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PROCEEDINGS

**The Ministry of Fuel and Energy Suggests a Conception
for Attracting Foreign Investments**

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It is obvious that the oil and oil refinery industry of Russia is in a crisis. The major high-yield deposits have to a large extent been exhausted; in some cases by as much as 60-90 per cent. Accordingly, the extraction of oil has dropped significantly. The fact that the development of the deposits was carried out at an inadmissibly rapid rate (6-12 per cent of the initial reserves) also contributed to the fall in extraction levels. As a result of the intensive, and by no means efficient, application of methods to increase oil yields, there was a sharp growth in the quantity of water in the volumes of extracted liquid. This led to a large number of deposits being taken out of use and to an increase in the proportion of unproductive and not readily extractable reserves.

The condition of newly-developed reserves has also sharply deteriorated. Not one major high-productivity deposit has been opened recently. The average daily yield of one new well in Tyumen province (Russia's main oil extraction province) fell from 138 tonnes in 1985 to 12-13 tonnes in 1992. The financial, material and technical costs of producing 1 tonne per day of new capacity has risen by 10 times in 17 years.

There has been a drop in financing for geological exploratory work. Thus, in Western Siberia, where the level of development of forecasted resources is around 35 per cent, from 1989 onwards, financing for geological work dropped by 30 per cent, and volumes of exploratory drilling were reduced by the same amount. As a result, the growth in industrial reserves in that region fell one and a half times.

The sector is in dire need of high-productivity technology and extraction and drilling equipment. Depreciation of most of technical resources is at over 50 per cent; only 14 per cent of machines and equipment meet world standards; 70 per cent of the stock of drilling installations is outdated and in need of replacement, and a third of well repair units were

taken out of production 5-7 years ago. At the same time domestic industry satisfies 40-80 per cent of the sector's requirement for the principal types of material and technical goods.

After the collapse of the USSR the situation vis-à-vis supplies of oil industry equipment from CIS republics deteriorated: being monopoly producers of many types of goods (Azerbaijan alone is currently owed around 37 per cent of material and technical goods produced for oil-workers), factories in the republics are inflating prices and cutting supplies of equipment to Russia.

Low domestic oil prices have made it impossible for oil extraction enterprises to finance themselves (this situation remains the same despite a series of increases in oil prices). At the same time the high rate of reserve exhaustion has created the need for an accelerated rate of compensation for the disposal of extraction capacities.

As a result, there has been a sharp deterioration in material, technical and financial provision for the sector. In 1992 alone the total volume of investment in the oil industry fell by 25-30 per cent (by comparison with 1991). At the same time the volume of budget appropriation (previously the main source of financing) fell by over 40 per cent. The sharp reduction in centralized investment, the shortage of currency resources at enterprises and the rupture of economic relations with some republics of the former USSR have led to a sharp decrease in supplies of oil industry equipment and drilling equipment and materials, and hence to a reduction in the volume of drilling work. Thus, in order to maintain Russia's current level of oil extraction, new capacities must be introduced providing for the extraction of 118 million tonnes a year.

This will require the drilling of 62 million metres of operational wells. In 1991 only 27.6 million metres were drilled.

During the last few years oil and gas extraction enterprises have been consistently subject to short supplies of material and technical resources needed to keep their wells functioning. Moreover, equipment supplied by domestic factories is of a low quality, leading to an unjustifiable increase in the volume of repair work. The number of inactive wells has therefore increased sharply: the number of inactive wells is over 25,000 (17.3 per cent of the available fund), of which 12,400 were above the technically justifiable norm. The average yield of inactive wells, according to a minimum estimate, is about 8 tonnes of oil a day. For that reason alone at least 30 million tonnes annually remain unextracted.

In the long-term it is impossible to solve the problems of the fuel and energy complex without restructuring the whole system of energy utilisation and wide implementation of energy conservation technologies. Considerably raising the efficiency of energy use is our strategic task. But nowadays the actual task in the short-term is to prevent the rate of oil extraction from falling further. Otherwise the country very soon will face the necessity to import oil and oil products.

Nowadays one of the most effective ways to stabilize the situation in the oil industry may be attraction of foreign investments.

Taking into consideration the specific importance of the sector for the whole Russian economy, the Government of Russia adopted on June 1, 1992, decrees N368 and 372, which define short and medium-term (until 1997) requirements in external financing for the oil and oil refining industries, which constitute 30 billion dollars.

The required value of financing cannot be provided exclusively at the expense of credit attraction (in this case more than 50 million tonnes of oil would be additionally required for export during 1993-98). It is necessary to look for attracting the new foreign finance and technological potentials not on a loan basis, focusing instead on direct foreign investments. According to expert assessments, foreign investors could invest as much as 60-70 billion dollars into the oil industry of Russia, and that exceeds the short-term requirements.

It is obvious that we do not expect the investments will flood into the Russian oil industry. And there are several reasons for that. Presently there is excess of demand for investments in the world financial market. Therefore, many firms and financial institutions prefer to invest in the countries of traditional oil extraction, which have a stable economic environment: in the Middle East, in South East Asia, in America.

The Russian market attracts potential oil and gas investors due to a large resource base, not the worst conditions (according to world standards) in terms of extraction expenses, high qualification of workers, and the conversion possibilities of the former military and industrial complex for producing of oil extracting equipment, etc.. But we can expect considerable reallocation of financial streams to Russia only after the creation of an investment climate in the country, at least not less favourable than that in the regions of traditional oil and gas extraction.

That is why we draw very serious attention to creating the legislative base: The Law on Mineral Resources has been adopted. The Decree On the Procedure of Licensing Resource Utilisation and the Law on Oil and Gas is being prepared. Negotiations are also being carried out on the packet of documents of European Energy Charter.

We think the attraction of foreign investments in the Russian oil industry should proceed from the following main principles:

- Relations with all countries should be created on principles stated in European Energy Charter and in attached legislative documents, according to which the common energy and economic-legal space should be formed for the whole industrially developed zone of the world. There should be common conditions for all participants concerning access to energy resources, markets, transportation, access to technology and capital markets etc., which will meet the balance of interests of receiving countries and potential investors concerning both the regime of investments and political matters.
- Directions and forms for attracting foreign investments are determined according to the priority and urgency of the problems to be solved. Oil extraction reduction in operating deposits is the biggest problem in the short-term. The most rapid return on investments for western investors (within three to four months) may be reached through restoration of idle wells. Western investors (and what is most important - small and medium size firms) can be attracted here with direct investments on a service contract basis. But for the country, using western credits to buy necessary equipment is more preferable. The equipment in that case will be used by our home producers with repayment for credits by delivery of the part of additionally extracted oil.

The medium (three to five years) term envisages an arrest in the decline of extraction by a large scale commencement of already-opened deposits which are not under development due to lack of investments. Foreign companies will participate in their development on a tender basis and receive guarantees for investment reimbursement in the form of the right to export a part of extracted oil, with possible reinvestment of the profit into JV shares.

The participation of foreign investors in the development of both the deposits out of use and high-yield perspective deposits are a principally new approach that will make it possible to drastically cut the time it will take to bring them to full capacity, as well as to maximize rent confiscated by the Russian side.

The tender terms should be equally applied to both the foreign and domestic investors, including private ones such as local oil-producing associations responsible for the development of new deposits.

In the long (eight to ten years) term one can expect a sudden change in the extraction rate to take place as a result of bringing on-stream already-explored new oil deposits. The attraction of foreign firms (as a rule large ones, or in the form of consortiums) should be carried out on a risk-contract basis. As long as the rouble is "soft", the preferable form of agreement is the production-sharing contract, which allows the foreign partner to take responsibility for all service expenditures and risks and to cover the expenditures in kind at the expense of production sharing.

The already-signed contracts for exploration and development of deposits in Sakhalin's offshore region, the Nizne-Volzski area and Komi will attract foreign investments of as much as 9 billion dollars.

The medium and long investment terms for the oil industry should be used to involve foreign finance and technology potentials as much as possible into the process of Russian defence industry conversion and the creation of facilities necessary for producing oil-extracting equipment.

Expected foreign investments offered (as a rule, jointly by consortiums of interested firms, including producers of equipment and investment banks) will total at the initial stage as much as one billion dollars, according to the US firm Goldman Sachs.

One must proceed with legislative initiative to provide foreign investors in Russia with guarantees against worsening economy conditions caused by the introduction of this or that measure in this field.

In this connection, one should insert a reservation into the existing law on foreign investments guaranteeing non-deterioration of conditions within a predetermined period of time, since the registration of an enterprise with foreign investments as a legal entity. This juridical term should be also applied to the domestic investors taking into account the principle of "national investment policy" according to Russian legislation. This will substantially decrease the risk of investment into Russian oil industry.