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# **The Privatization of the Russian Coal Industry**

## **Policies and processes in the transformation of a major industry**

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In the early 1990s, Russia implemented mass privatization with swift ownership changes in many industries. A notable exception was the coal sector, one of the world's largest, which was in deep crisis and unable to function without massive subsidization. The Government undertook a far-reaching program of sector restructuring, closing heavily loss-making mines and cutting subsidies. The positive impact of the restructuring program led to a slow but sustained improvement in the industry's attractiveness to private investors and by end-2001, some 77% of coal output was accounted for by private operators. The paper provides reasons for a different approach to privatizing an industry with a record of serious social, environmental and labor problems and looks at the risks ahead.

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## **ABSTRACT**

This paper provides an overview of the privatization of the Russian coal industry. It reviews the salient aspects of the Government's privatization policy as it evolved over the years, and looks at the reasons for the successes and the pitfalls encountered along the way. Specific procedures and methods of sale are described in detail. A profile of the new owners of the industry is given, with a look at the implications for competition in the industry and at first performance indicators. As the World Bank has been closely involved in the support of the Government's coal sector restructuring program through provision of financing and policy advice, throughout the paper aspects of World Bank advice are considered.

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## **EXECUTIVE SUMMARY**

In 1993, the Government of Russia embarked upon a major restructuring of the country's coal industry, which was virtually entirely State-owned at the time. While the question of the future ownership of the industry was much-discussed in the first years of restructuring, the industry's ownership structure remained mostly unchanged until the end of 1997. Four years later, by the end of 2001, privately-owned Russian coal companies produced around 77% of the industry's output, and privatization proceedings were underway for the last major coal companies remaining in State ownership. Accordingly, it is expected that by the end of 2002, over 90% of the industry's output will be in private hands. This remarkable ownership transformation has taken place over just a few years despite the widespread perception of the Russian coal industry as a troubled, loss-making industry with a potentially militant work force. Seen from this point of view, the experience of the privatization of the Russian coal sector clearly demonstrates that perceptions of a major industry and its attractiveness to investors can change dramatically over a short period of time.

This paper provides an overview of the privatization of the Russian coal industry. It reviews the salient aspects of the Government's privatization policy as it evolved over the years, and looks at the reasons for the successes and the pitfalls encountered along the way. Specific procedures and methods of sale are described in detail. A profile of the new owners of the industry is given, with a look at the implications for competition in the industry and at first performance indicators. As the World Bank has been closely involved in the support of the Government's coal sector restructuring program through provision of financing and policy advice, throughout the note aspects of World Bank advice are considered.

While there are some initial encouraging performance indicators, it is clear that the newly privatized Russian coal companies face a number of challenges that go well beyond ordinary market risk. The note concludes with a look at the problem areas which will require resolution in order to ensure the long-term viability of the privatized Russian coal industry.

### **Key Periods of the Privatization of the Russian Coal Industry**

Three distinct periods can be identified in the privatization of the Russian coal industry. These are: (i) the initial period of spontaneous privatization (1990-1992); (ii) the period of trust management (1995-1997); and (iii) the period of competitive direct privatization (from end-1997 to the present). The significance of each period is briefly described below.

*Spontaneous Privatization (1990-1994).* In the final years of the Soviet Union, transformations in the legal status and organization of State property took place with unprecedented and uncontrolled swiftness. Legislation enacted in this period allowed enterprise managers to exercise more control over the assets they managed, which in many

cases resulted in the assumption of actual ownership of the concerned assets. In the coal sector, the groundwork was laid during this period for the eventual privatization (through leases with the option to purchase) of some choice assets, including Russia's largest and one of its most efficient underground mines. In all, however, these assets represented less than 10% of production.

*Trust Management (1995-1997).* At the outset of coal sector restructuring, even ardent proponents of privatization in Russia believed that direct privatization was not an option for the Russian coal industry. In addition, there was outright opposition to privatization on the part of the influential industrial lobby. To the limited extent that reform of the industry's ownership structure was identified as a goal of the first phase of the Government's coal sector restructuring program, the focus was on measures to complete the corporatization of the industry, establish competitive coal companies capable of self-financing on a long-term basis, and transform the management structure of coal sector enterprises. In response to the World Bank's advice that a clearly articulated policy of privatization would be the best means to achieve the goal of a competitive and viable coal industry, the Government proposed the gradualist approach of trust management, whereby independent trust managers, in return for a fee, would carry out the restructuring of selected coal companies in preparation for their eventual privatization.

A host of factors detracted from the overall credibility of the trust management process as developed in the case of the Russian coal industry, and discouraged the participation of reputable independent trust managers in the competitive tender process. These included: the inadequacy of the legal framework developed for trust management; the insufficiency of the company information that was provided for the preparation of bids; the unattractiveness of some of the companies proposed for trust management; the failure to develop a legally viable, straightforward mechanism for the remuneration of trust managers linked to performance results; and vagueness in the formulation of the obligations of trust managers, particularly vis-à-vis eliminating company debts (including significant levels of wage arrears.)

*Competitive Direct Privatization (end-1997—present).* The flaws of the trust management approach began increasingly to be acknowledged in the first half of 1997, when the Government and the World Bank began discussion of a possible second adjustment loan in support of coal sector restructuring. The Government subsequently adopted the policy of competitive direct privatization of the coal industry. The process has not been without controversy and delays of one sort or another, and has been particularly sensitive to changes of Government and other events in the life of the country that threatened to undermine the overall commitment to privatization, or to jeopardize the transparency of the privatization transactions. Nonetheless, competitive direct privatization has resulted in the transfer of the State's ownership interest in the larger part of the Russian coal industry, and ultimately has proven the most effective approach to preserving and strengthening the viable core of the Russian coal industry.

## **Privatization Success Factors and Challenges for the Future**

The privatization of the Russian coal sector is a relatively recent phenomenon that took place in the context of a complex struggle for the control of the valuable assets of the Russian coal industry. Real progress in this area became possible only after the Government recognized the flaws of the trust management policy, which lent itself to abuse by those eager to justify a “go-slow” approach, in some cases with the goal of gaining control over the assets being offered for trust management. It is likely that had this approach prevailed, the ultimate effects would have been to delay privatization of the coal industry by many years and to preclude direct competitive privatization altogether, which could ultimately have caused the industry more harm than good.

While the involvement of the World Bank provided a certain financial incentive to advance reform and helped establish a framework for the policy dialogue that facilitated the privatization of the Russian coal sector, this factor alone is not sufficient to explain why the privatization of the Russian coal sector has, to date, succeeded beyond most expectations. Without the Government’s underlying commitment to reform (attributable in part to the sector’s long-standing drain on the economy), the privatization of the industry would not have happened. Other key factors that contributed to the successful privatization of the sector include:

- The liquidation at the end of 1997 of Rosugol, the national coal monopoly, which eliminated the opposition to direct privatization on the national level (although regional opposition has remained a force to contend with). This development, which generally cleared the way for the implementation of the coal sector restructuring program, was strongly supported by the World Bank.
- In contrast with the approach taken under trust management, the Government began competitive direct privatization of the industry by offering for sale some of the industry’s most attractive assets, surface mines in Siberia. As these included the industry’s largest producers, the privatization of three companies was sufficient to create a critical mass of private producers and to effect a broad-based change in the perception of the industry and the role of the State in it.
- Coal’s reputation as an undesirable, troubled industry dissuaded Russian investors with considerable financial resources but with no connection to the coal industry from joining the competition for control of the industry, providing various groups with roots in the sector and an understanding of its long-term potential to secure control of the assets offered for sale, and helping establish a competitive industry in which no single group dominates.
- The proven track record of the Government’s program of closure of heavily loss-making mines and significant yearly decreases in the allocation of subsidies to the sector were reassuring to private investors contemplating the acquisition of long-term interests in the coal sector.
- Generally, opposition to privatization from organized labor was not an issue in the Russian coal sector once the Government had clearly demonstrated its

commitment to reducing subsidies regardless of the industry ownership structure, and private owners emerged as better employers than the State.

It is noteworthy that in all cases of competitive sale, the bidders for the assets have been Russian investors, although Russian legislation on privatization does not exclude foreigners. It is possible that foreigner investors might have been attracted to bid on coal sector assets had the Government carried out such best-practice measures as the appointment of investment bank advisors; preparation of financial accounts to international accounting standards; environmental audits; debt restructuring; etc. But these are not standard practice in Russia, and in any event it would be more appropriate to view the absence of foreign investors in the coal sector in the broader context of the general problem of attracting foreign investment into the Russian economy, compounded by specific aspects of the coal sector (the need for long-term financing, limited export potential, etc.) In most cases, and certainly in countries with more attractive investment climates and where environmental standards are more consistently applied than in Russia, the goals of privatization would be more effectively furthered through the implementation of these best-practice measures and with the participation of foreign investors.

The privatization of the Russian coal industry has succeeded to the extent that it achieved the fundamental goal of the transparent transfer of the viable portion of the industry to the private sector. The present coal industry ownership structure indicates that this is one of the most competitive of Russia's natural resource industries. The new owners appear generally to be good corporate citizens, and the initial performance indicators are encouraging, showing an increase in productivity at the privatized mines and good performance in paying down wage and other arrears. At the same time, Russian private coal producers face particular risks beyond the usual commercial risk facing any producer.

These risks derive to a great extent from aspects of the privatization process itself as it took place in Russia and, more generally, from the presently incomplete implementation of the Government's coal sector restructuring program. The particular challenges faced by the industry and the Government include the following:

- Most privately-owned coal companies inherited significant historical tax and other liabilities, as these were not written-off at the time of privatization.
- The regulatory framework is inadequate for the needs of both the State and the newly privatized industry.
- The industry faces a potential investments crisis resulting from its limited access to reliable, long-term investment financing.
- No accountability has been assigned for certain environmental liabilities.
- The industry is susceptible to interference from regional administrations.
- A potential future concern is the possibility of the concentration of ownership in the hands of a limited number of financially powerful groups, raising the question of whether there is a need for enhanced anti-monopoly controls, for example, over subsequent share transactions.

Clearly, these risks vary in their sensitivity to policy intervention by the Government, and even more so in terms of the Government's ability to address them adequately through pre-privatization measures. Of those listed above, the problems that can most effectively be avoided through the proper design of a privatization program are those where the fundamental risk derives from an inadequate definition of the liabilities attached to the enterprise to be privatized, including liabilities of a known value (such as taxes and debts to creditors) and contingent liabilities, such as environmental and health damage, where credible estimates of the potential cost of the liability are usually not available. The Government also clearly plays the leading role in reforming the regulatory framework so that it responds to the changed circumstances of industry ownership and the evolving role of the State as the regulator and guarantor of anti-monopoly policies.



## **INTRODUCTION**

In 1993, the Government of Russia embarked upon a major restructuring of the country's coal industry, which was State-owned with the exception of some private producers accounting for less than 10% of total production. The initial focus of restructuring was on implementing a program to close heavily loss-making mines and on reducing subsidies to the sector; while the issue of the future ownership of the industry was much-discussed in the first years of restructuring, the industry's ownership structure remained essentially unchanged until the end of 1997. Four years later, by the end of 2001, privately-owned Russian coal companies produced around 77% of the industry's output, and privatization proceedings were underway for the last major coal companies remaining in State ownership. Accordingly, it is expected that by the end of 2002, over 90% of the industry's output will be in private hands. This remarkable ownership transformation has taken place over just a few years, with the critical periods of change occurring in the years 1998 and 2000, despite the widespread perception of the Russian coal industry as a troubled, loss-making industry with a potentially militant work force. Seen from this point of view, the experience of the privatization of the Russian coal sector clearly demonstrates that perceptions of an industry and its attractiveness to investors can change dramatically over a short period of time.

This paper provides an overview of the privatization of the Russian coal industry. It reviews the salient aspects of the Government's privatization policy as it evolved over the years, and looks at the reasons for the successes and the pitfalls encountered along the way. Specific procedures and methods of sale are described in detail. A profile of the new owners of the industry is given, with a look at the implications for competition in the industry and at first performance indicators. As the World Bank has been closely involved in the support of the Government's coal sector restructuring program through provision of financing (for budgetary support and technical assistance) and policy advice, throughout the note aspects of World Bank advice are considered.

While there are some initial encouraging performance indicators, it is clear that the newly privatized Russian coal companies face a number of challenges that go well beyond ordinary commercial risk. The note concludes with a look at the problem areas which will require resolution in order to ensure the long-term viability of the privatized Russian coal industry.

## **KEY PERIODS OF THE RUSSIAN COAL INDUSTRY**

Three distinct periods can be identified in the privatization of the Russian coal industry: (i) the initial period of spontaneous privatization; (ii) the period of trust management; and (iii) the period of competitive direct privatization.

*Spontaneous Privatization (1990-1994).* The tumultuous final years of the Soviet Union affected the coal sector along with the rest of the economy. Transformations in the legal status and organization of State property took place with unprecedented and uncontrolled swiftness; so, for example, a wholly-owned State enterprise could be

transformed into a joint-stock corporation in a matter of days, on the authority of the State Property Committee alone. Such transformations had far-reaching implications for the legislative framework applied to the enterprise's operations, and facilitated the efforts of company insiders to gain ownership control over the State-owned assets with whose management they were charged.

The Law on State Enterprises (1987) allowed enterprise managers to exercise more autonomy at the expense of the line ministries, which had previously placed considerable restrictions on the managers' power over state-owned enterprises (SOEs). In 1988, the leasing of SOEs and cooperatives was permitted. Small private companies, limited liability companies and joint-stock companies were allowed in 1990. In many cases, instead of improving the productivity and strengthening the public benefits of the SOEs, managers diverted profits and engaged in asset-stripping both legally (through leaseholds and cooperatives) and illegally (by showing a fraction of actual profits and paying exorbitant employee bonuses and benefits.) In the coal sector, spontaneous privatization accelerated in 1991 as employees were permitted to purchase options in lease agreements with the new right to set up joint-stock companies, often buying leased assets at book value, which was a fraction of their true value. All mines privatized during this period were set up as joint-stock companies with ownership dispersed among their employees, some even without the consolidation of control by the managers, and were called (after the legacy of strict State control) "people's enterprises".

There are two distinct aspects of the legacy of this period for the privatization of the coal sector. First, the groundwork was set for the eventual privatization (through leases with the option to purchase) of some choice assets, including Russia's largest and one of its most efficient underground mines; in all, however, these assets represented less than 10% of production. With the exception of one mine, these mines have remained private, although in many cases ownership has changed hands, sometimes more than once. Control has gradually been consolidated in the typical case, as employees tend to sell their shares.

Second, in an effort to assert control over the rapid transformation of ownership of the economy's productive assets, and specifically to prevent the divestiture of the State's most valuable assets, the Supreme Soviet introduced the concept of "reserving" the Federal shares in a State enterprise, making it impossible to privatize the enterprise. The reservation of Federal shares in coal companies precluded their inclusion in the mass privatization program of 1992-1994, during which period some 75% of the economy's productive assets and output with 50% of the SOE workforce passed into private ownership.

In order to reserve the Federal shares in an enterprise, the issuance of a Presidential Decree or a Government Resolution is required. Similarly, in the event that the decision is taken to privatize an enterprise in which the Federal shares have been reserved, another Presidential Decree (or Government Resolution) is first required to "unreserve" the shares. This procedure remained as a feature in subsequent phases of the privatization of the coal industry. The Russian experience has indicated that this process can take up to several months and requires constant attention from the ministries responsible for privatization. This additional procedural complexity was a response to unique historic circumstances; in

a more stable environment it would be inadvisable to further complicate the already complex process of privatization.

*Trust Management (1995-1997).* To the limited extent that the Government's first formal policy paper on coal sector restructuring (approved mid-1995) identified as a goal the reform of the industry's ownership structure, its focus was on measures to demonopolize and commercialize the industry, not on the divestiture of the State's overwhelming ownership interest in the sector. The reasons for this ranged from the outright opposition to privatization on the part of the influential industrial lobby, to the more widely held conviction that the dire condition of the Russian coal industry precluded its direct privatization. The general view in Russia was that before it would be possible to proceed to privatization, the Government needed to complete the corporatization of the industry, establish competitive coal companies capable of self-financing on a long-term basis, and transform the management structure of coal sector enterprises.

The World Bank supported the Government's vision of a competitive coal sector, and believed that a clearly articulated policy of privatization would be the best means to achieve this end. In part in response to the advice of the World Bank that the viable core of the industry should be transferred progressively to the private sector, the Government proposed the gradualist approach of trust management, whereby independent trust managers, in return for a fee, would be responsible for the restructuring of selected companies in preparation for their eventual privatization; it was generally thought that the preparation period would last around three years once the trust manager was appointed and in place. From the point of view of the World Bank, trust management was a second-best option, but, as noted above, the Government was not willing to consider direct privatization. In its mid-1996 agreement with the World Bank for the first coal sector adjustment loan in the amount of \$500 million (Coal SECAL 1), the Government committed itself to specific targets in the area of trust management. In the event, while a number of companies were proposed as candidates, the Government did not meet the target of appointing trust managers for companies accounting for 25% of 1995 production. Trust managers were eventually appointed at two companies whose combined total production represented only about one-third of the target level.

As became increasingly clear towards the end of 1996 and into the first half of 1997, when the Government and the World Bank began discussion of a possible second adjustment loan in support of coal sector restructuring, the interim policy of trust management was problematic and, moreover, imposed unnecessary costs and other burdens on the Government.

A host of factors detracted from the overall credibility of the trust management process as developed in the case of the Russian coal industry, and discouraged the participation of reputable independent trust managers in the competitive tender process. Generally, the legal framework developed for trust management was inadequate and in some points contradicted higher order Russian legislation, which led to considerable delays in implementing the policy. Specific deficiencies included: the inadequacy of the company information that was provided for the preparation of bids; the unattractiveness of some of the companies proposed for trust management; the Government's failure to develop a

legally viable, straightforward mechanism for the remuneration of trust managers linked to performance results; and vagueness in the formulation of the obligations of trust managers, particularly vis-à-vis eliminating company debts (including significant levels of wage arrears.) Another flaw in the design of the system was the ambiguity over whether the trust manager would be allowed to participate in the eventual privatization. Had the trust management period lasted longer, this ambiguity would have served as a deterrent to both trust managers and potential bidders for the asset to be privatized. Trust management deals were generally lacking in transparency, were particularly vague regarding property rights, and had devastating results for at least one company which, instead of being restructured, ended up in bankruptcy.

While it was intended as a compromise policy, as an interim approach with particular legal and procedural complexities and deficiencies, trust management lent itself to abuse by those eager to justify a “go-slow” approach, in some cases with the goal of gaining control over the assets being offered for trust management. It is likely that had this approach prevailed, the ultimate effects would have been to delay privatization of the Russian coal industry by many years and to preclude direct competitive privatization altogether, which could ultimately have caused the industry more harm than good.

As 1997 progressed, the problems of implementing the interim policy of trust management became one of the central points in the dialogue between the Government and the World Bank. The shared recognition of the failure of this approach led to the Government’s decision to adopt the policy of competitive direct privatization, which was supported by the World Bank’s second coal sector adjustment loan (Coal SECAL 2), made available to the Government in December 1997 in the amount of \$800 million. Half of this amount was disbursed upon loan effectiveness, with the remainder to be disbursed over time as specific conditions were met, including conditions directly pertaining to privatization.

*Competitive Direct Privatization (end-1997—present).* Privatization through various methods of competitive sale has resulted in the transfer of the State’s ownership interest in the larger part of the Russian coal industry. The process has not been without controversy and delays various sorts, and has been particularly sensitive to changes of Government and other events in the life of the country that threatened to undermine the overall commitment to privatization or to jeopardize the transparency of the privatization transactions. Nonetheless, competitive direct privatization ultimately has proven the most effective approach to preserving and strengthening the viable core of the Russian coal industry.

The table below shows the Russian coal companies that have been privatized through competitive sale from late 1997 through the end of 2001 (corresponding to the period of effectiveness of Coal SECAL 2) with information on the number and type of auctions, the size of the Federal package, and each company’s share in total current industry production.\* The figure for non-competitively privatized production includes the

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\* Under Russian law, a “private” entity is a company or partnership in which the State owns less than 25% of the shares or other property rights. As defined in the Government’s agreement with the World Bank for Coal

companies privatized in the period of spontaneous privatization and also a number of more recent cases in which ownership control has passed to private owners in ways that do not conform to the definition of privatization agreed with the World Bank, for example, through bankruptcy or through legally questionable removal of individual mines from companies (these are generally small producers). Finally, a small percentage of current production is accounted for by *de novo* producers.

Table 1. Privatized Russian coal companies: auction details and share in production.

<b>Company</b>	<b>Date(s) of sale</b>	<b>Method(s) of sale</b>	<b>Federal package (% total shares)</b>	<b>% 2000 production</b>
Yuzhny Kuzbass (surface)*	12/97; 12/98	CT/IC;SpecAuc; StanAuc	80.3 (25.5, 28.8, 26.0)	4.3
Kuzbassrazrezugol (surface)	12/97; 12/98	CT/IC;SpecAuc; StanAuc	80.4 (25.5, 28.5, 26.4)	13.4
Krasnoyarskugol (surface)	2/2000	CT/IC	75.4	14.6
Mezhdurechenskugol	6/2000	CT/IC	100.0	0.7
Chitaugol (surface)	10/2000	StanAuc	15.75	4.3
Khakasugol (surface)	11/2000	SpecAuc; StanAuc	81.7 (43.0, 38.7)	0.6
Vostsibugol (surface)	2/2001, 12/2001	SpecAuc; StanAuc	41.5 (20.0; 21.5)	7.2
Kuznetskugol	6/2001, 7/2001	Two SpecAuc	80.7 (40.0; 40.7)	4.0
Kuzbassugol	8/2001, 9/2001	SpecAuc	79.37 (39.37; 40)	6.5
Kiselevskugol	12/2001, 12/2001	Two SpecAuc	65.2 (32, 33.2)	0.7
<b>Total privatized at end 2001 (competitive privatization)</b>				<b>56.2</b>
<b>Other private producers (non-competitive privatization)</b>				<b>17.4</b>
<b>De novo firms</b>				<b>3.8</b>
<b>TOTAL private sector share of current coal production, end 2001</b>				<b>77.4</b>
<i>Privatization in process:</i>				
Dalvostugol	1/2002	StanAuc	40.3	0.8

StanAuc = standard auction.

SpecAuc = specialized auction.

CT/IC = commercial tender with investment conditions. \*“(surface)” indicates primarily surface producer.

In all cases of competitive sale, the bidders for the assets have been Russian investors, although Russian legislation on privatization does not exclude foreigners. It is possible that foreigner investors would have been attracted to bid on coal sector assets had the Government carried out such best-practice measures as the appointment of investment bank advisors; preparation of financial accounts to international accounting standards; environmental audits; debt restructuring; etc. But this is not standard practice in Russia, and it would have been unrealistic to expect the Government to make an exception in the

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SECAL 2, “privatization” means the competitive sale to the private sector of all Federal shares in a company, with the exception of the golden share. It does not preclude an ownership interest of regional or local governments. These, however, are generally small, below the 25% required to block a vote, and the tendency has been for regional governments to sell their shares to the private sector.

case of the coal industry. It would be most appropriate to view the absence of foreign investors in the coal sector as an aspect of the general problem of attracting foreign investment into the Russian economy, compounded by specific aspects of the coal sector (the need for long-term financing; limited export potential; the well-known and negative precedent of a foreign owner of a mine which suffered a bad explosion and subsequently closed etc.)

While the involvement of the World Bank provided a certain financial incentive to advance reform and helped establish a framework for the policy dialogue that facilitated the privatization of the Russian coal sector, this factor alone is not sufficient to explain why the privatization of the Russian coal sector has, to date, succeeded beyond most expectations. Without the Government's underlying commitment to reform (attributable in part to the sector's long-standing drain on the economy), the privatization of the Russian coal industry would not have happened. Other key factors that contributed to the successful privatization of the sector include:

- The liquidation at the end of 1997 of Rosugol, the national coal monopoly, which eliminated the opposition to direct privatization on the national level (although regional opposition remained a force to contend with). This development, which generally cleared the way for the implementation of the coal sector restructuring program, was strongly supported by the World Bank.
- In contrast with the approach taken under trust management, the Government began competitive direct privatization of the industry by offering for sale some of the industry's most attractive assets, surface mines in Siberia. As these included the industry's largest producers, the privatization of the first three companies shown in Table 1 was sufficient to create a critical mass of private producers and to effect a broad-based change in the perception of the industry and the role of the State in it.
- Coal's reputation as an undesirable, troubled industry dissuaded Russian investors with considerable financial resources but with no connection to the coal industry from joining the competition for control of the industry, providing various groups with roots in the sector and an understanding of its long-term potential to secure control of the assets offered for sale, and helping establish a competitive industry in which no single group dominates.
- The proven track record of the Government's program of closure of heavily loss-making mines and significant yearly decreases in the level of subsidies to the sector were reassuring to private investors contemplating the acquisition of long-term interests in the coal sector.
- Generally, opposition to privatization from organized labor was not an issue in the Russian coal sector once the Government had clearly demonstrated its commitment to reducing subsidies regardless of the industry ownership structure, and private owners emerged as better employers than the State.

## **INSTITUTIONAL ARRANGEMENTS: WHO DECIDES, AND WHO EXECUTES DECISIONS**

In the period of mass privatization, most of the decisions on the transformation and sale of SOEs were initiated and implemented by the State Property Committee (GKI) headed by Anatoly Chubais, the champion of privatization in Russia. As noted above, the privatization of the coal sector took place mostly after the completion of the mass privatization program, by which time the authority of GKI had declined despite its promotion to the status of ministry. However, in keeping with a Presidential decree from 1992 that mandated the preparation of privatization plans for Russian enterprises above a certain size, privatization plans existed for most coal companies from the early 1990s. Even if there was no particular intention of privatizing the companies, as was the case with the coal industry, these privatization plans eventually proved to be useful documents, as they contained fundamental information on each company that might otherwise have been difficult and time-consuming to collect by the time it was needed.

For most coal companies sold through competitive privatization, the decision to privatize emerged as a consensus between the three major agencies involved, the Ministry of Energy (MoE) (which after the liquidation of Rosugol assumed management responsibility for the State's holdings in the coal sector), the Ministry of State Property Relations (MGI) and the Russian Federal Property Fund (RFPF), which is the sales agent.\* The role of the Ministry of Finance (MoF) is limited to participation in the commission that sets the floor price. MoF has no role in the preparation and execution of the transaction. The form of sale has been specified in the Presidential decree (alternatively a Government Resolution) to "unreserve" the Federal block of shares in the company.

MGI is responsible for preparing the privatization plan (or revising the existing plan from the early 1990s), which becomes the share issue prospectus upon approval. MGI also looks at the financial and social condition of the enterprise. Operational issues are looked at by the line ministry, MoE. Historically, Rosugol and company management opposed privatization, as it meant a loss of control and influence for both. As it is impossible to privatize a company with active insider opposition in such cases the Government usually had to remove the resisting management. However, the situation today is fundamentally different: MoE increasingly sees its role as a regulator of the sector and believes that its direct operational role vis-à-vis the remaining coal SOEs should eventually be phased out.

RFPF is the sole and exclusive sales representative of the State in privatization transactions. RFPF also sets the sales strategy, appoints an independent appraiser to

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\* Despite the unambiguous nature of RFPF's role, interagency confrontations between MGI and RFPF took place throughout the 1990s. The confrontations began in the early 1990s, when GKI was a stronghold of reformers in the Government and the RFPF reported to the Supreme Soviet, which opposed mass privatization. Although RFPF has since been included in the structure of the Government, frictions remain between the two agencies. The new privatization bill discussed in the Duma in May, 2001 (and still under review in January 2002), includes a proposal initiated by MGI to merge RFPF into its structure; it is not clear what will happen in this regard.

determine the value range of the property to be sold, calls upon the interagency commission to set the starting price of assets, decides on the transaction details (deposits, date of sale, bid collection locations, deadlines for bid submission, etc). The announcement is published in *Reforma* bulletin, the official source of upcoming privatization transactions, which, unfortunately, is published in extremely small edition sizes and not easily obtained. RFPF has not heeded the advice of the World Bank and other donors to provide for a wider circulation of data on companies being privatized (for example, through postings on the Web or increasing the circulation of *Reforma*), citing its need to carry out intricate and sensitive pre-privatization consultations with potentially interested and qualified buyers, who are limited in number for a sector as complex as the coal sector.

## **PREPARATION OF THE COMPANY FOR PRIVATIZATION**

This section reviews various measures that are part of the preparation of a company for privatization, including activities of a procedural nature and activities of a political or consensus-building nature. In some cases, activities are described that are *not* part of the pre-privatization process in Russia. They are included in this discussion because they are typical, if not constant, aspects of pre-privatization preparation of a company, and the Russian experience might suggest lessons of a positive or negative nature.

“Unreserving” of Federal Shares. As explained above, as the Federal shares in coal companies were “reserved”, before the shares can be made available for sale they must be “unreserved”. This necessarily leads to the involvement of Federal agencies other than MGI, whose authority to set policies for privatization extends to “unreserved” assets only.

Consolidation of Shares. Before an enterprise can be privatized, the State’s shares in its subsidiary companies must be consolidated. As repeatedly demonstrated by the experience in Russia, this can be a legally complicated, politically difficult process that encompasses some of the basic challenges of privatization faced by any government, including the need to ensure transparency, equity in the distribution of shares, and the appropriate valuation of assets. As illustrated by the example in Box 1 below, “The Consolidation of a Russian Coal Company”, years could pass before the ownership and financial consolidation of a company were finalized. This was due partly to the delays inherent in the trust management period and the resistance to privatization on the national level, and partly to regional opposition. An example of the latter is the Federal Government’s decision to consolidate surface mines in Irkutsk, Chita and Buryat regions into the company Vostsibugol in 1992. Shares in one of the mines retained by the Irkutsk oblast administration in a form of trust management were finally transferred by the regional authorities to MGI for consolidation into Vostsibugol’s charter capital only in December 2000, in preparation for the announcement of the sale of all Federal shares in Vostsibugol.



### Box 1: The Consolidation of a Russian Coal Company

The privatization of state-owned enterprises (SOEs) in natural resources was handled differently from the privatization of the manufacturing industries in Russia, under rules specified in separate Presidential decrees. Most regional coal companies were established in 1992 by Presidential Decree No. 1702, “On the Corporatization of Coal Companies”, through consolidation of Federal ownership in open joint-stock companies created earlier when some shares of individual mines were bought up, mostly by employees under lease-holding schemes. In the case of Krasnoyarskugol, the largest coal producer in Russia by volume, consolidation entailed a process of merging the ownership of 15 companies, including three major surface mines and 12 auxiliary service companies. As were other regional coal companies, Krasnoyarskugol was formally established in 1992 by exchanging the Federal shares in these 15 subsidiaries for shares of the holding company, Krasnoyarskugol.

In the Federal government’s plan for the initial distribution of shares, the Federal government was to receive 50% of the stock of the subsidiaries, 40% were to be sold to the employees (meaning the actual workforce), and the remaining 10% were allocated to the administration of Krasnoyarsk region. The ownership structure of the holding company at consolidation was different: Federal government, 48%; Krasnoyarsk region, 40%; and employees, 12%. As can be seen, the regional government’s share in the holding company Krasnoyarskugol was significantly higher than its share in the subsidiaries, reflecting a period of increasing regional influence vis-à-vis the center. The Federal government’s shares in the consolidated holding company were transferred to Rosugol for “operational management”, and at the same time were “reserved”.

In 1996, in an effort to strengthen the Federal government’s control over regional coal companies, Presidential Decree No. 168, “On the Enhancement of the Regional Coal Companies” (February 2, 1996), ordered the issuance of additional Federal shares through increased contributions to companies’ charter capital. As a result, the Federal block of shares in Krasnoyarskugol increased to 75.4%, while the share of the region was reduced to 18.8% and the employee-held shares were diluted to 5.8% of ownership (in this context, “employees” refers to employees of the *holding company*, who numbered thirty-six people at the time).

In 1999, when the decision was taken to privatize the company through competitive sale, the company’s ownership consolidation had been completed but it had not yet been financially consolidated. This meant that the subsidiaries essentially continued to function as independent companies, and the State’s control over the assets was weak. Only 5% of the cash flow of the operating subsidiaries passed through the books of the holding company, and despite the fact that receivables were on the rise, fiscal and wage arrears were also increasing.

The financial consolidation of the company was finalized only after the Federal share of 75.4% in the company was sold in February 2000 to a private buyer. The privately-held company has consolidated sales of coal produced by its constituent mines, as well as supplies and cash flows, and has been making timely payments of taxes and wages.

*Divestiture of Social Assets.* Most of the social assets that were on enterprise balance sheets from the Soviet period were transferred to local municipalities throughout Russia by Presidential decree beginning in the early 1990s. By the beginning of the period of competitive direct privatization of the coal sector, these processes were largely completed and most enterprises no longer have social or other “non-profile” assets on their

balance sheets. The few exceptions to this are assets considered by the company management to be of particular value, typically “rest and rehabilitation” types of assets.

*Pre-privatization Restructuring.* The practice in the Russian coal sector has been to refrain from carrying out pre-privatization restructuring on the company level. Among the reasons for this are: (i) the general philosophy at GKI/MGI that the new owner knows best what should be done for the company and that therefore SOEs should be sold “as is”; and (ii) lack of government funding for restructuring. The main advantage to this approach is that it facilitates relatively quick privatization. The risk, of course, is that the company will prove ill-suited to function in the new environment, and it may weaken the new owner’s incentive to manage the privatized company in a responsible fashion with a view towards its long-term sustainability. At the same time, several of the more competently managed State-owned companies have used the period of State-sponsored restructuring of the coal sector to implement company-level restructuring programs, and in many cases these programs have led to significant improvements in the performance indicators of the State-owned companies. In such cases, the personality of the general director of the enterprises and the enterprise’s overall management capacity are the most important factors.

*Financial Restructuring/Write-Offs.* The pre-privatization debts of companies were not written off in the privatization process, and this is one of the primary sources of financial vulnerability that privatized coal companies face today. In those cases where commercial tenders with investment conditions were used as the method of sale (see Table 1), most of the obligations under the so-called “investment conditions” consisted of paying the company’s tax arrears (and associated penalties) to the Federal and regional budgets; thus, these fiscal liabilities were explicitly recognized as a part of the company’s total debts and adequately addressed in the sale process. In all other cases, the existence of the significant debt to all levels of the budget and the various extrabudgetary funds (in which the accrued penalties for non-payment significantly exceed the principal debt) and to other creditors makes even companies with otherwise good prospects susceptible to bankruptcy. In the last year, the Federal government has resolved to eliminate the part of the debt problem that pertains to Federal-level debt through a mandatory debt restructuring program in which indebted enterprises throughout the economy must participate, but this does not address the problem of debts to regional and local governments and to other creditors.

*Environmental Audits.* Under Russian privatization law, the provisions on general liabilities are unambiguous in requiring the seller to disclose all liabilities. However, the law contains no explicit reference to environmental liabilities. References to environmental liabilities are rarely if ever published in *Reforma*, in which all sales of Federal property must be announced in advance. The reality of practice in Russia is that environmental liabilities are not explicitly taken into consideration in the pre-privatization process, and Russian investors do not generally commission environmental audits.

While existing environmental law and regulations in Russia clearly assign responsibility for mitigation of environmental (and any other) damage to the enterprise that caused the damage, legal practice in Russia in relation to the environmental liabilities assumed by the new owner in the case of privatization are ambiguous and as of yet

untested in the legal system. Most likely, some kind of cost-sharing arrangement will be instituted once this issue begins to assume significant proportions. The potential problems arising from this situation and possible solutions are discussed in more detail below in the final section on challenges to the long-term viability of the coal industry in Russia.

Appraisal of Company Value. Before a company may be privatized through a competitive process, its value must be appraised and a starting price established. In most cases MGI and RFPF have accepted the values of coal companies recommended by independent appraisers. If Russia's earlier voucher privatization program was aimed at the rapid distribution of State property with little regard for the price received, the current objectives of privatization now include maximization of proceeds for the State Treasury. Discounted cash flows, industry comparables, and proven reserves (the latter of particular importance for the extractive industries), and mandatory site visits by mining and financial teams are increasingly used as asset valuation techniques instead of residual book values. The World Bank's technical assistance loan was used in a number of cases to finance company valuations. In most of these cases, MGI and the RFPF used the appraisers' values.

Agreement of Plan with Regional Authorities. In a country with a Federal system and complex political relations between the regions and the Federal government, there are risks for the Government both in (i) seeking to agree Federally mandated privatization programs with the regional authorities; and (ii) refraining from doing so. In the experience of the coal sector, specific privatization plans have usually been agreed with regional authorities, although at times this has led to protracted and complicated negotiations, particularly when the regional administration is also a shareholder in the company being privatized. Given that companies are generally more vulnerable to post-privatization interference of one sort or another from regional and local authorities than from the Federal authorities, to the extent possible it would seem most politic to practice a policy of inclusion rather than exclusion, without compromising the Federal government's policy-setting prerogative.

Trade Unions. Privatization plans are not explicitly agreed with the coal trade unions, but the trade unions have been generally accorded an important role as a partner in the development and implementation of the Government's coal sector restructuring program, and they maintain their own dialogue with the private owners of the industry (who now represent their main employer group). The coal trade unions have generally not voiced criticism of either privatization as a policy goal or the manner in which that goal has been pursued. Factors that have contributed to the lack of controversy in this regard are the absence of any major post-privatization reductions-in-force, the private owners' excellent track record in the timely payment of wages and the reportedly higher wages at private companies, and the new owners' willingness, to date, to abide by the provisions of the Sectoral Tariff Agreement, the collective agreement between the union and a group representing sector employers.

The trade unions' important role as a partner in coal sector restructuring has been enhanced by support from the World Bank's technical assistance loan. Over the last five years, financing from this loan has allowed the trade unions to conduct regular seminars on

topical issues in sector restructuring (including on relations with private employers), to maintain legal services in the coal regions, and to carry out monitoring and other activities of relevance to sector restructuring.

*The Role of Technical Assistance.* Technical assistance can be effectively applied to help carry out most of the activities described above. In the case of the Russian coal sector, the World Bank's technical assistance loan was used to finance such privatization-related activities as: a privatization expert on the staff of the implementing agency; business appraisals and initial price calculations for some coal companies; and the development of a pre-privatization restructuring program for a State-owned company (Intaugol). In addition, numerous technical assistance activities have been used to strengthen management capacity at both private and State-owned coal companies (e.g., a major management and financial training program) and to further the policy dialogue in ways that help secure the success of the State's divestiture of its ownership interest in the coal sector (e.g., environmental audits at continuing mines and a review of the legislative/regulatory framework to make it more consistent with the industry's present ownership structure and future needs.) Technical assistance was also used to finance stakeholder support programs and public relations campaigns, and these are invaluable in helping to inform the concerned public and to create a positive atmosphere for the execution of the Government's privatization policy.

## **METHODS OF SALE: STRATEGIC AND PRACTICAL CONSIDERATIONS**

This section reviews methods of competitive sale that have been used in the privatization of the Russian coal industry. While each method is described individually, in practice two or more methods may be used to sell the Federal package of shares in any given company. The advantage of a mixed approach is that it gives the Government greater tactical flexibility to achieve whatever particular strategic goal it has set for itself in deciding to divest its interest in a given company. The risk is that this tool will be used ineffectively, and will back-fire. In concrete terms this could mean that the Government fails to sell all of the Federal shares in a company, or will fail to maximize revenue from the sale, or will generally suffer from the loss of timeliness in completing the privatization transaction.

Before reviewing the methods of sale, a few words are in order about the conditions that prevailed in late 1997, when the Government adopted the policy of competitive direct privatization and the World Bank's Coal SECAL 2 was made available to the Government. At the time, there was not (and there has not been since then) a "master plan" of companies to be privatized at a particular point in time or in a particular order. The only general principle that the Government adhered to was to divest first the most viable surface mines in Siberia. The World Bank supported this flexible approach, and the Coal SECAL 2 privatization targets were defined in terms of overall percentages of production by the private sector, not in terms of specific companies to be privatized. Another advantage to this approach is that it put the specific decision-making regarding privatization firmly where it belongs, in the hands of the Government.

Direct sales of State property are forbidden under Russian privatization law, which requires that all forms of privatization be competitive.\* This notwithstanding, Russia has been reluctant to adopt international best practice in privatization. Efforts of the IFIs, including the World Bank, to introduce an open and transparent system of international tenders with reputable and experienced investment banks acting as financial advisors, public placements, or even a verifiable system of direct sales have consistently failed in spite of commitments reached on the bilateral and multilateral levels. At the same time, in the case under review here, most of the industry has been privatized through competitive sale under relatively fair and transparent conditions. The Russian coal industry, long perceived as a troubled industry offering little potential to capture large economic rents, did not excite the interest of such sectors as oil, metals and infrastructure, which ultimately has benefited the transparency of the privatization process and resulted in a more competitive sector.

*Commercial Tender with Investment and/or Social Conditions.* Under the Privatization Law, if the Federal block of shares is greater than 51% of a company's stock, this form of sale must be used. While at first glance it would appear that this method would have been required for most of the privatization transactions that have taken place (because in most cases the Federal package has been greater than 51%), in practice it is possible to circumvent this requirement by splitting the Federal shares into two or even three blocks and to auction each block separately using any method. The only significant case in which this method has been used as the exclusive method of sale is Krasnoyarskugol. Commercial tenders were used in conjunction with other methods in the cases of Kuzbassrazrezugol and Yuzhny Kuzbass.

The primary disadvantage to this method of sale is that drafting the investment conditions and agreeing them with the regional authorities is a time-consuming and cumbersome process that is often marked with controversy. Experience has shown that the formulations of the investment conditions can be made in a rather opaque fashion and used to give favor to one potential buyer over others. MGI is responsible for this work and usually does not have the clout to deal effectively with the regional governors, who generally try to extract as much as possible from the Federal authorities in the process of negotiating the specific investment conditions. Investment conditions have usually included payment of tax and other fiscal liabilities to the Federal and regional budgets, as well as commitment of investments in kind or in cash.

Under the law, social conditions may also be stipulated in the context of a commercial tender. In practice, however, these have never been used in the Russian coal sector. No conditions limiting the ability of the new owners to lay-off employees have been imposed, and the potential issue of an excessive work force has never been considered in a sale and purchase agreement. At the same time, it should be noted that the Government's rationale for the use of the golden share rests largely on concerns over the potentially negative social impact of privatization. As of yet, however, the Government

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\* In the new privatization bill currently under consideration in the Duma, direct sales are proposed for special situations, e.g., when there is only one bidder, or only one potential buyer of specialized assets.

has never invoked the veto power of the golden share to prevent a private owner from laying off workers.

In general, to date social considerations have not emerged as issues or obstacles in the privatization process. There are at least three reasons for this: (i) in the pre-privatization period, significant reductions in enterprise workforces took place through the transfer of social assets (and associated employees) to municipalities, and, in many cases, closure of individual mines financed by the Federal budget; (ii) in the post-privatization period, there have not been any major lay-offs from the privatized companies, and employment has actually grown at some; and (iii) the Russian Labor Code clearly stipulates the employer's responsibility to finance social protection (severance and wage arrears, if any exist) for all workers laid-off in connection with a reduction-in-force. Depending on the outcome of on-going efforts to reduce the excess workforce in the industry in the context of the mine closure program (which is fully funded by the State), this may emerge as more of an issue in the future, when more underground mines have been privatized (most of the privatized capacity comes from surface mines) and productivity improvements lead private owners to reduce the workforce.

The World Bank has consistently advised against this form of privatization in the coal sector, recommending that the Government replace it with simple and/or specialized auctions; eventually the Government accepted this advice and most of the direct privatization that has taken place since mid-2000 has been carried out through auctions. In practice this has meant that in many cases Federal blocks of shares have been divided into smaller blocks and sold at separate auctions. As has been shown by recent auctions of coal companies, however, this approach can be an obstacle to achieving the timely completion of the sale of shares, and may even result in residual shares that the Government cannot sell at any price.

*Specialized Auctions (IPOs).* “Specialized voucher auctions” were a popular form of privatization often used in Russia in the early years of mass privatization that was modeled after the IPO and allowed for the participation of thousands of buyers. Since vouchers were the method of payment, the process was simplified, and the services of investment bankers and book builders were not required. Instead, a system of national and regional bid collection centers was set up to allow for the participation of “investors” willing to buy shares of companies which were not their employers and often located in other regions. This system, operated with the assistance of Western advisors, proved to be quite effective in preventing insider trading and collusion (however, efforts to replicate the voucher auctions elsewhere without the safeguards of the Russian system led to fraud, e.g., in Azerbaijan).

The voucher auctions were based on a simple principle: any non-priced bid was to be satisfied by the allocation of a portion of equity of the company being privatized. In practice, two types of bids were accepted: priced and non-priced. In a priced bid ( $x$  vouchers for  $y$  shares) the bidder purchased the requested number of shares provided that the bid was at or above the “auction price” calculated at the close of the 2-week bid collection period. Priced bids lower than the auction price were returned to the bidder. The auction price was calculated using software which allowed for share splitting and

rounding if the numbers of bids and shares could not be adjusted to maximize the allocation of shares. The non-priced bids were satisfied at the auction price calculated upon the close of the auction.

Although no coal companies were sold through the method of the voucher auction, subsequent methods of sale used for the coal industry were based closely on the voucher auction. Also, vouchers were used by employees of coal companies to pay for the preferred shares allocated to them upon corporatization (the period 1992-1994) in accordance with the variant of privatization used for SOEs in the natural resources industries.

In 1994, a Government decision introduced an IPO type of sale for cash, called “specialized cash auctions”, based on the experience of the voucher auctions. This form, now called simply “specialized auctions”, has been used extensively in privatization of the coal industry. The current specialized auctions differ from the earlier specialized voucher auctions in two important points: (i) they require a market-based valuation; and (ii) a floor price is set. The auction commission sets the floor price for a share bid, meaning that non-priced bids must match this minimum value. The auction price is calculated as the average of all bids collected during the bid collection period (from 2 weeks to 3 months) from all bid collection centers, usually banks and other financial intermediaries located in major cities with potential demand for the shares, with an announcement of not less than 45 days before the auction closure. All priced bids that are equal or higher than the auction price are satisfied. All non-priced bids are matched with the number of shares at the auction price.

Specialized auctions possess many of the attributes of IPOs: they result in multiple winners (vs. the one-winner-takes-all of the regular auction or tender), the participation base is broad (anybody willing to buy a share must get it if a non-price bid is submitted), accessibility to bidders who can use a bid reception agent in another city instead of traveling to Moscow to participate in open outcry or closed-envelope auctions. The major difference is the Government’s reluctance to use financial intermediaries as the lead sales agents: for Federal property the RFPPF and its branches in some 40 regions are always the sales agent, lead financial adviser and the “book builder” all in one.

*Standard Auctions.* In a standard auction the highest bid wins all. Standard auctions are conducted when the Federal block of shares is not very large (either because it never was, or because a small blocks of residual shares results from a specialized auction). For example, in October 2000, the Federal block of 15.75% of Chitaugol, a surface steam coal company in Eastern Siberia, was sold at auction. Bidders, who were pre-qualified and had to be registered by a certain date, submitted bids in an envelope at the auction at which they were allowed to be present. From a tactical point of view, standard auctions are the most convenient way for the Government to ensure that residual shares resulting from a first round consisting of a specialized auction will be sold, as the winner must take all. In practical terms, this tactic would be advisable only when the sales agent is reasonably confident that a purchaser exists who needs to acquire some additional shares in order to achieve a controlling interest in the company.

## **A LOOK AT THE NEW OWNERS OF THE RUSSIAN COAL INDUSTRY, IMPLICATIONS FOR COMPETITION AND SELECTED PERFORMANCE INDICATORS**

The privatization of the Russian coal sector is a recent phenomenon, and private ownership of the assets sold competitively is in its first generation. Sooner or later, post-privatization changes of ownership will take place, and the results of these transactions could have significant implications for the industry's long-term development, including the degree of competition in the newly privatized Russian coal industry. While the market for coal assets being offered through privatization is at present quite competitive, it must be recognized that this is in part the result of such independent and volatile factors as the prices in other fossil fuel markets, which have recently surged. For these reasons, it would be premature to attempt a far-reaching assessment of the impact of privatization on the Russian coal sector. Nonetheless, as this is the issue of ultimate relevance, an attempt is made here to take a first look at the coal industry's new owners, to consider the issue of competition in the coal industry, and to review some early performance indicators of the privatized portion of the industry.

Consultations with local governments and Federal government officials indicate that privatized coal companies are generally held to be responsible corporate citizens, making timely payments of current taxes and as a group considerably more successful than State-owned companies in reducing wage arrears to workers. For example, at the beginning of 2001, there were essentially no wage arrears to workers at Kuzbassrazrezugol and Yuzhny Kuzbass, the first two companies privatized through competitive privatization in 1997- 1998, and at Krasnoyarskugol, which was privatized in 2000. In contrast, the industry average for wage arrears at the beginning of 2001 was equivalent to about two months of wages.

*The New Owners of the Russian Coal Industry.* Currently, there are five major private groups operating in Russia's coal industry. Two of the groups, Rosuglesbyt and Uglemet, have their origins in coal mining.\* The Rosuglesbyt group controls about 15% of total production of coal in Russia, while Uglemet controls about 5%, including a large percentage of total coking coal production. Both groups are reportedly considering investments in the power sector in the event that private control of generating companies is permitted in the restructuring of RAO UES. In addition, Uglemet has entered the steel industry, relying on its own supplies of coking coal to supply the steel mills. Uglemet has acquired the sixth largest steel producer in the country, Mechel (Chelyabinsk Iron and Steel Plant) and is qualified as one of the major candidates for the privatization of Magnitogorsk Iron and Steel Plant, one of the three largest Russian steel mills, slated for privatization sometime in 2002.

The other three owner groups entered the coal sector through backward linkages from steel plants. The three groups are Urals Mining and Metals Group (UGMK); MDM

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\* Rosuglesbyt is a major coal trader and has purchased the largest producer, Krasnoyarskugol, and Sakhalin Coal Corporation. Uglemet is the parent company of Yuzhny Kuzbass and Mezhdurechenskugol.



Group (MDM); and Eurasian Metals Group (EURAS). UGMK first purchased Serov Metals plant, Nizhnii Tagil Steel plant, Kuznetsk steel mill, and then acquired shares of Kuzbassrazrezugol, Russia's largest coal exporter, and Khakasugol (managed jointly with SibAl, a powerful non-ferrous metals group), giving the group control of about 14% of current production. MDM group, which also owns assets in the steel sector, became the owner of Vostsibugol and Chitaugol, which together produce about 12% of total production. EURAS took control of Rospadskaya and Kuznetskugol, the largest producer of coking coal in Russia, and shares control over the Mezhdureche surface mines with UGMK. With these companies, EURAS controls about 10% of total current production.

Despite the power sector's obvious interest in coal, the power companies of RAO UES did not participate in the privatization of the coal industry, primarily because RAO UES is not considered a private buyer under Russian privatization law, and is therefore not allowed to participate in tenders. However, even if this obstacle could be overcome, other factors have discouraged the development of vertical integration of the Russian power and coal sectors. There is one example of a captive coal mine owned by a regional generator, and its experience has generally not been positive. The record of this company, LuTEK, in Russia's Far East, has been poor in regard to safeguarding (i) the interests of the development of coal deposits against the pressing needs of the power distribution companies with lingering non-payments by customers, leading to under-investment in coal extraction equipment, burden removal and capacity expansion; and (ii) the stability of power supply to customers during the 2000/01 winter's severe energy crisis in the Far East. Other efforts to set up more coal-power companies in Russia have failed due to the opposition of regional administrations, who are unwilling to cede control to the central management of RAO UES, and well as the financial weakness of the cash-strapped power companies compared with the more solvent competitors from the steel and metals sectors.

The steel/metals groups have acquired steam coal mines as well as coking coal mines. Their interest in coking coal is obvious, as this is a direct input into the production of steel. As for their interest in steam coal, it appears that the reason for this is to allow the metal companies, major consumers of electricity, to put pressure on the power distribution companies of RAO UES in the context of bargaining for lower electricity tariffs and other terms of service for their steel mills and smelters.

The present coal industry ownership structure indicates that this is one of the most competitive of Russia's natural resource industries, although the degree to which this outcome can be attributed to conscious design is limited. The more likely ally in this case was the troubled state of the coal industry itself, and the industry's considerably less attractive position as a potential provider of economic rents when compared to such lucrative sectors as oil and gas or metals. Coal's image as a troubled, economically unviable sector with high social liabilities made it unattractive to many Russian investors, particularly those based in Moscow, to say nothing of foreign investors, and gave an opportunity to regionally-based investors, often with a background in the coal sector, to acquire ownership of such potentially valuable assets as the Siberian surface mines.

Post-privatization control over competition policy is the responsibility of the Ministry for Antimonopoly Policies and Support of Entrepreneurship (MAPSE). Under

Russian law, any merger and acquisition deal involving more than 20% of shares should be reported to this ministry, which legally and technically has the authority to stop the deal. In reality, few deals in other industries have been prevented by this Ministry, including the egregious case of the aluminum industry, in which the Russian Aluminum group was created with control over at least 75% of the market with the consent of MAPSE. The enforcement of competition rules in the Russian coal industry looms large on the agenda of concerns for the future, particularly since three of the five groups which control the private portion of the coal sector are linked by alliances and strategic partnerships, if not explicitly through cross-ownerships.

*Initial Performance Indicators of Privatized Companies.* It is too early to arrive at broad-based, robust conclusions about the impact of privatization on the Russian coal sector. Ideally, such an analysis would be based on data that are either not yet available, or that exist but are not accessible for reasons of commercial confidentiality. Nonetheless, in the cases of the first three companies to be privatized competitively (which together account for about one-third of total coal production in Russia), initial performance data for the post-privatization period show some positive tendencies, as demonstrated below.

Table 2. Three privatized coal companies: selected indicators.

	1997	1998	1999	2000
<b>Kuzbassrazrezugol*</b>				
Production (thous tonnes)	27,992	31,447	34,184	34,557
Productivity growth (% over previous year)	n.a.	n.a.	12.0%	2.4%
Wage arrears (months at year end)	3.09	n.a.	0.52	0.04
Ratio A/P to A/R	n.a.	n.a.	1.45	2.09
<b>Yuzhny Kuzbass*</b>				
Production (thous tonnes)	8,994	9,103	10,248	10,983
Productivity growth (% over previous year)	n.a.	n.a.	14.6%	4.7%
Wage arrears (months at year end)	0.80	n.a.	0.07	0.02
Ratio A/P to A/R	n.a.	n.a.	1.36	1.20
<b>Krasnoyarskugol<sup>+</sup></b>				
Production (thous tonnes)	33,649	32,925	34,241	37,522
Productivity growth (% over previous year)	n.a.	n.a.	n.a.	7.2%
Wage arrears (months at year end)	3.71	n.a.	0.57	0.08
Ratio A/P to A/R	n.a.	n.a.	1.73	1.51

Shaded area indicate the years of each company's functioning primarily as a privatized company.

\* Privatized in 1998. <sup>+</sup> Privatized in 2000. A/P – accounts payable. A/R – accounts receivable.

As Table 2 indicates, production and productivity have been growing at these companies. And while it is true that the industry's overall production has increased for the last three years, the rates of increase were greater at privatized companies as a group. From 1999 to 2000, production at all privatized companies grew by about 8%, while at

State-owned companies the growth in production was slightly above 5%. Productivity has also increased throughout the industry. In the case of the State-owned underground mines taken as a group, a particularly significant determinant of the productivity growth has been the closure of heavily loss-making mines and the resulting downsizing of the labor force on the company level, as distinct from fundamental improvements at the mines remaining in operation. In the case of the privatized companies shown above, virtually no downsizing of the work force has taken place; that is, productivity growth is driven by better organization of the production process and investments in more efficient equipment.

The ratio of accounts payable to accounts receivable at these three companies is among the lowest in the industry. In contrast, the average ratio for non-privatized companies in 1999 was about 3.0, and it worsened to 3.6 in 2000.

Table 3 below shows the average productivity of Russian coal companies classified by type of mining and ownership status, and demonstrates the contrasts between the privatized part of the industry and the part that was still in State ownership through the end of 2000. As can be seen, the most productive producers are the surface mining companies that were privatized through competitive procedures (this is also the single largest group of producers in terms of its share of overall production). By far the least efficient producers are those companies remaining in State ownership. (The point here is not to ascribe causality but rather, to describe the variation in the industry.)

Table 3. Productivity of Russian coal companies, 1998-2000 (tonnes per man-month, average for each group).

	% 2000 production*	1998	1999	2000	% change 1998-2000
<b>Surface</b> (no. companies)					
Privatized competitively (5)	44%	215	247	282	31%
Not privatized (4)	7%	134	132	127	-5%
<b>Underground</b> (no. companies)					
Private ("spontaneous" privatization) (4)	5%	81	99	112	38%
Privatized competitively (2)	1%	60	63	70	17%
Privatization in process (2)	11%	59	73	81	37%
Not privatized (6)	9%	40	43	46	15%

\* Column totals to 77% due to incompleteness of company-level data on productivity.

## CHALLENGES TO THE LONG-TERM VIABILITY OF THE COAL INDUSTRY IN RUSSIA

Russian private coal producers face particular risks beyond the usual market risk facing any producer, particularly in the energy sector. The Government of Russia faces the risk of the failure of any part of its restructuring program, including the policy of competitive direct privatization that has led to the transformation of the industry's

ownership structure. The risks faced by all those interested in the industry's long-term prosperity to a great extent derive from aspects of the privatization process itself and, more generally, from the presently incomplete implementation of the Government's coal sector restructuring program. The particular challenges faced by the industry and the Government include the following:

- Most privately-owned companies inherited significant historical tax and other financial liabilities, as these were not written-off at the time of privatization.
- The regulatory framework inadequately reflects the changed roles of the State and the newly privatized industry, and potentially places unnecessary constraints on the industry's future development.
- The industry faces a potential investment crisis resulting from its limited ability to attract reliable, long-term investment financing.
- No accountability has been assigned for certain environmental liabilities.
- The industry is susceptible to interference from regional administrations.
- There is a possibility of the concentration of ownership of the industry, which could have negative implications for competition in the industry (which was the fundamental rationale of privatization).

Clearly, these risks vary in their sensitivity to policy intervention by the Government, and even more so in terms of the Government's ability to address them adequately through pre-privatization measures. Of those listed above, the problems that can most effectively be avoided through proper design of a privatization program are those where the fundamental risk derives from an inadequate definition of the liabilities attached to the enterprise to be privatized, including liabilities of a known value (such as taxes and debts to creditors) and contingent liabilities, such as environmental and health damage, where credible estimates of the potential cost of the liability are usually not available. The Government also clearly plays the leading role in spearheading the reform of the regulatory framework and bringing it into conformity with the changed circumstances of industry ownership and the evolving role of the State as the regulator and guarantor of anti-monopoly policies.

*Historical Tax Burden.* While the problem of historic enterprise debts exists throughout the Russian economy, it is particularly acute for the coal sector. As of September 1, 2001, the industry's net payables were about Rb 54 billion, or \$1.8 billion, which exceeds the total value of coal delivered in 2000 (about Rb 41 billion). In recent months, the Government has taken decisive steps to address this problem through establishing mandatory debt restructuring programs. All Russian enterprises with Federal-level debts must work out a debt payment schedule with the Ministry of Taxation and Revenue by a certain deadline, or risk bankruptcy. Given the good cash flow in the coal industry in recent years, for most producers this requirement should not present an insuperable burden, at least as concerns their Federal-level tax arrears and related penalties. However, as coal companies' Federal-level debts represent less than 30% of their overall debt to all creditors, meeting obligations to other creditors (regional and local government and private creditors) is still a significant challenge.

Regulatory and Legislative Framework. The Russian coal industry provides a striking illustration of the discrepancy between the swiftness with which the ownership of a major industry can change hands, and the considerably slower pace of reform of the regulatory and legislative regime in response to the changed ownership structure. This industry-specific situation is compounded by the challenge post-Soviet Russia faces in reviewing and revising the entire legal and regulatory system inherited from the Soviet era. As of today, the laws and other rules and regulations that govern the functioning of the coal industry (and mining industries in general) are in dire need of revision. Key issues for the coal sector include: the sector management within the Governmental system and the general institutional responsibilities; the right of license holders to assign, transfer and pledge rights; the limited description, continuity of and automatic succession to higher levels of title; labor and social issues; and matters of taxation. On the positive side is a productive and generally reformist attitude in the State Duma towards many issues of fundamental legislation, which affect the coal industry along with the rest of the economy; the Ministry of Energy's focus on the need for regulatory reform; and the growing recognition of the private sector as a key partner, along with the trade unions and other stakeholders, in the regulatory reform dialogue.

Investments. The historical tax burden and other inherent attributes of the coal sector (its sensitivity to energy price fluctuations; low potential for earning foreign currency; the long investment cycle; etc.) detract from the ability of private Russian coal companies to obtain long-term investment financing. Ministry of Energy estimates of the total level of investments required by the industry over the period to 2020 are based on assumptions of a considerable increase in the demand for coal as a result of overall economic growth and a sharp turn away from domestic consumption of natural gas, which in part will be driven by a widespread switch to coal as a fuel for power generation. While the forecasted ascendancy of coal is a debatable issue, it is clear that at the very least, the industry needs a high level of investments to replace its highly depreciated capital stock if it is to maintain current levels of production.

At the same time, data on actual investments in the coal industry show a positive trend over the period 2000-2001. While hard data are not yet available, it has been estimated that the industry made about Rb 15 billion in investments in 2001, financed primarily by companies' re-invested own funds made possible by the good cash flows of recent years; coal companies have also received loans from Russian and, in some cases, foreign banks. If these and other positive developments continue, including the general reform of the banking system and financial markets, the industry should be well-placed to meet its future investment needs, particularly as major producers gain access to foreign sources of credit.

Environmental and Health Liabilities. Russian law clearly assigns responsibility for mitigation of environmental damage to the enterprise that caused the damage. As concerns the ca. 200 heavily loss-making mines in the mine closure program that is being implemented in the context of sector restructuring, the State has reaffirmed its responsibility for the environmental damage wrought by the operation and closure of the mines, and provides financing from the budget to mitigate this damage. As concerns continuing mines that were privatized and that may continue to operate for many years,

however, there is as of yet no established practice for the treatment of environmental liabilities expected to “come due” in the future. In other countries (for example, Great Britain), this problem was addressed at the time of privatization, when cost-sharing arrangements were agreed between the State and the new owner.

Generally, environmental liabilities have not yet emerged as a post-privatization issue in any industry in Russia, including coal and other extractive industries. In the case of coal, there is ample anecdotal evidence that the future costs of mitigating environmental damage from coal mining were not taken into account when the new owners prepared their bids for the assets (it has been said that, under existing regulations, this would have resulted in negative net present values). One of the reasons for this disregard of future environmental costs is the disjoint between the stringency of Russia’s environmental legislation and the weak and inconsistent enforcement of the rules. Another reason is the bias, inherited from Soviet times and compounded in post-Soviet times by the contraction of GDP and the loss of jobs in the economy, in favor of extracting natural resources where profitable over mitigating the environmental impact of that economic activity. More generally, environmental awareness and sensitivity remain relatively low in Russia. A coal-industry-specific reason is that most privatized coal capacity consists of surface mines, where the environmental impact, while profound, is not generally of a life- or property-threatening nature, and no closure of privatized mines has taken place outside the context of the Government’s on-going mine closure program. As even local authorities have not shown a tendency to demand timely completion of land reclamation works from the owners of surface mines (preferring instead to lobby the Government for funds to repair social infrastructure assets, to relocate residents and for other local needs), potential legal conflicts over the assignment of liabilities between the private owners and the State would appear to be a matter for the future. The development of equitable cost-sharing mechanisms (potentially between the private company, the Federal government, and the concerned region) would help to avoid these potential conflicts. To provide for the costs, including environmental mitigation, of mine closures that will take place at mines that are 100% the responsibility of the private sector, the introduction of mandatory escrow accounts is being considered. It should be noted, however, that the common practice in other mining countries of requiring a mine closure plan as part of a development plan for a new mine is still widely dismissed in Russia as an unnecessary complication, indeed, a disincentive to the developer.

Some examples of cost-sharing arrangements exist in the coal sector, i.e between State and new private owner, and these may serve as models in any future mechanisms. These are mine-specific agreements whereby private owners have received subsidies to partially cover the costs of mitigation of environmental damage at mines that have recently entered closure. In these cases, the tenure of the private ownership of the mine is obviously quite limited and, most importantly, the Federal program of subsidization of the coal industry still exists. For these reasons, this model is probably of limited application to expected future circumstances, when the Federal source of financing will no longer exist, and the demand for environmental mitigation funds will be greater, as more privatized mines enter closure. Given the ambiguity of the legislative treatment of this class of environmental liabilities, it would be reasonable to anticipate future disputes between

owners of privatized mines and the State in which the owners claim that they had not been given sufficient information regarding the liabilities before the privatization transaction was completed.

The question of ultimate relevance here becomes the intentions of the industry's new owners, whether they will prove to be good corporate citizens who take on their responsibility for environmental mitigation (likely in the context of a reformed regulatory framework), or whether they asset-strip and dump their properties on the State once it is no longer possible to avoid environmental mitigation work. Given the good prospects of the Siberian surface mines that represent the bulk of the private ownership and the roots of the typical new owner in the Russian coal industry, the former scenario seems more likely. But the challenging task of finding the right balance between legitimate (and enforced) environmental regulation and helping the coal industry prosper lies ahead.

As concerns the liabilities (actual and potential future) arising from damage to the health of coal workers, viable and self-financing mechanisms to deal with them have been established. The systems in place for national provision of medical and disability benefits are financed through payroll taxes. In the case of disability, which has particular relevance to the coal industry, the legislation that introduced the national system is relatively new and is undergoing refinement. The taxes paid by employers are actuarially determined and assign greater tax burdens to more dangerous industries, thus providing for an equitable distribution of costs across the economy and introducing an incentive to employers to improve safety in the work place. Refinements presently being considered by the agency responsible for the administration of the national disability program include allowing a limited differential in the tax paid by individual employers in a given industry based on their actual experience, which essentially extends the existing incentive structure from the level of the industry to the level of the employer.