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PSA DEBATE in Russia: Getting rid of Rivals by A. Konoplianik

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PSA DEBATE: GETTING RID OF RIVAL

Andrei Konoplianik

March 17, 2003

A discussion has been sparkled in Russia whether or not a production sharing agreement (PSA) is needed as a special investment regime. This is not a "just-asking" kind of question because it relates to multibillion investments in the Russian oil industry. Given that I headed the group of PSA law developers and consider myself personally responsible for emergence of PSA's in Russia, I cannot stay away from the discussion.

A massive propaganda campaign has recently been launched in the Russian press, seeking to discredit PSA's. One of the key sponsors and masterminds of this campaign is well known: Michael Khodorkhovsky, the YUKOS head. Which of the recent developments added so much to the aggressiveness of PSA opponents? This is precisely the heart of the issue which calls for an investigation. Maybe, it is not the PSA "defects" that are the true reason for the concerns of PSA opponents and maybe it is not the care about national interests that is driving their crusade but some other matters or considerations?

According to Sergei Bogdanchikov, Rosneft President, "the campaign is headed by two companies who acquired the most productive fields as they vied for a piece of the oil cake. For this reason, they have the lowest cost of crude oil production, secured for themselves the competitive edge for now and they want to keep it for the next 15 to 20 years."

On the face of it, a person unfamiliar with crude oil economics, finance and law may be led to believe that the care about national interests is the core of the standard set of anti-PSA arguments: under a PSA the government allegedly gets less tax which, moreover, arrives much later than under the existing tax system; PSA projects would push up production in excess of what is publicly needed and would reduce world market prices; and there is no spare pipeline capacity to move PSA production, which may result in a collapse of the Russian transportation system. To many this sounds a kind of convincing the more so as it comes from lips of the oilmen (although a new wave of them who arrived in the industry from money markets in the wake of privatization). A variety of other reasons are being cited including those based on sheer jingoism, with one being, in my view, the true reason for torpedoing PSA's. According to Michael Khodorkovsky, "PSA regime restricts the growth potential for Russian company capitalization. Why invest in Russian companies where one may get a field under the lucrative terms of a PSA?" "Therefore, PSA regime undermines Russia's energy security", concludes Khodarkovsky.

Consequently, a PSA is a rival. The rival to higher capitalization. But why should it be higher? To be able to sell them to international oil giants. The higher the capitalization the dearer the price of a block of shares offered for sale. All this, however, is now wrapped up in the currently popular PR wrapper saying "Security" and "National Interests" that may scare the man on the street away from the genuine reasons.

I respect smart managers and finance investors. Their objective is to buy low and sell high. They did buy low (remember the lien auctions?) and they do want to sell high. International oil companies are the only buyer (for that very reason they were banned from Russian oil industry privatization because under such a scenario the oligarchs would not have received their anticipated price delta of today – the government might have received it then).

What strategic foreign investors want is not *just* shares but the shares secured with predictable-risk disposable assets. Foreign companies do not have – and they cannot have by definition – those administrative resources of Russian companies which help them minimize their individual risks and maximize rent under any circumstances by, *inter alia*, pushing law-makers to pass the laws such companies need. Foreign companies need long-term stability to implement capital intensive projects – precisely what the PSA regime is about. For this very reason, the first of such transactions involving purchase of Russian oil company shares is the BP/TNK deal whose assets include PSA projects such as *Kovykta*, *Samotlor*, *Uvat* and *Sakhalin-6*. This means that involvement in PSA projects, on the contrary, dramatically enhances the investor attractiveness of relevant Russian companies if these decide to offer a block of their shares for sale.

Alas, those who call the BP/TNK deal a breakthrough showing that investment is possible in Russia outside PSA's are very wrong. From my prospective, the deal is the evidence to the contrary. For this very reason, Russian companies, which rejected PSA projects in their time because they own the newest and, thus, the most high-yield fields under any tax system, regard PSA's as a dangerous rival: the existence of an alternative investment in the Russian oil industry (which the PSA regime is) dramatically reduces the attractiveness of buying shares of companies that are not involved in a PSA. Consequently, this alternative must be eliminated. Such that investment in Russia may only be funneled through purchases of Russian company shares. Such that the cash generated by these sales may flow into the accounts of their Russian owners.

Well, the conclusion regarding the true reasons for combating PSA's is as follows: get rid of the rival. But why now? OK, let's look at this issue from a different prospective.

The idea that fields should only be developed on a "national" tax basis has been generated by the management of companies whose fields enable them – due to their favorable privatization outcome – to reap a higher natural rent. Their interest is clear: with uniform tax rates they pay less than under the PSA regime which allows the government to claim an additional portion of natural rent. Therefore, they don't need a PSA.

PSA regime is economically attractive typically in two boundary areas of the resource spectrum, i.e. for mega-projects and small fields. The higher the oil price the narrower the boundaries of PSA applications and the broader the use of licensing. And *vice versa*. For this reason, when oil prices are low (like in the late 1990s) all oil companies develop the need for replacing the tax system with another tax mechanism – in our case, with a PSA arrangement based on individualized taxation of projects which, by definition, have individual natural and, thus, economic features. This means that during such periods PSA's relieve companies of excessive tax burdens.

Consequently, at the time of high current and forecast prices, the economic incentives for Russian companies to use PSA's tend to go down. Following this logic, PSA criticism should also become less scathing because the market prices are high, incorporating the high "war" premium of expecting a war with Iraq. However, the world oil market is now in a state of "backwardation": futures quotations for a remote future are lower than closer future quotations (e.g. in the middle of the previous month NYMEX quotations for Texas Light blend deliveries in April 2003 and December 2004 equaled $36 and $24 per barrel, respectively). This means that the market does not believe in future oil shortages. Future prices are lower than current ones but still are two to four times higher than the 1998-1999 levels which fell to $8 per barrel, causing a wave of support to PSA's even from their present-day opponents.

Therefore, interested Russian owners of oil companies need to sell them now when the prices are high. As was noted above, to push the price even higher, foreign buyers should be deprived of any alternative opportunities for investing in the Russian oil industry. Generally, this is the end of the story of who sees PSA's as getting in the way and why.

The author is Deputy General Secretary of the Energy Charter Secretariat (Brussels). The views expressed in this article do not reflect the positions of the Secretariat or any of the Charter Member States.