

A struggle for mineral rent

By ditching the PSA system, the Russian government and parliament are working against the national interest because it will result in a loss of tax revenues to the state. Only the opponents of the system stand to gain by its removal, writes Andrei Konoplianik, deputy general secretary of the Energy Charter Secretariat

PRODUCTION-SHARING agreements (PSAs) were introduced in Russia in 1996 as an alternative to the existing licensing system, but were abandoned by parliament, on the proposition of the government, in June. As a result, the state will receive less in oil rents – certain developments that would have been viable under a PSA will not go ahead and a handful of lucrative projects will pay less tax than they would have done if PSAs had been maintained.

Some companies have attacked the PSA regime, successfully sowing public alarm by arguing that it is against the national interest. Among the claims are that the government receives less tax, delivered later than under the licensing system.

However, the real motivation is that these companies see the PSA as a competitive threat, because the system would draw a greater number of rich, technically competent foreign oil companies into the country's oil industry. Without PSAs, the reasoning goes, their firms will be in a stronger competitive position and will, therefore, be worth more to potential buyers (*PE* 7/03 p12).

Ironically, the value of Russian oil firms does not necessarily have any bearing on the national interest – the proceeds of share sales would mostly end up in the pockets of private investors, not in the state's coffers.

But there is a second motive behind the anti-PSA movement – removing rent-based taxation. PSAs are an economic and legal instrument designed to reach an optimum distribution of mineral rent between the state, the owner of the subsoil resources, and the investor. Under a PSA, taxation is customised to a particular development. Its negotiated character (which is based on a mutually acceptable profit-oil split) and its stability over the project's lifetime are among its advantages over the existing licensing system.

PSAs involve a lower level of risk for companies, making financing easier and cheaper to raise and attracting a greater number of investors – important considerations for an economy in transition. This should – went the thinking of the drafters of PSA legislation in the mid-1990s – have a positive knock-on effect on the level of investment protection provided by the licensing system.

It seems that attempts to create a more secure environment for investment have not succeeded. Rather than diminishing the barriers to investment outside the PSA regime – especially where foreign direct investment is involved – the government and parliament have been influenced by a powerful lobby in the Russian oil business and have instead decided to destroy the PSA system.

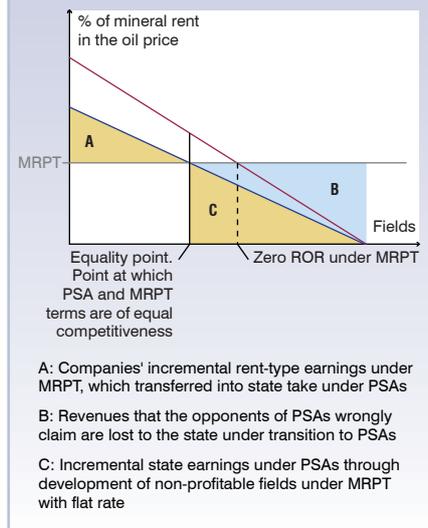
The tax regime

The PSA does not constitute a preferential tax regime for companies. Taxation is rent-based. PSAs will, overall, always yield greater revenue to the state than the licensing system. The latter involves a flat-rate, royalty-type, revenue-based taxation scheme, known as the mineral resources production tax (MRPT). This came into effect on 1 January 2002. For 2002-2004, MRPT was set at Rb340 a tonne (\$11.22/t). It is presently pegged at Rb347/t. From 2005 onwards, it will be set at 16.5% of gross revenue.

In small projects, the burden of the flat tax rate will prevent companies from achieving an adequate rate of return (ROR) and fields will not be developed. State revenues in these cases will be zero. A PSA would enable the same project to go ahead, as it allows the state and the investor to compromise on terms. The result is a reasonable ROR for companies and additional tax revenues for the state.

In projects that provide subsoil users with higher-than-average rents, PSAs can maximise state revenues by allowing case-by-case adjustments to taxation levels.

Figure 3: Transfer from MRPT to PSA



However, the MRPT is inflexible and can, therefore, act as a cap on state revenues. This is another reason why a few oil companies have resisted PSAs.

Figures 1-3 present hypothetical and simplified distribution curves of Russia's oil fields, according to diminishing productivity (it is represented by a straight line for ease of comparison). Figure 1 illustrates the distribution of the mineral rent between the state and investor under the MRPT system and Figure 2 illustrates this same distribution under the PSA system.

Face the consequences

Figure 3 indicates the consequences for the state budget of transferring from the MRPT to the PSA system. The state would receive additional revenues, denoted by zones A and C. Under MRPT, it would not receive this revenue, as zone A rents would be retained by the companies (with the flat rate of tax capping state revenues). And zone C rents would not be generated in the MRPT case, because, under this system, companies would not start developing the fields, given the prospect of negative profitability.

The opponents of PSAs view the picture differently. They argue that if PSAs are used to develop fields to the right of the equality point, the state would face "lost revenues" (zone B). This conclusion is based on a mathematical calculation of the tax that would be generated by the MRPT's flat tax rate. Although this is higher than tax revenues under PSAs, the argument is invalid,

Figure 1: Flat-rate tax system

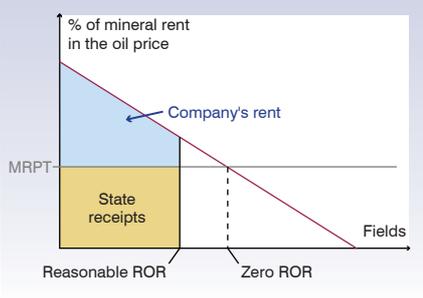
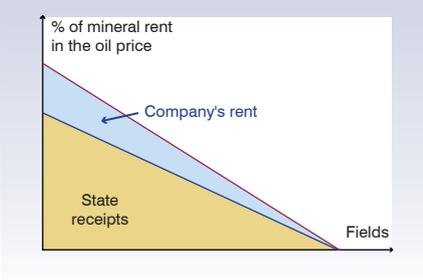


Figure 2: PSA



Russia: PSAs

because no investor would develop a field with an unreasonably low or negative ROR. Therefore, PSA revenues in this zone must be compared with zero revenues under the MRPT regime.

Secondly, they have kept quiet about the possibility of PSAs being employed in another part of the resource spectrum where the share of rent in the price exceeds the tax level (effective tax rate) under the MRPT by more than reasonable ROR (zone A).

Fair share

In that zone, PSA arrangements would considerably increase the tax burden on companies. They would result in a larger state take at every budgetary level (federal, regional, local), while preserving investors' RORs at an acceptable level, in turn stimulating investment in exploration and production. This is precisely what Russian oil companies opposing PSAs fear most: they would have to share revenues more fairly with the state (as well as facing more competition).

Paradoxically, PSAs could prove more attractive for the state in the zones both to the right and to the left of the break-even point:

- PSAs would be more attractive to the right of this point because companies would find it unprofitable to develop fields in this zone on any non-PSA terms; and
- PSAs would be more attractive to the left of the point because reliance on PSAs in this

zone guarantees larger tax receipts for the states than the MRPT system.

It is companies with the most favourable reserves structure (which they received free from the state during privatisation in the 1990s) that are not interested in the existence of the PSA regime in Russia, but prefer the flat-rate MRPT system. Yet the state

PSAs are resisted by companies that have something to lose if such arrangements become widespread

– in absolute contradiction to the argument that PSAs are contrary to the national interest – faces major losses under flat-rate MRPT in all zones of the reserves spectrum, compared with any type of differentiated-taxation mechanisms, either based on the licensing system, or on the PSA scheme.

That does not mean that the licensing system should be dispensed with and PSAs introduced for all subsoil developments (even though Western companies lobbied for such proposals in the mid-1990s). The different categories of risks arising under PSAs and the licensing system make peaceful coexistence of both regimes possible. All other conditions being equal, PSAs are more

effective from the standpoint of fair rent allocation. But negotiations on PSA terms are more time-consuming and delay field development, and, therefore, cash-flow.

Nonetheless, some Russian firms have fought against PSAs and in favour of flat-rate tax to protect windfall profits to preserve an extra margin of income. This struggle has occurred in two phases. First, there was a push for a flat rate of tax and, once that had been attained, for a ban on PSAs. The effect has been to eradicate rent-based taxation in the Russian oil industry. The sequence of the steps also has its own logic – all Russian oil firms produce crude in Russia under licences. PSAs are only a future possibility and priority was given to existing cash flows.

PSAs are resisted by those who have something to lose if such arrangements become widespread – companies that would have to give more to the state than they do at the moment. This has resulted in such determined opposition to rent-based taxation, it explains why they have railroaded the flat-rate MRPT during decision-making on the oil taxation and why they are out to besmirch the very idea of PSAs. It is a mystery why the government has gone along with it. □

The author led the group that drafted the Russian PSA law. The views expressed in this article do not reflect the positions of the Secretariat or any of the Charter's member states.

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