US legislative models post World War II.

<sup>31</sup> Brian Levy/Pablo Spiller (Eds) *Regulations, Institutions and Commitment*, Cambridge University Press, 1996.

- the well established civil service culture with reasonable pay, reasonable independence and a tradition of not switching between the regulated sector and the regulatory agencies;<sup>32</sup>
- the, as far as one can ascertain, almost complete absence of corruption UK civil service (though there are other features, such as class and alumni-cohesion which may permit influence-brokering transcending the organisational lines);
- the existence of an unusually well informed and qualitatively high-level business and financial press in the UK (mainly Financial Times and Economist) which carry on an almost continuous debate and scrutiny of general and specific issues of industry regulation;
- the difficulty, anchored in political culture and tradition, politicians have in countermending decisions made by senior civil servants, particularly if those are in independent positions (as the energy regulators) and are supported by influential parts of the business and financial community and press.
- the fact that the regulators actions to promote a competitive system in the UK did not constitute the idiosyncratic personal preferences of the regulators but conformed with and reflected the dominant nature of the economic policy discourse in the UK.

None of the above criteria is fulfilled in CIS-countries. Instead, these are characterized by a post-Soviet civil society, elements of which we have described above. Nothing indicates that the fundamental gap between the Anglo-Saxon and the post-Soviet legal and economic culture be narrowed in the near future.

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<sup>32</sup> In an interview with senior Offgas staff I have been informed that very few Offgas staff have subsequently been employed by the regulated industry. This would indicate that their independence is not softened by the desire to later obtain a better paid job with a gas company. The opposite is the case in virtually very developing or post-Soviet country where a job in the regulatory agency/Ministry is far less attractive than a job in the resource-rich state and now also privatised energy companies and where a conducive regulatory performance is often seen as enhancing the regulatory official's value for being appointed to a regulatee enterprise.

## **Outlook: towards a post-Soviet mode of implementing imported regulatory reform in the energy sector**

If one is able to identify such elements in legal, economic, institutional and political culture which prove essential for the specific functioning of the regulatory regime in a home/origin state, then it seems highly unlikely that a mere copying of the distinct regulatory regime only and re-potting it in a very different societal setting will produce similar results. The response must differentiate between very "technical" issues which function on their own, with very little input from and dependency on a society's culture, and the non-technical, or "soft" factors. The more a regulatory regime is not technical but rather in constant interaction with other characteristic facets of the country's institutional regime and culture, the less can the home/origin states performance be used to predict the performance in the host/transplant state<sup>33</sup>. This does not mean that the ultimate result, once the energy reform achieves some level of stability and equilibrium, is not a good one. It only indicates that the any economy working with foreign concepts and institutional building stones will build a system that will express its own history, culture and class relations, tempered by the logic of economics and technology of the energy industries, even if on paper their laws may look like a straight translation.

Hands-on experience shows that energy reform in the countries of the former Soviet Union is indeed different from anything we have seen so far in other regions of the

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<sup>33</sup> This distinction calls for a differentiation between "technical" regulation - which is more easily portable, and "substantive" regulation which is more anchored to culture, class and institutions. It used to be said that traffic rules are "technical" - but as we know the same traffic rules produce very different results, depending on national driving culture (i.e. as between Manchester and Milan). Alan Watson's work - see supra - tends to suggest that very formal rules of contract law may be more "technical" and work similarly wherever applied, but rules providing supervision and monitoring by a formally independent regulator and powerful regulatee enterprises are likely to work very differently depending on the particular cultural and institutional setting. The recruitment of the regulator and his/her staff; their control over resources; their relationship with the political powers, with the relevant public opinion and the opinion-formation processes with the professions, universities and other media, their job prospects at the end of their tenure; the legal rules - but also the way they are applied - relating to independence, remuneration, dismissal and re-appointment all play a role in how a regulator can and will interact with the regulatee enterprises, but also in his/her power and value-based relationship with other relevant stake-holders.

world. Though ambitious reform programs were formulated, more or less copied from the Anglo-Saxon deregulation experience, no post-Soviet country has come near to establishing efficient enterprise structures in the energy sector. Instead, the post-Soviet countries are characterized by integrated industry structures, regional monopolies, absence of an established legal and economic framework, and “management by barter”. Not even the formal elements of reform (legislation, setting up of regulatory institutions) are yet fully in place.

The energy sector is probably best suited to identify the characteristics of post-Soviet transformation: the introduction of a legal culture, and the introduction of economic constraints. Both have so far been formally introduced, largely obeying to assistance and pressure from abroad. Yet the perception that Western lawyers and economists had in mind has not trickled down into the post-Soviet reality. We have raised some markers on the interaction between society’s institutions and its legal, commercial and political culture in that specific-post Soviet context. The specificities of these countries, rather than disappear in some kind of convergence toward “transition”, are not only here to stay but they will most likely grow. Identifying these post-Soviet specificities is a necessary condition for following the future of regulatory reform in these countries’ energy sectors and providing technical assistance.