FOIA Number: 2012-0769-F

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Russia and Ukraine

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Scott — pls read + point me to most important parts — David

THE ATLANTIC COUNCIL
OF THE UNITED STATES

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Basic Concepts for the Development of Energy Policies for Russia and Ukraine *presents comprehensive policy recommendations which establish a sound foundation for intergovernmental discussions in the area of energy. While "shock therapy" is not deemed appropriate for Russia and Ukraine, the working group believes that transition to a market system should be pressed diligently and deliberately, taking into account the major adjustments which must be made by society to adapt.*

The Atlantic Council offers these recommendations as a constructive contribution to the revitalization of the energy sectors at a time of economic and social difficulty in Russia and Ukraine.

David C. Acheson
PRESIDENT

David A.
FYI

III. OVERALL ECONOMIC AND LEGAL POLICIES — RECOMMENDATIONS FOR RUSSIA AND UKRAINE

1. Both countries should take deliberate actions to move their economies to market prices.

2. Stabilizing of the *ruble* (Russia) and the *coupon* (Ukraine) and achieving the convertibility of these currencies are critical.

3. Inflation should be reduced to a range of 10 to 20 percent a year to contribute to the stability of these currencies, to foster the use of credit on a responsible basis, and to moderate the impact on personal and enterprise incomes.

4. The use of liberal credit and loan forgiveness to maintain enterprises which are not economically viable must be dramatically reduced. Such credit should be supplied as part of a long-term plan, which would include specific restructuring and downsizing of industrial sectors and large enterprises.

5. There must be greater recognition that the success of an enterprise is based on an economic setting in which prices recover costs and allow for capital formation, and competent management is fostered. Competent management is more important than ownership structure in developing effective industry. Privatization alone is not a panacea.

6. Particular efforts should be made by each republic to identify economically viable sectors and enterprises and redirect capital to strengthen such institutions.

7. Steps must be taken to foster the creation of domestic capital which can be used to revitalize promising industry sectors and undertake new ventures.

8. The governments of republics, and central banks and individual enterprises must come to recognize that access to international capital markets and foreign

United States Department of State

Bureau of Oceans and International Environmental and Scientific Affairs

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FAX TRANSMISSION

DATE: 18 February 1994

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TO: Interagency Working Group for Islands Conference

SUBJECT: Meeting 22 February 10:00 Room 1406 (next to Loy Henderson Conference Room - use C Street Entrance)

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Issues to Be Addressed by Russia and Ukraine in the Energy Sector

ISSUE	PRIMARY CONCERNS
Market Pricing	• Pricing of exports and energy resources for domestic use • Impact of non-convertibility of *ruble* and *coupon* • Economic and social impacts
Investment	• Investment funds from profits limited by controls on prices and costs • Lack of credit availability because of weak banking sectors and high inflation • Private control of natural resources
Legal Regimes	• Responsibilities/authorities of levels of government not defined • Ownership rights limited • Due process lacking • Contract sanctity and dispute settlement weak
Taxation	• Taxes unpredictable and sometimes based on production levels rather than profits • Split of profits between investors and government unclear • Split of profits among levels of government unpredictable and unstable
Competition	• No competition allowed in some energy sectors • Limited effort to trade off optimizing service efficiency through monopolies and benefits of competition to consumers
Foreign Investment	• Relative role of foreign investment not defined • Balance between encouragement of foreign investment and control not defined • Role of production-sharing contracts inadequately defined
Government Responsibilities and Authorities	• Relations between government of a republic and other political institutions unclear • Intra-republic relations often contentious
Responsibilities to Various Stake Holders (consumers, employees, owners, governments, etc.)	• Lack of systems, legislation and contracts which balance interests of all groups • Lack of a "safety net" to provide services to the general population as industry changes • Labor-management relations
Energy Efficiency	• Impact of higher prices on efficiency *vs* overall economic impact
Environmental Performance	• Inadequate management and worker training • Lack of investment funds • Insufficient technology transfer, in particular, in coal, oil, nuclear, and electric power sectors • Establishment of performance standards rather than requiring specific actions • Safety/health of workers and general population • Safety of nuclear facilities
Information Systems	• Lack of standardized data on energy systems

INTERNATIONAL COOPERATION TO ASSIST RUSSIA AND UKRAINE
THE THE ENERGY SECTOR

Recommendations

1. *This Atlantic Council project should form a working group to develop—in cooperation with the project's sponsoring organizations and their respective governments—an in-depth plan for U.S.-Japanese cooperation on technological and financial assistance and management training.*

2. *A series of U.S.-Japanese private sector seminars should be organized for Russian and Ukrainian policy-makers and operating executives to discuss the benefits of foreign investment, with particular emphasis on technology transfer, transfer of managerial practices and capital availability. Over time this program should include internships and other assignments providing continuing exposure to Western companies and decision-making.*

3. *A project should be undertaken under the auspices of Partners in Economic Reform (PIER) and appropriate groups in Japan, Russia and Ukraine to identify the most important coal burning technologies, taking into account cost/benefit calculations. This team should work with governments and the World Bank to develop a major five-year schedule for introducing such technologies.*

4. *A project should also be undertaken by such organizations as the U.S. Agency for International Development, the Energy Conservation Center (Japan) and appropriate groups in Russia and Ukraine to identify cost-effective ways in which the World Bank could increase its effort to significantly improve energy efficiency. Existing energy efficiency centers in Russia and Ukraine should play a key role in this endeavor.*

MOVEMENT TO MARKET PRICES

Recommendations

1. *Governments should develop a specific set of goals to move over a period of two to seven years to market prices. An intermediate goal (two to four years) should be to move to prices which will cover all costs of production—including, for example, operating costs, depreciation, taxes, royalties, and profit.*

   Subsidies should be provided to the extent necessary to compensate lower income groups, rather than maintaining low prices for all. Funds could be made available from royalties paid by oil and gas producers. Some of the earnings from exports of energy should be used to provide such subsidies. Provisions will also have to be made to assist workers facing unemployment because of bankruptcy of firms, and when possible, to restructure firms to undertake new activities.

2. *Russia and Ukraine should cooperate with the International Monetary Fund's (IMF) overall programs aimed at stabilizing their currencies. Within the framework of such cooperation, the IMF should increase assistance to Russia and Ukraine in adjusting to market prices for energy resources which would augment funds from export earnings or royalties.*

3. *The governments of Russia and Ukraine should recognize that in cases where monopolies are maintained, the prices charged by monopolies should be regulated. In establishing such regulation, market prices for competitive fuels must be taken into account.*

4. *Governments providing technical assistance should increase efforts relating to energy efficiency to help moderate the impact of higher prices by:*

   a. *reducing manufacturing and other costs.*
   b. *reducing energy demand, which should also contribute to increasing potential for energy exports.*

DOMESTIC CAPITAL FORMATION

Recommendations

1. *Economic policy and the legal system must be predictable and economically sound if capital is to be generated from investment and reinvested in the energy sector.*

2. *Prices and tax regimes must allow for the generation of profits by domestic and foreign investors to provide dividends to investors and generate capital for reinvestment.*

3. *Novel approaches should be encouraged to foster capital formation and to obtain credits on the international credit market. One such approach could involve the use of gas in storage in Western Europe as collateral for loans.*

4. *The governments of Russia and Ukraine should create special funds to invest in major infrastructure developments such as transportation systems—including pipelines. These funds could be established through a users' fee.*

SOUND LEGISLATION FOR INVESTMENT

Recommendations

1. *The governments of Russia and Ukraine should recognize the urgency of drafting legislation if domestic and foreign investments are to meet the capital needs of the energy sector.*

2. *The sound principles of the European Energy Charter should be followed in developing legislation.*

3. *The IEA and the World Bank should offer increased training opportunities on investment decision-making for government policy-makers and heads of enterprises in both Russia and Ukraine.*

4. *Energy companies in various energy sectors should create and offer two-to-three week intensive training programs on investment decision-making in national languages for senior executives of Russian and Ukrainian energy enterprises.*

5. *Russian and Ukrainian policy-makers should participate in a two-to-three week intensive program on international law relating to foreign investment.*

TAXES

Recommendations

1. *Russian and Ukrainian authorities should develop a deeper understanding of the optimum tax take from various types of ventures, as well as the need to levy taxes on profits, not investment or overall production or sales. In addition, overall tax burdens should be predictable for a number of years. This is especially critical as investors initially enter a country looking for signals from its government that it recognizes the desirability of predictability in government policies.*

2. *Various levels of governments having a stake in an energy project should create commissions to reach agreements on tax take and other financial benefits (percent of resources available for sale by government) before a project is undertaken, and not change these government takes until there is full discussion with managers and owners of the project on the economic implications of change.*

3. *The commissions formed should work with comparable bodies in other republics to develop tax treaties to avoid double taxation among republics; exchange information on tax legislation; help assure transparency; and to create institutions to resolve disputes.*

4. *The OECD should convene a series of tax seminars to assist the republics in undertaking the above endeavors.*

FOSTERING COMPETITION

Recommendations

1. *The European Community (EC) and the OECD should cooperatively undertake a continuing, long-term series of seminars on competition laws and enforcements for government and enterprise representatives of Russia, Ukraine and other NIS republics. These seminars should cover, among other subjects, economic benefits of competition, formulation of legislation, and specific application of competition laws in the energy field.*

2. *Russia and Ukraine should adopt trade and investment policies which encourage competition.*

3. *Studies should be undertaken in the oil, gas and coal sectors to review the long-term benefits of competition. At the same time, a study should be initiated to review the experiences of other countries with balancing reliability and efficiency of service with competition in the electric power sector.*

4. *As legislation is drafted to enhance competition, it should:*

   - *prohibit abuse of a dominant position;*
   - *prohibit participation in or support of international or domestic cartels;*
   - *"allow purchasers, distributors and businesses freedom to resell, export, purchase and develop their operation consistent with law, trade conditions, the need for specialization and sound commercial practice."*[3]
   - *foster international cooperation on competition issues.*

ROLE OF FOREIGN INVESTORS

Recommendations

1. *The full range of possible benefits of production-sharing agreements, concessions and service contracts for governments, national companies and foreign investors should be evaluated.*

2. *The law "On Foreign Investments" should establish a firm legal framework for production-sharing, concessions and service contracts in addition to joint ventures.*

3. *Russia and Ukraine should consider the concept of* **special energy economic zones**, *in which foreign direct investors could fully manage and finance projects. Government take would be determined by contracts having a 25 to 30 year life. Such special economic zones could be established in oil and gas exploration and production, coal development and electric power production. In some cases, for example gas turbines for electric power generations, agreements might include transfer to governments or indigenous private companies after a period of time.*

RESPONSIBILITIES & AUTHORITIES: CENTRAL GOVERNMENT & OTHER POLITICAL UNITS WITHIN A REPUBLIC

Recommendations

1. *Russia and Ukraine should form national commissions, composed of representatives of central and regional governments, to review current authorities and responsibilities for energy and environmental legislation, and recommend principles to guide development of legislation. These commissions should also establish rules for determining which government representatives should sign contracts.*

2. *Major areas which should be reviewed include:*

   Interstate commerce*—There is a critical need to ensure the free flow of goods and services across all regions by avoiding a patchwork of different, and potentially inconsistent, requirements. Transportation regulations need to be standardized to ensure equipment compatibility and consistency in meeting health, safety and environmental standards. In the energy sector, for example,this is essential to the efficient operation of pipelines. Similarly, consistency in fuel and vehicle specifications may require scrutiny at the republic level.*

   Trade and monetary policy*—To facilitate greater trade among republics or internationally, policy-making on trade issues should be based at the national/republic level. Policy-making should address issues such as export/import licensing, tariffs, currency convertibility, exchange rates, earning repatriation, etc. Decisions relative to monetary supply, interest rates, etc., are also best coordinated at the national/republic level.*

   Energy*—Republics should have prime responsibility for energy legislation, including determination of property rights and licensing. Republics should also play a lead role in establishing taxation and in pricing policies in the energy area. Goals regarding energy production targets, the optimal mix of energy sources, the desired level of energy imports/exports, etc., might be best considered at the national/republic level with considerable input from local areas. In addition, development of a general leasing schedule might also be coordinated at the republic level. Decisions regarding particular leases and royalties should be left to regional/local decision-makers. Thus, for example, at the republic level, a goal could be set to stabilize production at a certain level within a certain timeframe. To facilitate planning by investors, a multi-year leasing plan setting goals for certain amounts of acreage could be developed. The regions would then identify the most promising areas for leasing and set the schedule for offering specific leases for exploration and development.*

   Environment, health and safety goals*—The setting of broad policy objectives for environmental, health and safety performance standards should be considered at the national/republic level, but with specific decisions on how best to achieve those standards delegated to regional/local governments which can tailor the particular approach to local conditions.*

3. *Consideration should be given to the most effective ways to integrate energy and associated environmental policies. This could be done by giving these responsibilities to a single agency or by forming a commission.*

Recommendations

1. *Because of existing interdependence which cannot be quickly decreased, it is imperative that efforts to help assure free trade and investment among the republics be initiated and pursued.*

2. *Each republic should carefully review the potential for diversifying industrial capacity to the manufacture of energy producing equipment. This would not only benefit the energy sector, but contribute to the overall restructuring of industrial capacity. Any experience gained by Russia should be carefully reviewed in formulating such programs.*

3. *The principles of the European Energy Charter and the Global Agreement on Tariffs and Trade (GATT) should be fostered, following development of a free trade and investment union.*

4. *Consideration should be given to the creation of an institution to foster economic, energy and environmental cooperation among the republics. Such an institution might be modeled on the OECD and include a small governing council, functional committees and a secretariat.*

5. *Individual republics should be encouraged to become members of institutions such as the GATT. Adherence to the principles and rules of the GATT would foster the use of common principles in developing laws and regulations in the vital area of trade.*

6. *The above efforts might be stimulated by orientation programs for selected key officials of the republics on the history and roles of the OECD and the GATT.*

STAKEHOLDERS

~~SHAREHOLDERS~~

Recommendations

The working group recommends a pragmatic approach to this problem, while laws and regulations are developed and implemented. This suggests four actions:

1. *Identification of key stakeholders on a project by project basis.*

2. *Negotiation of contracts between the appropriate entity in each republic and the investor on terms and their respective takes.*

3. *Formal agreement among the key stakeholders in each republic on how the overall take available to the republic should be divided.*

4. *In addition, investors should direct particular attention to identifying stakeholders in a project and make appropriate efforts to address the needs of these stakeholders in planning and implementing projects (including infrastructure).*

ENERGY EFFICIENCY

Recommendations

1. *Move to market prices for energy area over a period of several years.* *(See p.12.)*

2. *Strengthen intergovernmental cooperation to increase energy efficiency.*

3. *Encourage Russia and Ukraine to be active participants in the World Energy Efficiency Association, a non-profit organization designed to exchange information in this area.*

4. *Foster legislation through the introduction of economically viable energy efficiency standards, and the technologies which can improve energy efficiency on an economically sound basis.*

5. *Undertake industry-by-industry, as well as commercial and residential sector, assessments to provide sound bases for action. These assessments should recognize that steps such as metering energy use, maintenance and simple control systems can result in significant energy savings.*

ENVIRONMENTAL PERFORMANCE

Recommendations

1. *Laws and regulations should be written to set performance standards, not to require specific actions or the use of specific technologies.*

2. *Cost effectiveness should be emphasized in evaluating various environmental policy options.*

3. *Strategies to address environmental problems should be as comprehensive as possible, taking into account air, water and land pollution.*

4. *Market-based policies should be encouraged in implementing environmental plans.*

5. *Liability for environmental cleanups should not be made retroactive. Priorities based on cost-benefit analysis should be established and public funds used.*

6. *Investments should be strengthened in the area of management and worker training on how to avoid environmental pollution.*

7. *Efforts to prevent pollution and minimize waste should be encouraged. Maintenance of facilities should be improved. Particular attention should be directed to rebuilding and maintaining pipeline systems.*

8. *Particular attention should be given to the adoption of available coal-burning technologies which can reduce particulate emissions, the release of sulphur and nitrogen oxides, and increase the efficiency of burning coal.*

9. *A study should be undertaken to evaluate the overall benefits (economic and environmental) of the use of renewable technologies, in particular, solar power for remote locations.*

DEVELOPMENT OF INFORMATION SYSTEMS

Recommendations

1. *Russia, Ukraine and other republics should agree on a common database for reporting energy supply/demand data. The system should be compatible with the system used by the IEA.*

2. *An inter-republic Energy Information Commission should be formed to develop and provide overall guidance for the implementation of such a database.*

3. *For successful implementation, each participating republic should establish small statistical groups to systematically analyze data developed throughout each republic. This data would be essential in formulating and implementing republic policies.*

4. *Implementation of such database systems will require widespread introduction of metering systems, systematic maintenance and regular compilation of data on supply and use.*

5. *To assist in this effort, the World Bank and the IEA should develop and sponsor a series of major training programs to review current data systems and sponsor a workshop to design energy database systems for republics of the NIS.*

Some major efforts have been undertaken in Russia to move towards market prices for oil and gas, to develop legislation which will be supportive of investment, and to restructure significant segments of the energy industry.

While recognizing these efforts, the working group believes that in addition to strengthening and/or undertaking the general policies detailed in Section IV, the following actions are necessary:

1. *More rapid movement in the development of general economic policies, legislation and institutions designed to increase economically viable oil and gas production. It is especially important that the work on oil and gas legislation be completed, in particular, addressing concerns regarding property rights, approaches to granting licenses and predictability of taxation. As discussed in Section IV, responsibilities and authorities, it is still essential that the legislative and regulatory powers of the central and regional governments be clarified in the constitution and in legislation.*

2. *Improvement of management practices and utilization of global state-of-the-art technology throughout the energy sector. It should be recognized that foreign direct investment provides one of the most rapid routes to bring in these advanced technologies and management practices, as well as providing the capital to make required capital investments.*

3. *Development of a long-term plan to improve the productivity, environmental performance and safety of coal mining operations and to reduce subsidies in the coal industry.*

   - *Interested governments should cooperate with the World Bank six-month effort to develop a restructuring plan for the coal industry. This study will look into approaches to addressing unemployment, creating a safety net for miners and increasing energy efficiency in the coal industry.*

   - *Consideration should be given to mounting a small-scale pilot project to set up specific mechanisms to assist miners and communities in adjusting to mine closings.*

4. *Increased efforts to rehabilitate pipelines.*

5. *Development of treaties with other republics regarding transit, regulation and tariffs for pipelines and other energy transportation systems.*

6. *Continuing measures to rationalize the structure, financing, pricing, mix of generation technologies, fueling, efficiency, and environmental requirements for the electric power industry.*

7. *Enhancing measures to establish up-to-date norms for safety and performance of nuclear facilities, and to meet such norms subject to shut-down penalties. The 50 principles developed by the International Nuclear Safety Advisory Group (INSAG) of the International Atomic Energy Agency (IAEA) should be used to guide operations of existing plants and the design and construction of new plants.[8] These principles are dependent on establishing a rational*

Recommendations

Ukraine should devote particular attention to developing and implementing the policies presented in Section IV of the paper (Conclusions and Recommendations). In addition to actions already underway, the working group recommends the following:

1. *Continued emphasis on the critical importance of energy conservation and particular efforts to move to market prices to foster conservation. In particular, the Energy Savings Institute of the Ukrainian Academy of Sciences should develop a program in cooperation with counterpart U.S. and Japanese institutions to focus on industrial energy conservation.*

2. *Undertaking a major one-to-two year study to lay out a long-term plan to restructure the electric and coal industries. (See Section V on Russia.)*

3. *Development of a comprehensive approach to optimizing oil and gas production. Ukraine should also accelerate discussions with foreign oil and gas enterprises to conduct geological studies to better determine the resource base for oil and gas.*

4. *Continued efforts to improve the safety and effectiveness of nuclear plants to meet up-to-date norms. These revisions should establish shut-down penalties for serious violations. (See Section V on Russia.)*

THE ATLANTIC COUNCIL
OF THE UNITED STATES

Basic Concepts for the Development of

Energy Policies for Russia and Ukraine

A U.S.-Japanese-Russian-Ukrainian Cooperative Approach

POLICY PAPER

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