PSA debate not over yet

Legislation marginalising PSAs leaves the state worse off, not better, writes Andrei Konoplianik, deputy general secretary of the Energy Charter Secretariat and one of the chief architects of the PSA system. In the first of two articles, Konoplianik explains why PSAs are needed and why there may be life left in them

THE DEBATE on production-sharing agreements (PSAs), one could argue, is over. Last month, President Vladimir Putin signed a new law that introduces a new chapter in Russia's tax code – defining the taxation system under PSAs.

Its effect is to marginalise the use of PSAs. In practice, only eight projects will be developed under PSA terms in Russia: three (Sakhalin-1 and -2 and Kharyaga) were grandfathered under the basic PSA law, signed by the then president, Boris Yeltsin, in late 1995; and five (Shtokmanovskoye and Prirazlomnoye, in the Barents Sea, Sakhalin-3 and two offshore projects in the north Caspian) are grandfathered by the present law to be developed under PSA terms.

Anti-PSA propoganda

But PSAs are not necessarily finished. The Russian media has conducted an anti-PSA campaign in recent months, based on the supposed defects of PSAs and the protection of national interests – both bogus reasons. The question to be answered is why the opponents (Mikhail Khodorkovsky, head of Yukos-Sibneft, is one of the model's best-known detractors) have turned up the heat.

Sergei Bogdanchikov, president of Rosneft says: "The campaign is headed by two companies [now one – Yukos-Sibneft – following their merger], which acquired the most productive fields as they vied for a piece of the oil cake. They have the lowest cost of production and secured a competitive edge, which they want to keep for the next 15-20 years."

Those unfamiliar with crude oil economics, finance and law might be led to believe that concern for the national interest, the nub of anti-PSA arguments, is a reasonable argument. Under a PSA, the government – claim the detractors – receives less tax, delivered much later than under the existing system; in PSA projects, there is an incentive to raise output beyond what is needed, which would reduce world prices; and there is no spare pipeline capacity to carry greater PSA output.

This sounds convincing, especially from the lips of oilmen (although many of them came from the financial sector after privatisation). Several other arguments have been used, some of which are jingoistic.

However, the real reason why PSAs have been torpedoed is that they would introduce a competitive threat to Russian firms and could erode their value. Khodorkovsky says: "The PSA regime restricts the growth potential for Russian company capitalisation. Why invest in Russian firms when one may get a field under the lucrative terms of a PSA?" He concludes: "The PSA regime, therefore, undermines Russia's energy security."

Higher capitalisation means more expensive shares, which means higher returns for shareholders when blocks of shares are sold to foreign investors. This is dressed up as protecting national interests, which can blinker ordinary people to the real reasons.

Foreign companies are the only credible buyers of Russian oil firms (which is why they were banned from privatisation; the oligarchs would not have received their anticipated price gains of today – the government might have received them then). However, they do not just want shares, but shares secured by predictable-risk disposable assets. Foreign firms do not have – and cannot have by definition – the administrative resources that help Russian companies minimise their individual risks and maximise income by, *inter alia*, pushing law-makers to pass laws of benefit to them.

Foreign firms need long-term stability to implement capital-intensive projects – precisely what the PSA regime is about. The first major transaction involving the purchase of Russian oil shares was the BP/Tyumen Oil (TNK) deal. TNK's assets include PSA projects such as Kovykta, Samotlor, Uvat and Sakhalin-6. This shows that involvement in PSA projects dramatically enhances the attractiveness of Russian firms to investors.

Removing the alternative

Those who call the BP/TNK deal a breakthrough because it shows investment in Russia is possible outside PSAs are mistaken. The deal is evidence to the contrary. Domestic firms that rejected PSA projects because they already own the newest and, thus, the most high-yield fields under any tax system, regard PSAs as a dangerous rival. An alternative route for oil industry investment (which the PSA regime is) significantly reduces the attractiveness of buying shares of companies not involved in a PSA.

For companies without PSAs, this alternative must be eliminated. Ironically, it is being removed in a way that channels investment in Russia through the purchase of Russian company shares and that means cash generated flows into the accounts of their Russian owners, with no benefit to the state, the ultimate owner of the country's resources. How does that correlate with the interests of the state if opportunities for investment are narrowed?

If the reason for axing PSAs is to remove the rival, why now? The idea that fields should be developed only on a national tax basis is propagated by managers of firms whose fields enable them – because of their favourable treatment under privatisation – to reap a higher natural rent. With uniform tax rates, they pay less than under a PSA, because the latter allows the government to claim an additional portion of natural rent. Therefore, these firms do not need a PSA.

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PSAs are economically attractive in two areas of the resource spectrum – in mega-projects and small fields. The higher the oil price, the narrower the boundaries of PSA applications and the broader the use of licensing. But the reverse is also true – in periods of low prices (such as the late 1990s) PSAs relieve firms of high tax burdens.

For now, prices are high and forecasts bullish, so there is less economic incentive for PSAs. But according to that logic, the criticism should have eased when the end of the Iraq war removed the war premium from prices. However, the oil market has been in backwardation (futures prices are lower than spot prices) for some time, which means it does not believe in future shortages – it can overcome a crisis (the Iraq war has proved it).

Futures prices are up to four times higher than levels in 1998-1999, when prices fell as low as $8 a barrel. Therefore, Russian owners of Russian oil firms must sell them now (Sibneft has succeeded in this). Depriving foreign buyers of alternative ways of investing in Russia's oil industry pushes oil prices and the share prices of oil companies higher still. □

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.