

The Fight Against PSAs In Russia: Who is to Benefit and Why Not the State?

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As is well-known among specialists, production-sharing agreements (PSAs) are just one in the spectrum of instruments available to attract investment in mining operations along with licence-based subsoil uses, concession agreements, and risk-service contracts. Different options prevail in different countries: some of the latter (making a majority) rely on only one arrangement for subsoil uses, while others (constituting a minority, but still numbering about a dozen) employ several at a time. Any instrument can be used to do a great deal of useful work, but can also cause, if mis-handled, serious injury to its operator and to others. To avoid the latter outcome, it is crucial to know how the instrument should be used, for what purpose, and under what circumstances. This is also true of instruments for subsoil uses, in particular, PSAs.

How many investment regimes in subsoil use are needed?

Along with licence-based subsoil uses, PSAs have been an option available under Russian legislation since January 11, 1996. Where the two parties—the State and the investor—agree, based on a range of parameters, that it is advisable to implement an extraction (exploration and production) project on PSA terms (or, on the contrary, on the basis of a licence), it means that this arrangement is the most advantageous among those on offer to the subsoil owner and the subsoil user. In the latter case, the State will reach this decision unilaterally (as licences are part and parcel of the injunction-based, administrative system for subsoil use regulation) while in the former case both the State and the investor must decide to enter into a PSA (as a civil-law part of the system for subsoil use). Hence, many of the pros in favour of PSAs compared with the licensing system. Hence, also, the numerous problems detracting from the effectiveness of PSA implementation, which are

engendered, in many ways, by the co-existence of such agreements with the administrative system for licensing subsoil use.

If there is no such alternative and access to subsoil resources is provided through a single channel only, the State has fewer reasons to make efforts to improve the investment climate in the country in general and in the subsoil use system in particular because, amongst other things, potential investors have no choice other than to take subsoil resources for use from the State on those terms which are on offer—or not at all. Therefore, prospective investors are compelled to “vote with their feet” either by taking their capital out of the country or by choosing to develop only such mineral fields as are the easiest to access and the cheapest to open up, while refraining from commitments to exploit those reserves which offer lower, but still adequate returns.

Single-channel access to subsoil is perfect for those companies which control the cheapest of resources and are out to make a quick profit by extracting the maximum within the shortest time. In contrast, those companies which are in the oil business in earnest and for the long term are interested in having a balanced portfolio of reserves exploitable at different costs so that, as the more readily accessible and cheaper-to-develop deposits are exhausted, they are gradually replaced by costlier-to-work fields, so that the companies—along with the entire country—thus avoid an investment crisis (which would be provoked by the inexorable increase in the cost of capital inputs following on from the depletion of those deposits that are inexpensive to develop) and an inevitable follow-up shortage of oil supplies. Avoiding such an outcome requires taking steps in good time to furnish the appropriate conditions for direct long-term investment—and not only for short-term portfolio investments which are generally targeted by stock market instruments. From this angle, competition between two or more categories of investment options may have positive effects by proving more effective (as competition generally does) for raising the effectiveness of investments and bettering the investment climate than the long-winded decision-making process (hobbled by all manner of departmental strife and rival lobbying interests) that constitutes the initiatives developing within the State establishment.

This is precisely why one of the major advantages of PSAs is that, owing to their attractiveness to the majority of potential investors (the others will be discussed below), they serve as a strong and creative catalyst for government agencies, prodding them into lifting redundant pseudo-protective barriers in existing legislation and marking out—by means of agreements on individual investment projects—the level to be matched by the country’s overall investment appeal. In Russia, however, the reverse process is in evidence, as the State, represented by its executive and legislative authorities and acting under the impact (and also involvement?) of powerful pressure groups protecting the interests of a segment of the domestic petroleum business, appears to have decided not to remove the legislative impediments to investments outside the limits of PSAs, but to eliminate the PSA option itself. Let us try and see why.

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PSAs and society

Since being authorised in Russia as a means of attracting investment into the extracting industry, PSAs have experienced several booms and declines in government and public interest in their existence. The reasons for these ups and downs included the following:

- low awareness among different branches of government and members of the public about the substance of this type of agreement, its place among other subsoil use arrangements, and the machinery of implementing PSA projects;
- reshuffles at State agencies, resulting in the departure of professionals familiar with PSA problems and their replacement by newcomers without such knowledge;
- scarcity of investment in the country and in the extracting industry, which depends to a substantial extent on fluctuating oil prices and the gradual emergence of the Russian national capital market;
- changes in general and special taxation (including that in the extraction sector, comprising the oil industry);
- shifts in that sector and especially that industry, as reflected in the rapid capitalisation of some companies and resulting changes in their interests and priorities, etc.

PSA legislation also forms the basis for project financing, while Russian companies and the Russian Government have so far mostly concentrated on laying legislative groundwork for corporate financing.

Over recent months the PSA issue has once again found itself the focus of attention. However, the current flurry of interest is different from others. Whereas previously PSAs were discussed as part of a more or less balanced debate in which the opponents and advocates of this type of investment agreement could argue on a roughly equal basis, the latest PSA controversy has been lopsidedly slanted against such subsoil use arrangements.

Interestingly enough, the anti-PSA crusade in the media is gathering momentum amid the continuing virtual ignorance of large sections of the population about PSAs. The Yabloko party, known for its vigorous support for PSA legislation, recently conducted a poll on its website, asking visitors whether Russia needs PSAs. As at April 7, 2003, the results were as follows.

Does Russia need PSAs?	Total: 132 votes	
Yes, it needs them	32 votes	24.24 per cent
Yes, it benefits from them	10 votes	7.58 per cent
No, they are harmful	34 votes	25.76 per cent
I do not know	7 votes	5.30 per cent
What are PSAs?	49 votes	37.12 per cent

One month later, on May 13, 2003, the figures were considerably different.

Does Russia need PSAs?	Total: 216 votes	
Yes, it needs them	46 votes	21.30 per cent
Yes, it benefits from them	14 votes	6.48 per cent
No, they are harmful	41 votes	18.98 per cent
I do not know	10 votes	4.63 per cent
What are PSAs?	105 votes	48.61 per cent

Two more months later the tendency has developed further.

Does Russia need PSAs?	Total: 353 votes	
Yes, it needs them	60 votes	17.00 per cent
Yes, it benefits from them	19 votes	5.38 per cent
No, they are harmful	63 votes	17.85 per cent
I do not know	18 votes	5.10 per cent
What are PSAs?	193 votes	54.67 per cent

It can, therefore, be concluded that most participants in the survey are simply unaware of what PSAs are. Significantly, their share (constituting a relative majority) has been steadily growing as the site has been visited by new people, with the percentages of the other optional answers shrinking. Visitors to the Yabloko site include, most likely, that party's supporters whose educational level, according to sociologists, is pretty high. And yet more than half of the visitors were completely unfamiliar with PSAs. The grasp of related problems on the part of the (larger) sections of the population with lower educational qualifications must be even weaker. In these conditions, the opponents of PSAs, when speaking out in the media against this form of subsoil use, often appeal (and very much deliberately so, judging by all appearances) not to the respective audiences' intellect, but to their emotions and they use rough and ready verbal and visual leverage, rather than shrewder arguments based on the comprehension and understanding of the subject-matter in hand, in order to influence those readers, listeners, and viewers with only mediocre IQs (such efforts all too often being presented in the nature of comics, like the "Artists Against PSAs" exhibition mounted at the State Duma legislature or a pictorial puzzle sponsored by a major Russian oil company in a number of newspapers, which represented the "great power's collapse" as the following three-step slide down the drain: from the Soviet Union to Russia to PSAs).

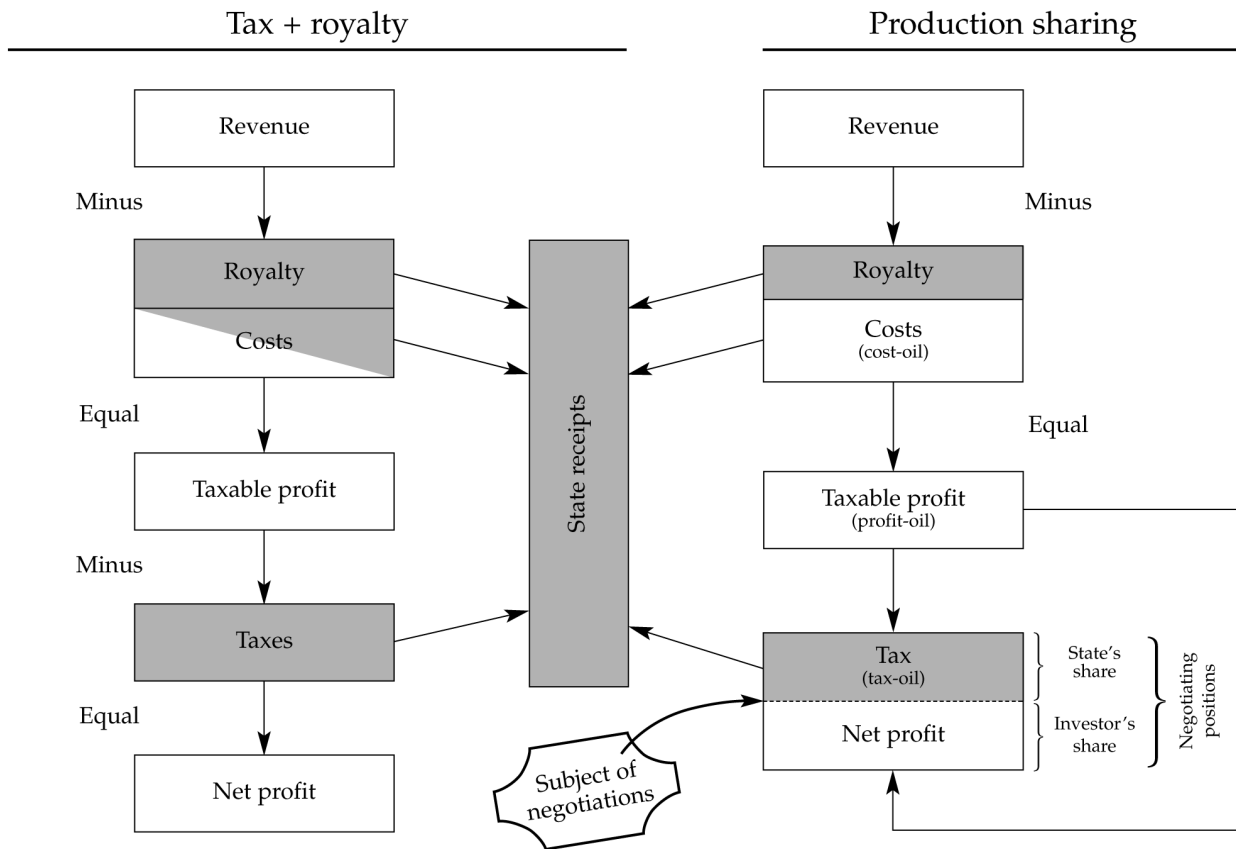
Such propaganda exercises (their duration and intensity lending themselves quite readily to forecasting) are undertaken ahead of all manner of "turning-point" events—such as a meeting on PSAs, held by the Russian Ministry of Energy's steering collegium in February 2003, or a meeting called by Russian Prime Minister Mikhail Kasyanov to discuss the same subject a few days later—with advance publications in the press helping to facilitate the desired decision-making by assuring the corresponding players of a favorable media background.

This article does not even attempt to take issue with those opposed to PSAs on the entire range of related matters—the PSA advocates, including this author, have already done so through many articles¹ and even books² (the latest³ is just off the press), and a curious reader can peruse them all. There is no need to repeat the same arguments already raised in recent publications to explain the latest wave of red-baiting

1 Practically all of them have been posted on the website of the Energy and Investment Policy and Project Financing Foundation (www.enippf.ru), which the author headed before his appointment to Brussels.

2 They are likewise listed on the above site.

3 A.A. Arbatov and A. Konoplianiuk, eds, compiled by M.A. Belova, *PSA Disputes* [in Russian] (Olita, Moscow, 2003), p.228.



Source: A. Konoplianiuk. *Complex approach for attracting foreign investments into Russian energy*. Dissertation in form of scientific presentation for Doctor of Economics degree. Moscow, State Academy of Management named after S. Ordjonikidze, 1995, p.81.

Figure 1: Basic difference between the mechanisms employed to assess dues to the State under the licensing system ("tax plus royalty") and under PSAs ("production sharing")

against PSAs in the Russian press (as part of efforts to fend off foreign competitors, including pre-sale intrigues in a bid to sell one's own companies to them at a higher price).⁴ Those in the know must already be aware of where this author stands: he has always argued for Russian legislation to encourage competition not only among investors (including vying for access to subsoil resources), but also among different investment options available for subsoil use.⁵ It is only in this way that it will be possible quickly and efficiently to create a felicitous environment for investment in the Russian energy sector and through it (by means of multiplier effects from such capital inputs) in other Russian industries also. Russian legislation must provide for subsoil use on the basis of licences, concessions, and PSAs, thus ensuring competitive niches for all types of business entity opting for subsoil use (including both the largest vertically-integrated oil

companies, and medium-sized and small non-integrated companies of all ownership types). It is from this patently "prejudiced" stand in favour of PSAs as a component of an integral system of subsoil use arrangements,⁶ making it possible to foster a competitive atmosphere in the mineral commodity sectors of the Russian economy, that this article will attack the opponents' case. The key point made below is that struggles against PSAs are struggles against rent-based taxation.

PSAs and mining rent

The point of departure is: what makes PSAs such a hazard that their adversaries spend vast sums of money to try and discredit them? Who needs to bring PSAs into disrepute? Who benefits from such tactics and why?

PSAs are nothing more than an economic and legal arrangement allowing for an optimum distribution of mining rent between the State as owner of subsoil resources and the investor developing a specific mineral field. But they are also an arrangement whereby it is possible (subject to proper use) to ensure a precise dynamic balancing in the allocation of mining rent receipts from each specific field between the

4 A. Konoplianiuk, "PSA Argument—Kill a Competitor" [in Russian], *Vedomosti* daily, March 17, 2002, p.4.

5 It is this concept that a group of PSA law drafters including this author in their time hammered out and defended during debates to determine the place of PSAs in Russian subsoil use and the ratio of PSA-based and licence-based projects. See, e.g. A. Konoplianiuk and M. Subbotin, *The State and the Investor: the Art of Coming to Terms (Concession Legislation in Russia)* [in Russian] (EPITSentr, Kharkov (Folio), Moscow, 1996), Pt 1: Theory and Practice of Concluding Concession and Other Contracts, p.125; Pt 2, Bills on Concessions and Production-Sharing: 1994–95, p.158; A. Konoplianiuk and M. Subbotin, *Controversy Over Sharing (Debates on the Law "On Production-Sharing Agreements")* [in Russian] (VNIIOENG, Moscow, 1996), p.222.

6 A. Konoplianiuk, "Concession Contract: Possible Place and Role in Russian Investment Legislation" in *Oil, Gas, Energy, and Law: 2001–02* [in Russian], a legal information yearbook on the Russian fuel and energy sector (Nestor Economic Publishers, Moscow, 2001), pp.77–92.

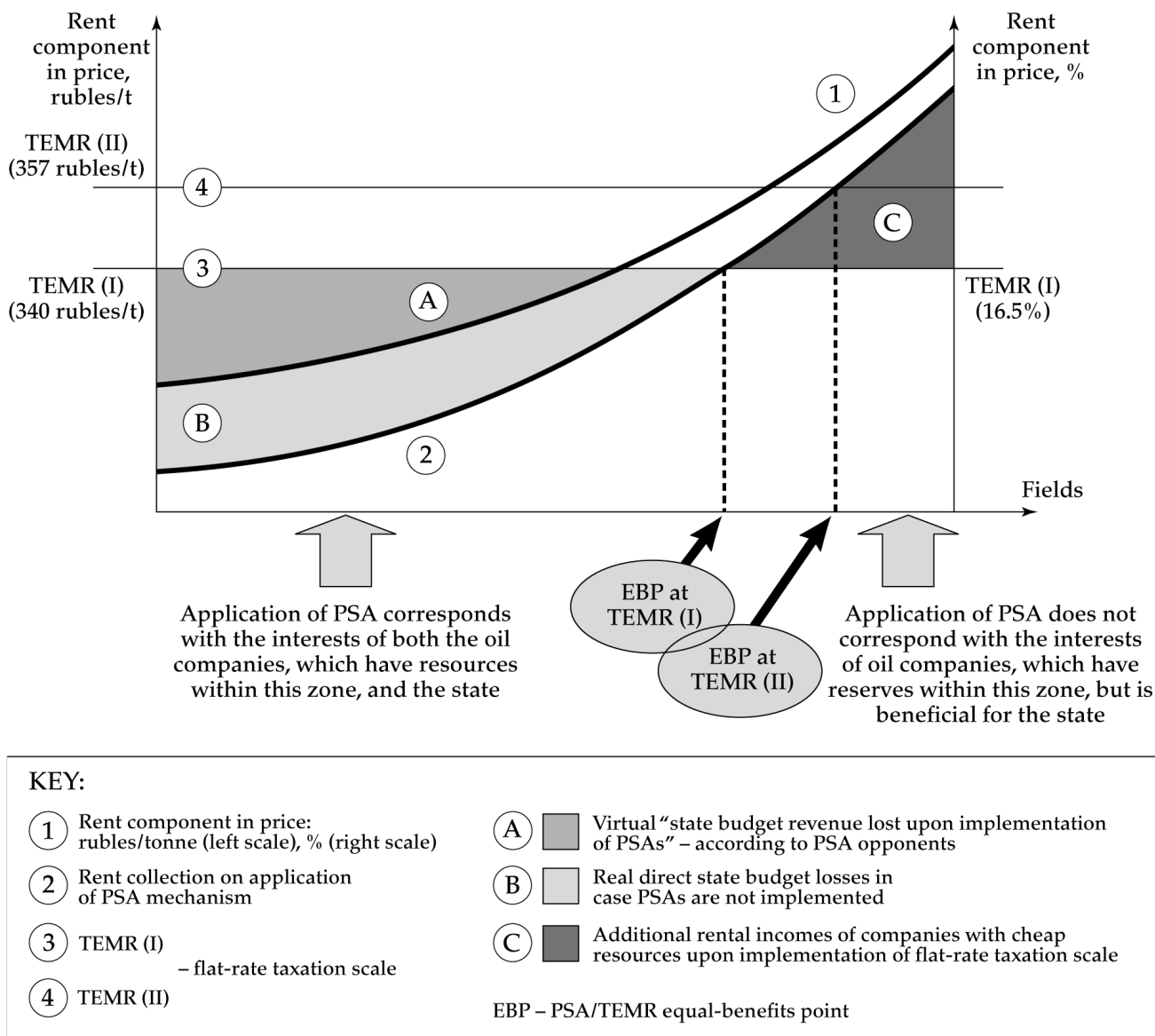


Figure 2: PSAs and the rental principle of taxation: who finds PSAs (dis)advantageous to pursue and where

two parties to the corresponding agreement (see Figure 1) compared with what, *a priori*, is a less accurate, *i.e.* other than optimal, sharing-out of the rent obtained where administrative law-based regulatory machinery is at play (in other words, compared with *any other* tax treatment of subsoil users unilaterally prescribed by the State).

Therefore, PSAs amount not to a preferential tax regime, but to a different, rent-based tax treatment for subsoil use, which will always yield greater revenue to the State than the so-called “national tax treatment” championed by their opponents (or, to use a less jingoistic term, “existing taxation arrangements”), because in some cases (in those projects where the burden of existing taxation arrangements will be unduly heavy) incomings from PSAs will equal zero, while in others (in projects leaving subsoil users with increased mining rent) PSAs could assure the State of larger tax receipts than existing taxation arrangements. This is, it seems, a key reason why PSAs are resisted so stubbornly by those oil companies enjoying the most favourable structures of reserves secured during the privatisation of the oil sector.

If all licensed oil fields in Russia are (hypothetically) arranged in an order reflecting increases in the percentage of rent in the price (see Figure 2), the answer to the question of why companies holding reserves that offer favourable development conditions find PSAs disadvantageous will become obvious (note that the rating list of deposits by the share of rent in the price is substantially different from the rankings by size of individual reserves, which are shown in Figures 3 and 4 below, because, as is known by professionals, it is not only the dimension of a deposit that determines the size of the corresponding rent).

In the author’s opinion, it is plain that the A zone on the left-hand side of the drawing (or the summation of two zones: A plus B—depending on how radical the opponents of PSAs are) does not amount to “the state budget revenue lost upon implementation of PSAs”, as is all too often claimed by the latter. At best, the alleged revenue shortfall is virtual and exists only on paper—if one assumes that investors choose to develop fields in this resource zone at a loss. Yet this argument, substantiated by the need to uphold State interests (and sounding especially compelling when

made by some of the biggest privately-owned oil companies), is among the cornerstones of the reasoning of anti-PSA crusaders.

The B zone reflects direct State budget losses where fields in the above resource category remain undeveloped on PSA terms (considering that, as follows from economic theory, they will not be exploited on the basis of licences).

Those opposed to PSAs constantly forget for some reason to mention that there also exists the C zone which reflects the relatively small portion of the resource category in question, fields which assure the corresponding subsoil users of rent that is much greater than their tax liabilities under, to use their terminology, "national tax treatment".

In time, the point where it is equally beneficial to pursue PSAs and to operate on the basis of licences will shift. Its final displacement vector (pointing left or right) will hinge on which of the following factors turns out to be dominant:

- ageing of the country's resource base and the priority development of such deposits as are the cheapest to exploit (which will push Curve 1 down); or
- cost-slashing innovation (which will force Curve 1 up).

The paradox, however, lies in that, ideally, PSAs could prove more attractive for the State in zones both right and left of the point:

- they would become more attractive left of the point because companies find it unprofitable to develop fields in this zone on terms other than PSAs; and
- they would become more attractive right of the point because reliance on PSAs there guarantees the State larger tax receipts than those due under existing tax arrangements.

Does this mean that the licensing system should be abolished and PSAs should be relied upon everywhere as the more effective option for the State to deal with foreign subsoil users in the oil sector? Not at all (even though Western oil companies in business in Russia did some active lobbying in favour of such proposals in mid-1990s through their association known as the Petroleum Advisory Forum). As repeatedly argued, the different categories of risks arising during the exploitation of reserves on the PSA basis and under the licensing system make their "peaceful coexistence" possible (all other conditions being equal, PSAs are more effective from the standpoint of "fair" rent allocation, but, by definition, also more time-consuming—because of their individual project-oriented nature—and result in a later commencement of actual field development, while licences constitute what is, in many respects, a less efficient decision-making system, but it is, however, standardised and, hence, ensures an earlier start for subsoil uses).

Obviously, selective use of PSAs⁷ is, all other conditions being equal, preferable for the state owning

⁷ PSAs can only be used on a selective basis, because, as will be demonstrated below, oil companies find it more profitable in a substantial number of cases to use other-than-optimal tax

subsoil resources (especially in Russia with its vast territory and diversity of natural conditions in oil fields) compared with any differentiated taxation, because no government is unilaterally capable of fine-tuning the "stair-step" scale of differentiated tax rates to an extent that will ensure an ideal sharing-out of rent collections with an investor, which is often possible through negotiations with investors in individual PSA projects. This was demonstrated by attempts undertaken to implement differentiated excises in the Russian oil sector in the late 1990s. But it is just as plain that it is more advantageous for the state to employ the stepped scale of differentiated taxation than to renounce any differentiated tax arrangements altogether and use a flat scale to charge special taxes (*i.e.* the mechanism in place to levy "tax on the extraction of mineral resources" (TEMR) over 2002–04), considering that the flat scale (just as the non-differentiated *ad valorem* rates which are to replace the flat scale for TEMR from 2005) is the least flexible tool in terms of taking account of different natural (and, consequently, commercial) conditions for the development of deposits in Russia. In other words, using the flat scale for taxation purposes is the same as determining an "average body temperature" per patient at a hospital for diagnosis and treatment of each individual patient in particular.

Another conclusion is that PSAs carry the greatest threat to those advocating the flat scale of taxation, because the latter presupposes larger losses for the state as subsoil owner compared with *any* differentiated taxation.

The above sheds some light not only on the logic of struggles against PSAs, but also on the sequence of developments in these crusades fuelled by the striving of corresponding businesses to retain the possibility of deriving outside rental income in the B zone (see Figure 2). Those crusades got underway following what can be considered to have constituted a kind of "contact reconnaissance" and "adjustment of fire" during a meeting of CEOs from major Russian companies with President Putin in May 2001, when M. Khodorkovsky of YUKOS in his position papers ("How to Stem the Capital Drain From Russia" and "How to Increase Russia's Revenue From Commodity Extraction") unveiled recommendations to "withdraw PSA-related benefits", which amounted to an effective plea to scrap PSAs as an idea contrary to "national tax treatment" and favouring only those individual subsoil users that rely on PSAs.

However, all indications are that even the more heavyweight pressure groups found it hard to push

arrangements under the licensing system, while opening up the targeted fields earlier, than to campaign—spending an extra one, two or even more years on relevant negotiations—for the best possible taxation treatment under PSAs: losses resulting from the inadequacies of the licence-based system may prove smaller than those caused by the late beginning of oil recovery in PSA projects. However, it is for investors themselves to make the respective choice. In order to be able to do so, they should enjoy the practical rather than virtual freedom to choose the conditions—licence requirements or the terms of a PSA—on which to develop a field upon winning a corresponding tender or auction for access to subsoil reserves. However, one should not expect that all prospective investors would then be preparing their bids only on PSA terms.

simultaneously for flat-scale taxation under the licensing system for subsoil use and for a ban on PSAs. It apparently seemed more logical and consistent in the circumstances to get the flat scale in place first (as an initial step) and then to exploit the success and concentrate on stamping out PSAs (as a follow-up step) with a view to finally eradicating rent-based or similar principles of taxation in the Russian oil industry. The succession of the steps is understandable, as *all* Russian oil companies today produce *all* of their crude in Russia under licence. PSAs mean nothing more for them than a future possibility. This explains the priority given to tussles for existing cash flows, with the fights for future cash flows receding into the background for now.

Therefore, PSAs are resisted by those who have a great deal to lose if such arrangements begin to be employed on a large scale throughout the country, namely, by such companies and their owners as will have in this case to give more to the State than they do presently (*i.e.* a higher percentage of their rental income). This is precisely why they have risen up in arms against the rent-based principle of taxation, why they have railroaded the flat tax scale during decision-making on the taxation of mineral production operations, and why they are out to besmirch the very idea of PSAs. But why has the State been going along with this?

PSAs and the State

The State will, after all, end up the final loser—even in those PSA projects which seem, at first glance, secured against the adverse effects of ongoing debates on PSA legislation and some new PSA projects. It is, for example, assumed that in any, even the most unfavourable, outcome of developments regarding the new PSA projects, those PSAs concluded (for the Sakhalin-1, Sakhalin-2, and Kharyaga projects) before the PSA Law became effective will turn out to be reliably protected under its “grandfather clause” (Art.2.4) and escape unscathed if the Government’s proposals are implemented. This, however, is wishful thinking. The laws of the financial market are stern, and dictate that the continued prolonged funding of these projects amidst an economic, legal, and political atmosphere which is increasingly hostile to PSAs will inexorably provoke greater risks from the point of view of financial institutions, meaning that borrowing costs (cost of capital) will likewise rise. As a result, the financial costs of the projects and, consequently, the reimbursable expenses (cost oil) will grow, while distributable output or profit production subject to distribution (profit oil) will shrink, thus detracting from incomings due to the State through its own fault.

The Russian press is being shamelessly used to manipulate the public into coming to see PSAs as unwarranted privileges leaving the State with a shortfall of taxes and other dues from the companies involved. The media are busy churning out all manner of twisted comments on PSAs for those deposits making for an inadequate share of rent in the price, the development of which on the basis of licences does not assure investors of acceptable returns under existing taxation rules (left zone on Figure 2). The above-

mentioned financial market laws and economic regulation require that the fields in question in such instances not be exploited (on a licensing basis), since the objective of investments is making a profit, and mineral field development is only a means of deriving such gains. In other words, the effects of PSAs in such cases should be compared against zero rather than any mythical “tax receipts” on paper, calculated on the assumption that the fields concerned will be exploited within the frameworks of the existing taxation system (even though they will not). This is why the employment of PSAs in the circumstances makes it possible to achieve a compromise between the State and investors and to enable the latter to obtain a satisfactory recoupment of investments, and the State to secure actual (and not nominal) tax collections.

The application of existing tax provisions with certain exclusions for fields in the zone concerned—*i.e.* their coverage by actual tax benefits to ensure that the alleviation of the tax burden on individual categories of deposits (for example, difficult-to-recover reserves or fields about to be depleted) will lower the break-even point as required to open up new fields and to keep profitably exploiting those already under development—can be proposed as an acceptable alternative (even though, in most cases, it will be less effective than PSAs). One practical example of this kind is the so-called Tatarstan experiment, the positive results of which are well-known to specialists.⁸

The opponents of PSAs just as stubbornly remain silent on the possibility of PSAs being employed in another part of the resource spectrum, where the share of rent in the price exceeds the taxation level (effective tax rate) under the taxation system applicable to licence-based subsoil use. In that zone, PSA arrangements would considerably increase the tax burden on companies, while preserving a rate of return at a level acceptable to them, *i.e.* would make for larger incomings to government budgets at every level and for the continued investment appeal of the corresponding field development operations (right zone on Figure 2). This is, evidently, precisely what the opponents of PSAs fear most of all: they will in this case be compelled to share their receipts on a fairer basis.

Sharing: what and how

Those cabinet members responsible for financial policies have lately been increasingly in favour of reducing the tax burden in industries unrelated to oil production by shifting it to the petroleum sector. The contemplated higher tax on the production of mineral resources should make up for the less severe overall taxation of the oil industry owing to cuts in other taxes, a Russian Deputy Minister of Finance, M. Motorin, said in a *Vedomosti*.⁹ In his opinion, taxes on oil companies and their employees over recent years have tended to decline: they have benefited from lower income tax (and oilmen are known to enjoy the highest pay), from a reduction in consolidated social

⁸ Russian Ministry of Fuel and Energy, “Conceptual Guidelines for Developing Russia’s Oil and Gas Complex” [in Russian], *Neftegazovaya Vertikal*, January 2000, No.1 (special issue), p.00.

⁹ *Neftegazovaya Vertikal* news service, March 24, 2003.

tax, from the abolition of turnover taxes and, to a substantial extent, from a drop in profit tax (but the author of this article is known to maintain a different view on the consequences of the "tax reform" in the petroleum sector¹⁰).

The question arises: how can this be done? (Let us ignore the question of whether this should really be done, as the political decision to go ahead in this respect appears to have already been made.) There are two ways to go about it: by taking a differentiated approach and by spreading the mooted benefits indiscriminately in a very thin layer among all. The Government obviously prefers the second option, which is easier to implement.

"The Ministry of Finance proposes that the base rate of TEMR related to oil operations be raised since 2004 to RUR 357 from current RUR 340 per tonne, which will secure tangible additional incomings to the government budget in the amount of RUR 11 billion", the Russian Minister of Finance, Alexei Kudrin, was quick to tell reporters.¹¹ How does this plan threaten the industry?

Should the tax burden be enlarged evenly for all companies by raising the specific rate of mineral production tax, this will extend the zone in which most Russian businesses will prove uncompetitive (see Figure 2), but will also offer greater relative competitive advantages for companies controlling those reserves which are cheap to exploit. The narrower the zone of competitiveness will become upon the application of mineral production tax for most companies the resource portfolios of which are differentiated in terms of cost levels, the more solid supporters of PSAs they should (sooner or later) become so as to be able to develop deposits today and tomorrow in a more efficient manner. In these conditions, the companies advocating the flat scale of taxation find it gainful to press for the final eradication of PSA arrangements so as to deprive their Russian competitors of an alternative possibility (and the Western competitors of the sole possibility, considering that Western businesses are not prepared to invest in Russian field development on any conditions other than PSAs) to open up new and continue exploiting existing deposits (because no one will agree to pursue any such operations at a loss). Should this policy line be buttressed by the synergy effects of a merger between the two Russian vertically-integrated oil companies most interested in developments taking the above route, this may eventually lead to their expanded market roles—both under flat-scale taxation and in the absence of PSAs—in full compliance with the interests of these two—and only these two—companies. Therefore, the

RUR 11 billion mentioned above may be obtained (if at all) at the expense of most Russian oil producers' competitiveness. Does the State really want this?

The above comments refer to the "all benefit equally" approach. What about the differentiated one? In that case, the tax burden on companies with the largest share of rent in the price can (and should?) be increased and that on companies with the smaller share of rent in the price left at the same level or even lowered. It is required, in other words, first, to forego the flat scale of taxes; secondly, to return to the discussion of specific parameters for differentiated taxation; and, thirdly, to open a debate on the employment of PSAs in the high-rent zone, the zone of fields boasting the best natural conditions rather than only those with the worst of conditions, as stipulated under the existing PSA Law. This will certainly blunt the competitive edge of companies with the best reserves (and, one gets the impression, also with the cream of lobbyist talent) compared with other subsoil users. Therefore, this author has no doubt as to their response to this kind of proposal. But one would also like to hear the Government's substantiated position on this score.

Different kind of rent

As it turns out, some experts look at differentiated taxation only in terms of its dependence on price conditions. In other words, they speak of "price rent", but apparently forget (?) about "mining rent". The First Deputy Chairman of the Russian Central Bank, Oleg Viugin (in this author's opinion, one of the country's best economists), for example, noted: "It is a fact that the State in its regulatory activities is fairly generous when sharing out rent with private companies". But he added in almost the same breath that: "That section of the curve corresponding to unduly high prices on oil should accord with an all but complete withdrawal of extra income".¹² What Mr Viugin meant, therefore, was price rent and so-called windfall profits as the base for stiffer corporate taxation (the United States, at the absolute peak of oil prices on world markets in the early 1980s. charged a special windfall profits tax), in other words, such revenue as the companies, strictly speaking, do not earn, but enjoy owing to a felicitous price environment (such as the one in evidence in the first quarter of 2003, when all major vertically integrated oil companies reported an enormous gain in profits—the "price bonus" for the war in Iraq). However, Mr Viugin said nothing of the mining rent which made it possible for some oil companies—even amid low prices—to derive larger profits than their competitors or, to be more precise, such profits (or their portion) which they likewise did not earn, but received as a windfall (*i.e.* from the State, considering that it is with its assistance that they landed the juiciest pieces of the petroleum pie in the course of privatisation).

Mr Motorin argued along the same lines in his interview mentioned above, when he said that the question of a higher export duty on oil in conditions

10 See A. Konoplianiuk, *Russia's Oil Industry Reform (Taxes, PSAs, Concessions) and Consequences for Investors* [in Russian] (Olita, Moscow, 2002), Ch.1, and other publications by the author on this subject: "Will the Well Do Well? Apropos of Ways to Improve the Bill on Tax on the Production of Minerals" [in Russian], *Neft i Kapital*, 2001, No.6, pp.12–16; "Increasing the Monetary Pressure. Tax Reform in the Oil Industry: Initial Results" [in Russian], *Izvestia*, November 21, 2001, p.7; "Congratulations on the New Taxes, Gentlemen! Analysis of Expected Results From Tax Reform in the Oil Industry" [in Russian], *Neft i Kapital*, 2002, No.1, pp.6–10; "Vicious Circle: New Tax System in Subsoil Uses No Better Than Old One", *Rossiyskaya Bizness Gazeta*, March 12, 2003, No.9 (399), p.5.

11 www.rusenergy.com, April 21, 2003.

12 "We Do Not Want Competition and Restrict it in Every Way" (interview with O. Viugin, First Deputy Chairman of the Russian Central Bank), *Kommersant-Denghi*, April 7–13, 2003, pp.20–22.

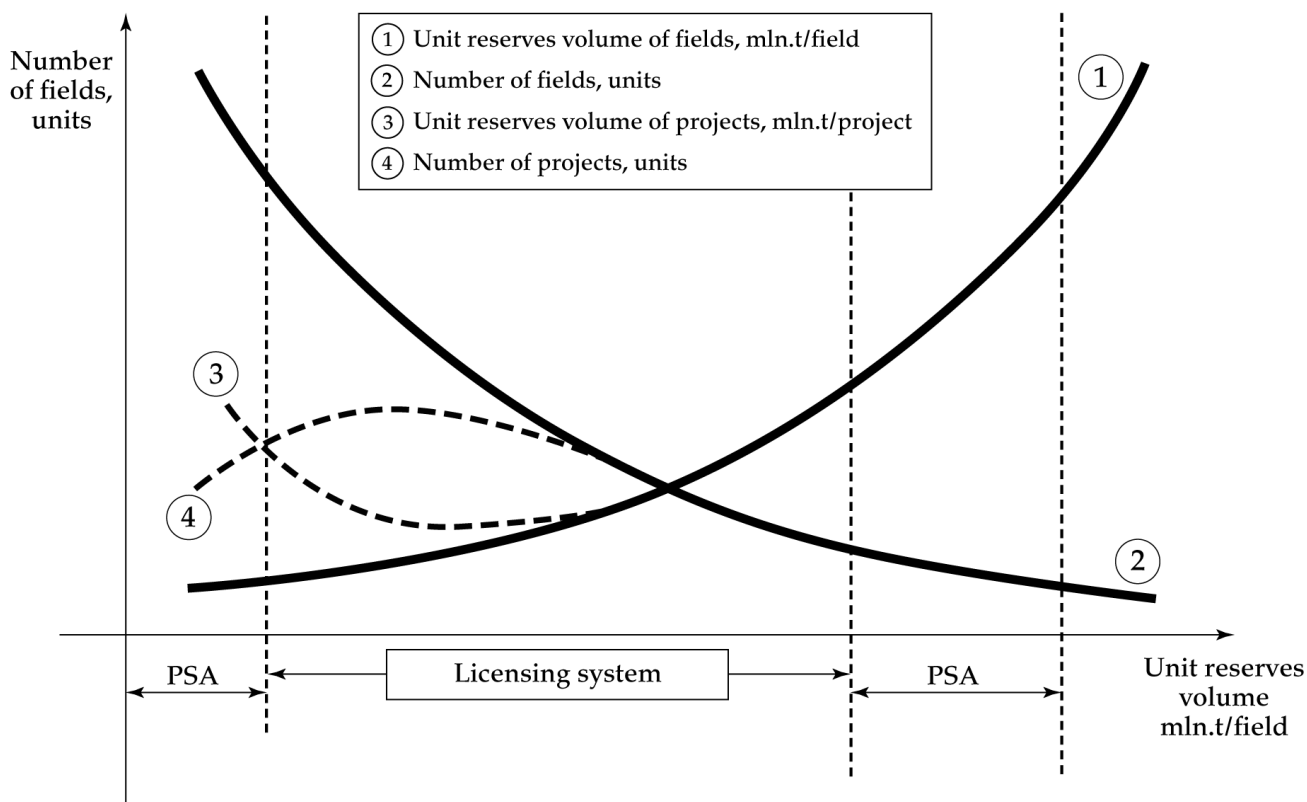


Figure 3: PSA preferential application zones

where "prices are extra-high" is being discussed. The idea contemplated is increasing the slant of the scale used to charge such duties should prices exceed US\$25 per barrel (currently, the scale is evenly inclined at every point, with the slope beginning from the zero mark at the price level of US\$8 per barrel).

Therefore, both of the professionals quoted above, as well as quite a few others, speak not of mining rent, but of pricing rent, which results from hikes in oil prices beyond their projected level. What this author means, however, is not price rent (which the existing TEMR mechanism, incidentally, is partially designed to recover and this, by the way, does not appear to be quite justified, considering that 100 per cent of tax payments by all companies, regardless of the percentage of their crude production they export, is thus made dependent on world oil prices¹³), but mining rent proper, in particular, that differentiated rent determined by differences in mining, geological, geographical, and climatic conditions facing companies engaged in mineral field development and embodied, in the final analysis, by the different economic parameters of such operations, irrespective of changes in oil prices.

Zones where PSA projects may be undertaken, and PSA-related risks

In January 1999, Art.2 of the PSA Law was amended to include an additional cl.5, which stipulated that in some cases, lists of subsoil sites, mining rights to which may be granted on a PSA basis:

¹³ Mineral production tax issues are dealt with in A. Konopljanik, *Russia's Oil Industry Reform (Taxes, PSAs, Concessions) and Consequences for Investors* [in Russian] (Olita, Moscow, 2002), Ch.1.

shall be established . . . other than upon approval by federal law if such subsoil sites comprise the following mineral deposits:

- oil fields whose recoverable reserves are under 25 million tons;
- gas fields whose reserves are under 250 billion cubic meters;
- primary gold fields whose reserves are under 50 tons;
- alluvial gold fields whose reserves are under 1 ton; or
- fields of other minerals other than those falling under the category of strategic minerals or hard-currency valuables.

The new provision has institutionalised the principle favoured by the drafters of PSA legislation from the very beginning, whereby PSA arrangements will, as a rule, be commercially attractive primarily in two marginal zones of the resource spectrum, namely that of mega-projects and that of minor deposits. The use of licences there today is too risky, as operations on their basis in such fields are either impracticable owing to prohibitive financial inputs required (cost of raising capital for mega-projects) or altogether impossible, as the break-even point proves higher than the levels of the reserves concerned as are required to yield the gross returns needed to recoup the investments called for (outsize "technical expenses" on small deposits) (see Figure 3).

The extent to which operations to develop small and medium-sized deposits prove competitive will be decisive for the choice of PSA arrangements. This is precisely why procedures for the preparation and signing of PSAs for such fields should be made as simple as possible ("time-value" factor), and this is also what the above amendment to the PSA Law was geared to. In order to raise the break-even point in the

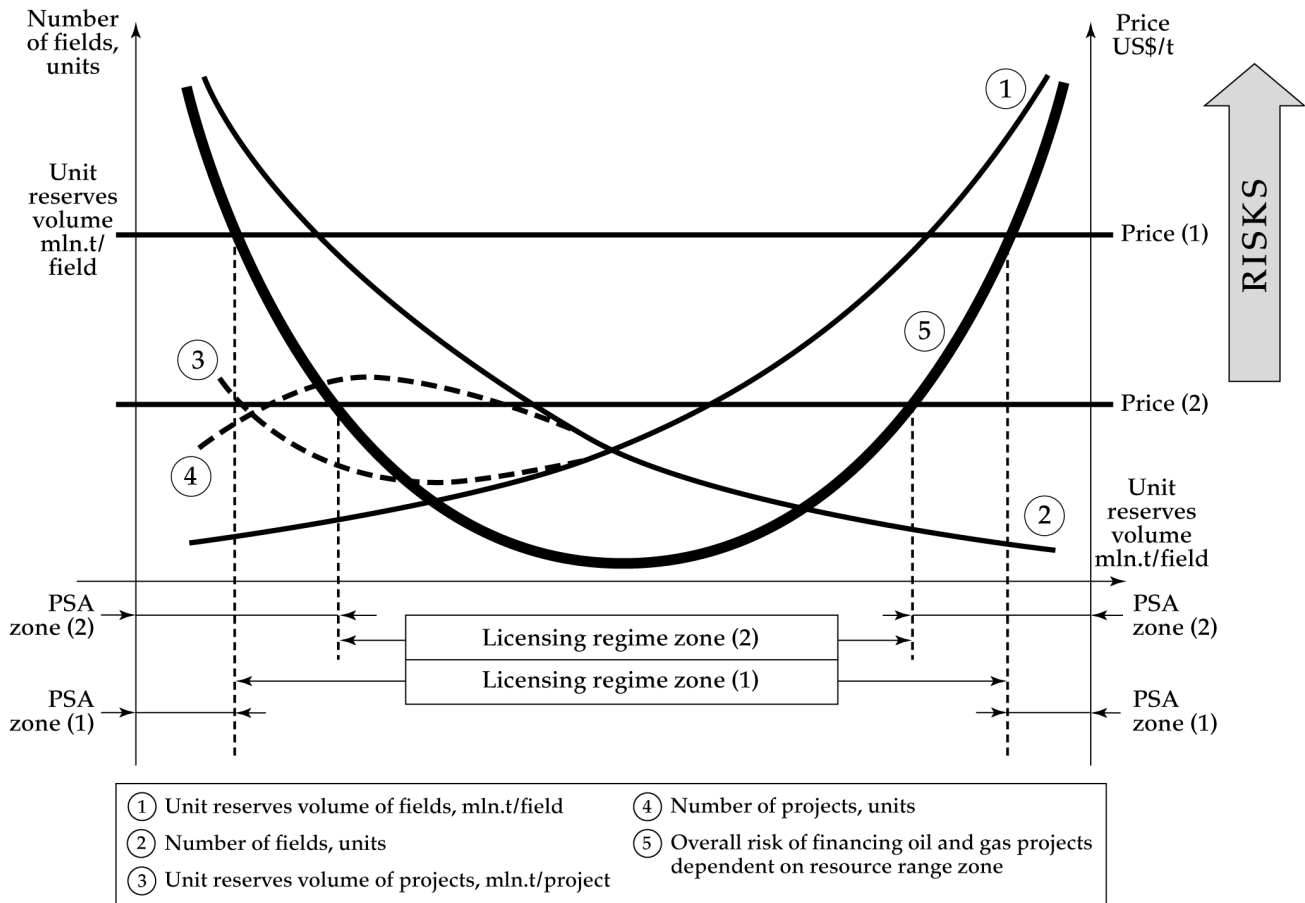


Figure 4: Evolution of PSA zones with oil price fluctuations

development of the fields concerned, it would also be advisable to provide for the possibility of and design routines (where economic efficiency can only be attained through the joint exploitation of a cluster of closely-spaced fields) for combining such subsoil sites—during their provision for use on PSA terms—into a single project to be covered by the summary procedure for the negotiation and execution of PSAs even if the total reserves of such deposits exceed those limits prescribed by Art.2.5 of the PSA Law (Figure 3). This will not be inconsistent with the PSA Law. Where several fields are united within the frameworks of a single project, the discounted cash-flow curve visibly rises along the y-axis.¹⁴ This is why the above provision will benefit all parties to PSA projects, including both the investors and the State, because it will make it possible to make fuller use of the mineral resource potential of individual territories through the bringing of extra commodity reserves into production and the instrumentality of both direct and indirect (adjoining and multiplier) effects for all participants.

Let us take another look at mineral production operations based on PSAs and those based on licences from the standpoint of investment risks. The employment of PSAs in the marginal zones of the resource spectrum becomes more alluring, because the risks encountered by licensees upon launching operations in such zones go through the roof (see Figure 4). This is when the factor of price movements starts to play a

significant role, since it bears upon the “width of coverage” as far as the competing arrangements are concerned. The higher the prices are, the greater is the measure in which they make up for the risks of the existing taxation system being non-optimal and the larger the area is where companies are interested in licence arrangements. Inversely, the lower the prices are and the more narrow the gap is between costs and prices, the greater the companies’ interest becomes in a more precise distribution of gross profits between themselves and the State. The lower the prices are, the less capable the price rent is of acting as a counterbalance to the inefficiency of the existing taxation system. Therefore, at a time of low prices (like those experienced in the late 1990s), all oil companies come to face the need to replace the uniform taxation system by a different arrangement—such as PSAs in our case—for the individualised taxation of projects which have what are, by definition, individual natural and, hence, economic characteristics. In other words, at a time of low prices, PSAs will deliver companies from over-taxation and their interest in such arrangements increases. At a time of high prices, it subsides. All this applies, however, to a situation where both systems are used in competition with each other.

If a “war of extermination” against PSAs is unleashed at a time of high prices, then other factors also are apparently at play, the same as are listed above in describing the second phase of struggles

¹⁴ See V. Grushin, A. Konoplianiuk and N. Oksengorn, “Procedure for Shunting Small-Scale Hydrocarbon Production Operations to the PSA Track (Offered by Way of a Discussion)”

[in Russian], *Neftnyanoye Khozyaystvo*, June 2002, No.6, pp.83–89.

against differentiated taxation. The interests of individual companies under such circumstances are readily manifest. But what about the State's vested interests?

One would like to hope that the Government will eventually take a statesmanlike approach to this issue, one that is in the public interest.

PSAs: What is to be done?

So what is to be done? Robbing Peter to pay Paul, *i.e.* buttressing some shaky constructions of the rickety PSA system at the expense of others, is not sensible. What should be done instead is to free the PSA machinery of the fetters holding back its effective use on an extensive scale. It is imperative, in other words, to give up the limited PSA use model which is advocated by some cabinet members¹⁵ to apply to only the very worst subsoil sites, with PSAs to be permitted there, according to them, only after the other subsoil users refuse to accept the fields in question on their own balance sheets (one can only imagine how inactive and unrepresentative the bidding will turn out for an auction mounted for such lean deposits and how near to the ground the resulting prices will work out). Therefore, struggles for the survival of a few PSA projects against the looming prospect of the "PSA concentration camp" championed for this kind of agreement by its opponents in and outside the Government are a possible path, but one leading to a dead end. This attempt resembles an episode narrated by a Soviet children's literature classic in which homeless boys eat from the same pot and some try to protect their portions of the soup—by using their spoons as guards to fend off intruders—while the others, stronger and more zealous eaters, quickly down one spoonful after another from their part of the shared vessel.

The highway to efficient PSA use is through a return to the idea of building such a system for their

employment in Russia as will maximise their positive economic impact for the State, while assuring investors of reasonable benefits as well. It is appropriate for this purpose to go back to the original PSA model design which existed until autumn 1995, when the two Russian parliamentary houses formed their relevant conciliation committee, and to try and upgrade it.

Therefore, it is crucial to forego such fundamental restrictions on PSA use as:

- lists of subsoil sites where PSAs are permitted;
- 30 per cent resource quota for PSA projects;
- approval of PSAs by laws;
- requirement that 70 per cent of the equipment bought for a PSA project be Russian-made, regardless of its competitiveness, and that 80 per cent of the personnel be local;
- complicated formalities for PSA preparation for small fields; and
- like non-economic constraints.

It is expedient to review the operating concept for PSAs for such arrangements to be renounced only for those deposits with the worst development conditions, and to design such tendering procedures for bidding for mining rights as will enable the winning companies themselves to choose the basis on which they would like, and be obliged to, exploit a mineral field (as long as existing laws allow only a license or only a PSA to be used for such purposes).¹⁶

It is to be hoped that the tide of insinuations over PSAs will inevitably ebb. But then the question will just as unavoidably be in order: why was the Russian Government sticking to the position in the PSA controversy that it had chosen to take—that of flat opposition to this mechanism for attracting investments for subsoil use? The author considers this position to be contrary to national interests, benefiting not society as a whole, but only individual Russian oil companies.

¹⁵ This has since been supported by the State Duma legislature by amending the PSA Law accordingly during its second-reading approval of that chapter in the Tax Code which is devoted to PSAs. The author sees that development as having amounted to an illegitimate act to alter (in passing, yet quite deliberately) the underlying concept of the PSA Law.

¹⁶ The author wrote about how this procedure could in principle be organised so as to make for the actual equality of the two existing subsoil use systems in the country way back when the PSA Law was only being drafted. See, *e.g.* A. Konoplianiuk, "Concept for Legalizing Production-Sharing Agreements in Russia: Key Aspects" [in Russian], *Neftyanoye Khozyaistvo*, 1994, Nos 11–12, pp.6–15.