

Streamlining Russian Oil Legislation Towards International Standards

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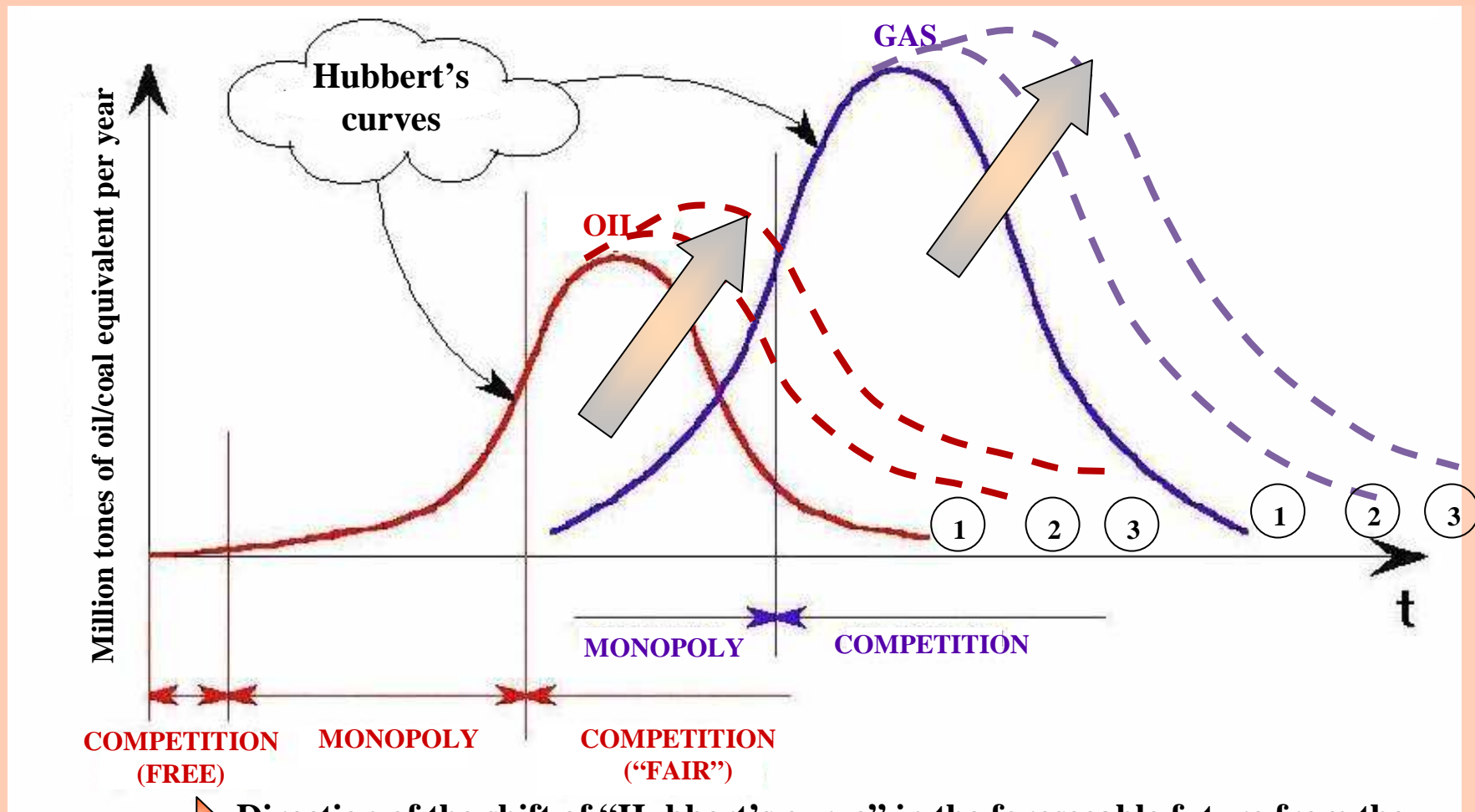
**Conference on “Russian Oil: Global Marketing and Investment Strategies”
16-17 October 2003, Paris**

CONTENTS

- 1. Towards energy markets liberalization : a political will or an objective tendency (worldwide trends)**
- 2. Energy Charter process and its instruments**
- 3. What Energy Charter Treaty provides for investors, in particularly in Russia**
- 4. Investment-related legislation trends worldwide and in Russian subsoil regulation**

1. Towards energy markets liberalization : a political will or an objective tendency (worldwide trends)

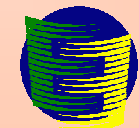
NATURAL DEVELOPMENT OF NON-RENEWABLE SOURCES OF ENERGY: FROM MONOPOLY TO COMPETITION



Direction of the shift of "Hubbert's curve" in the foreseeable future from the economist's perspective

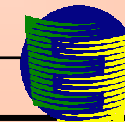
- ①
- ② & ③

Conventional oil and gas resources as of today
 Unconventional oil and gas resources as of today which will become conventional ones in the nearer ② and longer ③ future

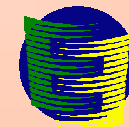
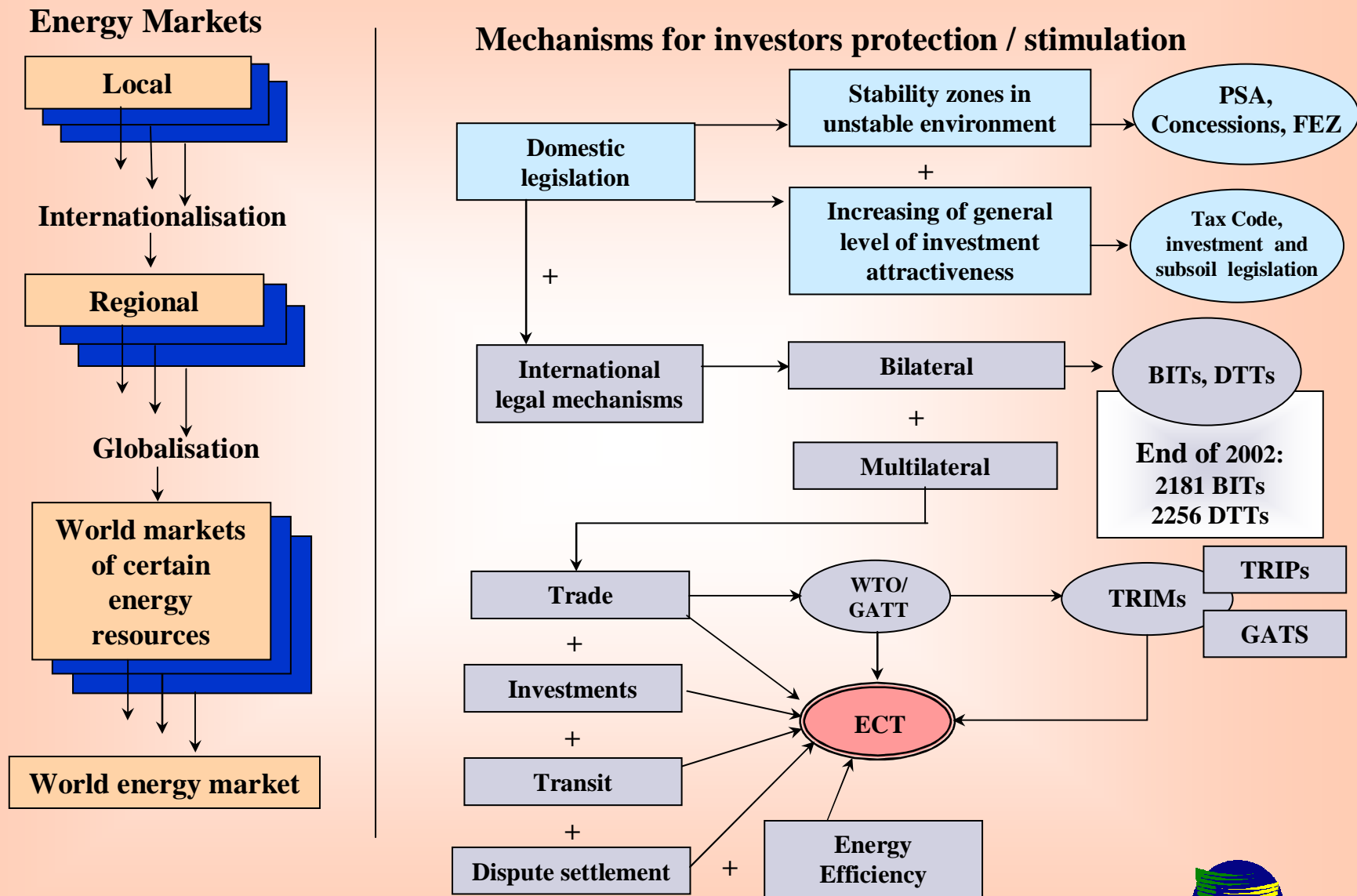


PRICING SYSTEMS AND CONTRACTS TYPES IN OIL AND GAS MARKETS

Market parameters	Pricing stages		
	1 st STAGE	2 nd STAGE	3 rd STAGE
OIL MARKET			
Contracts	Long term	(a) Long-term (b) Short-term	(a) Long-term (b) Short-term (c) Spot, forward, futures
Pricing formula	Cost-plus	(a) Escalation formulas in the competitive sphere of consumption (electricity generation) (b) Cost-plus in the monopoly sphere of consumption (transport)	Buy-back price (oil-to-oil competition)
Price escalation	Marginal production costs	(a) To prices of alternative energy resources (RFO – to coal) (b) To marginal production costs (light petroleum products)	To futures quotations
Price trends	Increase	Increase/decrease	Decrease
GAS MARKET			
Contracts	Long term	(a) Long-term (b) Short-term	(a) Long-term (b) Short-term (c) Spot, forward, futures
Pricing formula	Cost-plus	Escalation formulas	Buy-back price (gas-to-gas competition)
Price escalation	Marginal production costs	To prices of alternative energy resources (gas-to petroleum products, coal, electricity)	To futures quotations
Price trends	Increase	Increase/decrease	Decrease



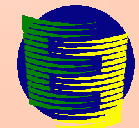
DEVELOPMENT OF ENERGY MARKETS AND MECHANISMS FOR INVESTORS PROTECTION / STIMULATION



THE CONTENTS OF BITs

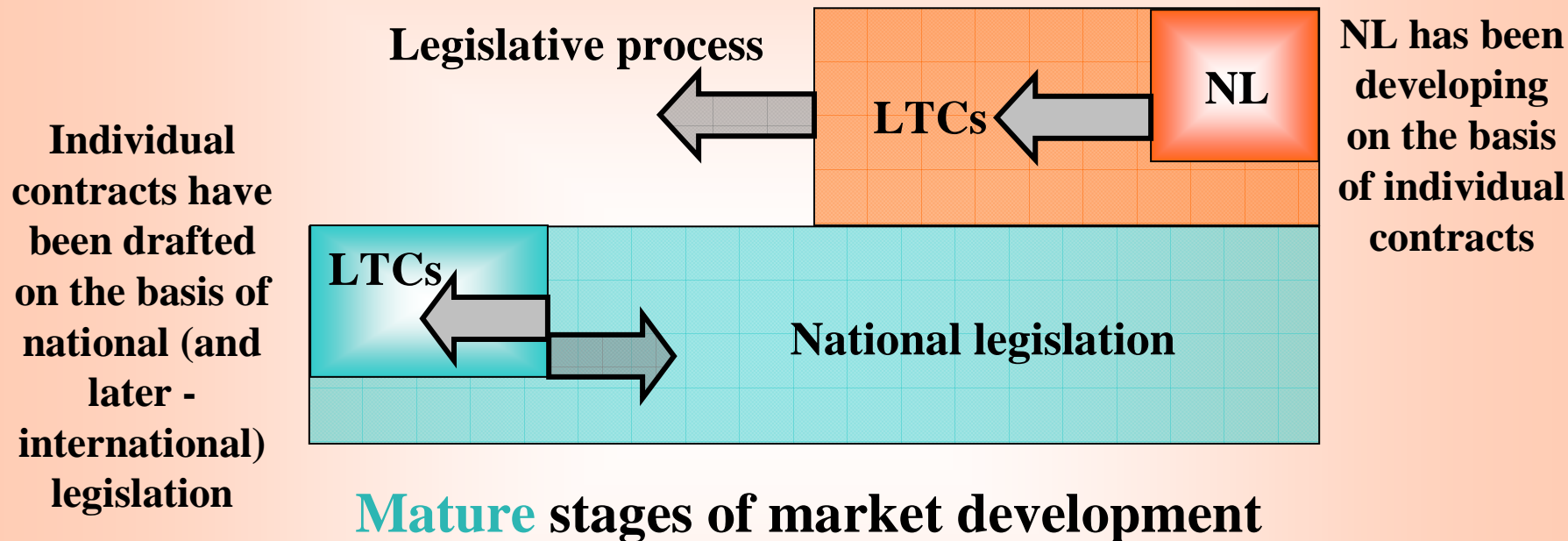
The scope and content of BITs have become more standard over the years. Today, the main provisions deal with the scope and definition of foreign investment; admission and establishment; national treatment in the post-establishment phase; MFN treatment; fair and equitable treatment; guarantees and compensation in the event of expropriation; guarantees of free transfers of funds and repatriations of capital and profits; and dispute settlement provisions, both State-State and investor- State. But given the sheer number of BITs, the formulations of individual provisions remain varied, with differences in the language of the BITs signed some decades ago and those signed more recently.

Source: UNCTAD, World Investment Report 2003



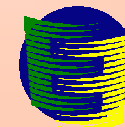
ENERGY MARKETS DEVELOPMENT AND PROJECT-RELATED VS. CORPORATE-RELATED LEGISLATION

Initial stages of market development



General risks (legislation) vs. specific risks (contracts)

1. Individual contracts
2. Individual contracts on the basis of national legislation
3. Individual contracts on the basis of international legislation



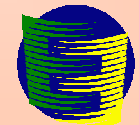
2. Energy Charter process and its instruments

ENERGY CHARTER HISTORY

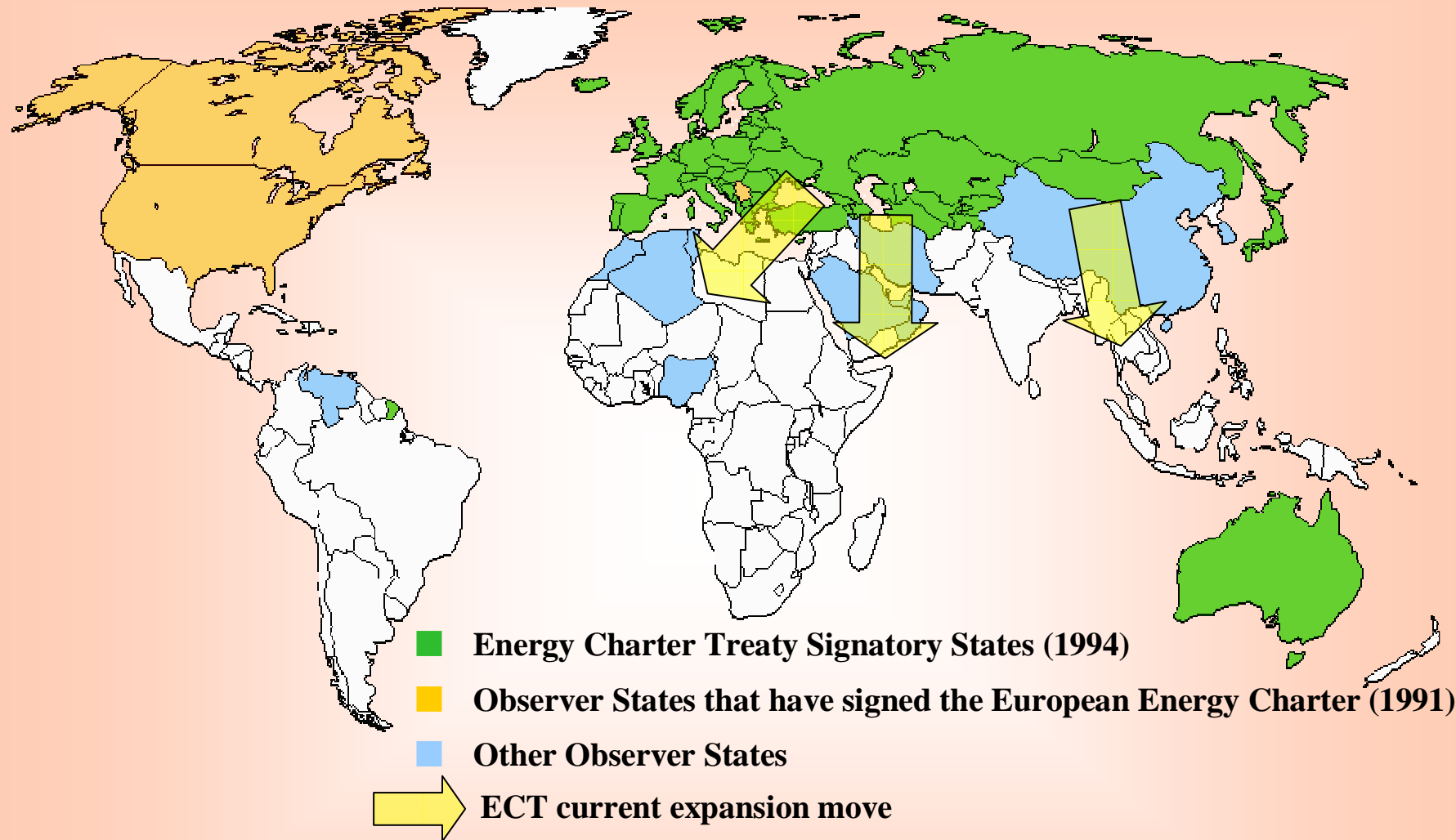
June 25, 1990	Lubbers' initiative on common broader European energy space presented to the European Council
December 17, 1991	European Energy Charter signed
December 17, 1994	Energy Charter Treaty (ECT) and Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) signed
16 April, 1998	ECT enters into force
As of today	<ul style="list-style-type: none"> • ECT signed by 51 states + European Communities = 52 ECT signatories • ECT ratified by 46 states + EC (excl. 5 countries: Russia, Belarus, Iceland, Australia, Norway) • Russia and Belarus : provisional application of ECT

Russia has started ratification process in 1996

RF State Duma (2001): Russia will ratify ECT, but not yet (depending on Transit Protocol)



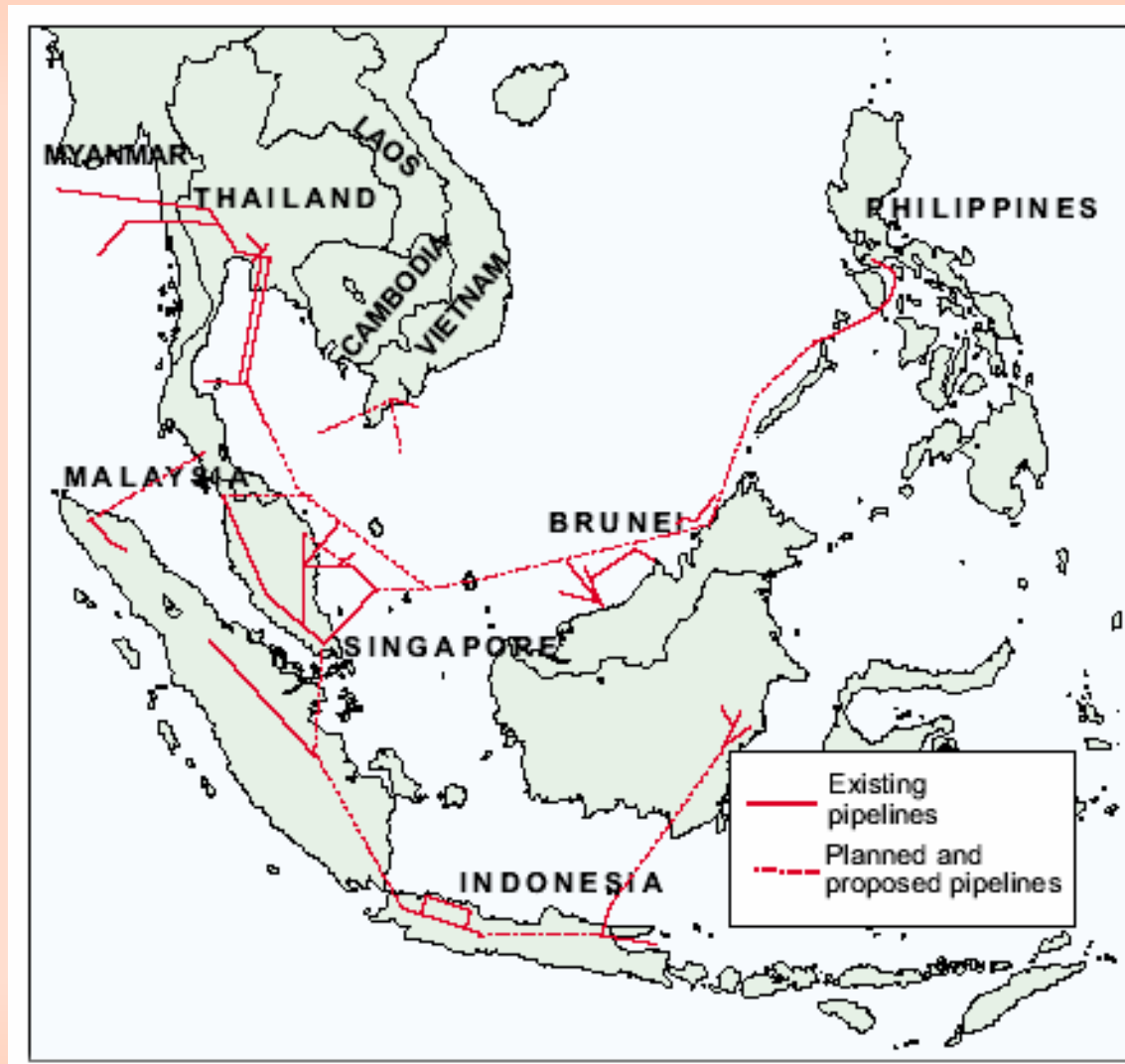
ENERGY CHARTER TREATY: GEOGRAPHY



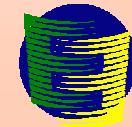
1. From trans-Atlantic political declaration to broader Eurasian single energy market
2. ECT expansion is an objective and logical process based on economic and financial reasons



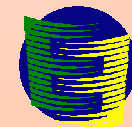
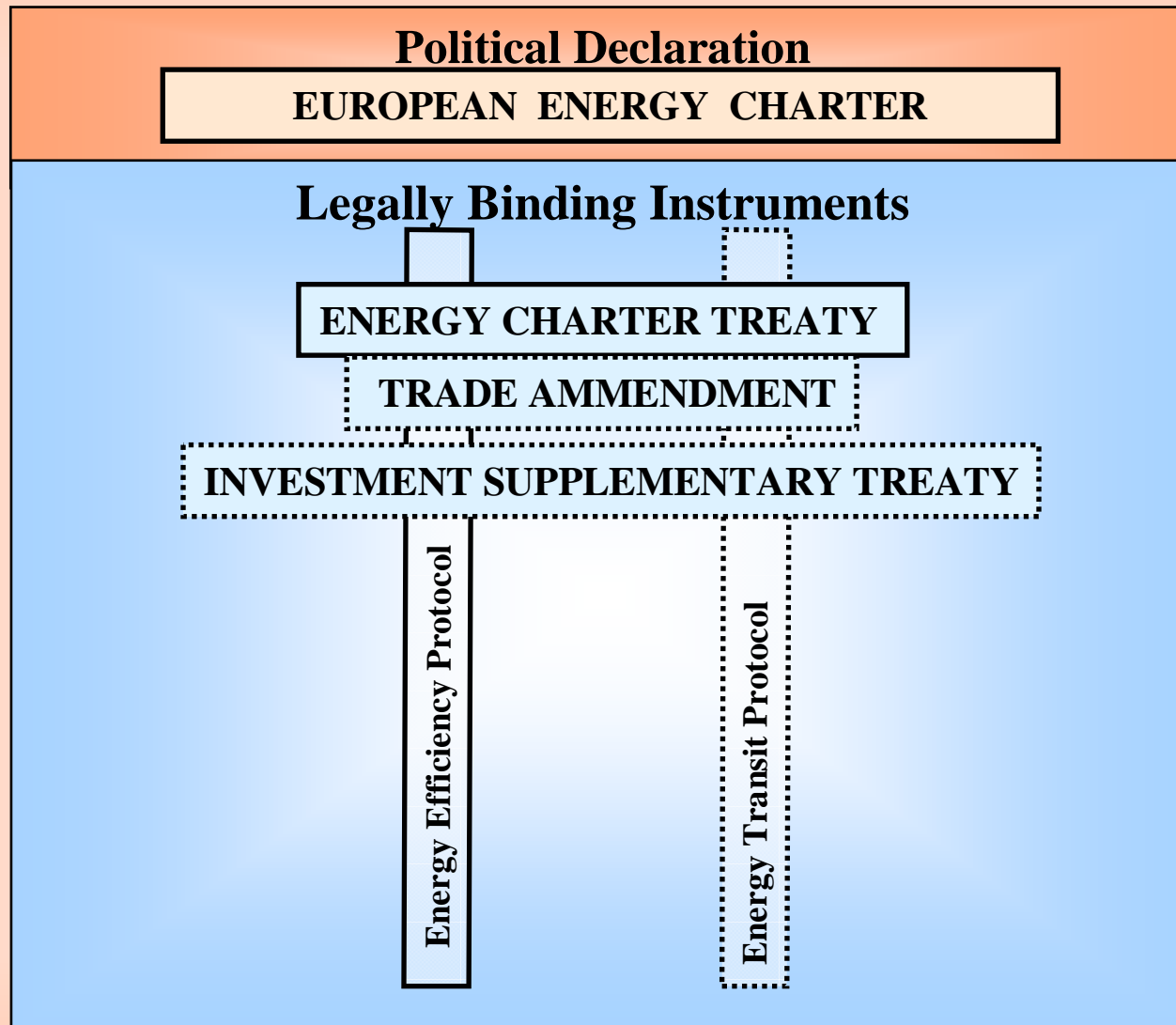
POSSIBLE SOUTH-EAST ASIAN GAS GRID



Source: ASEAN Center of Energy, Jakarta



ENERGY CHARTER AND RELATED DOCUMENTS

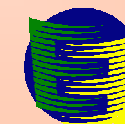


3. What Energy Charter Treaty provides for investors, in particular in Russia

MAIN CONTENT OF SELECTED INTERNATIONAL INVESTMENT-RELATED AGREEMENTS

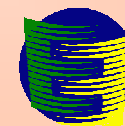
	Legal Status	Scope	Invest-ment	Trade	Transit	EE	DS
ECT	LB	Energy	+	+	+	+	+
WTO	LB	General	Services	+	-	-	+
NAFTA	LB	General	+	+	-	-	+
MERCOSUR	LB	General	+	+	-	-	+
OECD	LB	General	+	-	-	-	-
APEC	NLB	General	+	+	-	-	-

Source: J.Karl, Senior Expert, DEI, Energy Charter Secretariat



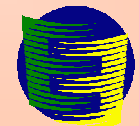
SPECIFIC ROLE OF THE ECT AS COMPARED TO OTHER INTERNATIONAL INVESTMENT AGREEMENTS

- **Is unique in covering all forms of energy cooperation (investment, trade, transit, energy efficiency);**
- **Is the first (and currently only) binding multilateral investment agreement with high standards of investment protection, including most broad and strong dispute settlement provisions (both State to State and Investor to State);**
- **Provides for a permanent policy forum among member-states of emerging broader Eurasian energy market for the discussion of energy-related issues – in the sphere of the most long-term and capital-intensive investment projects.**

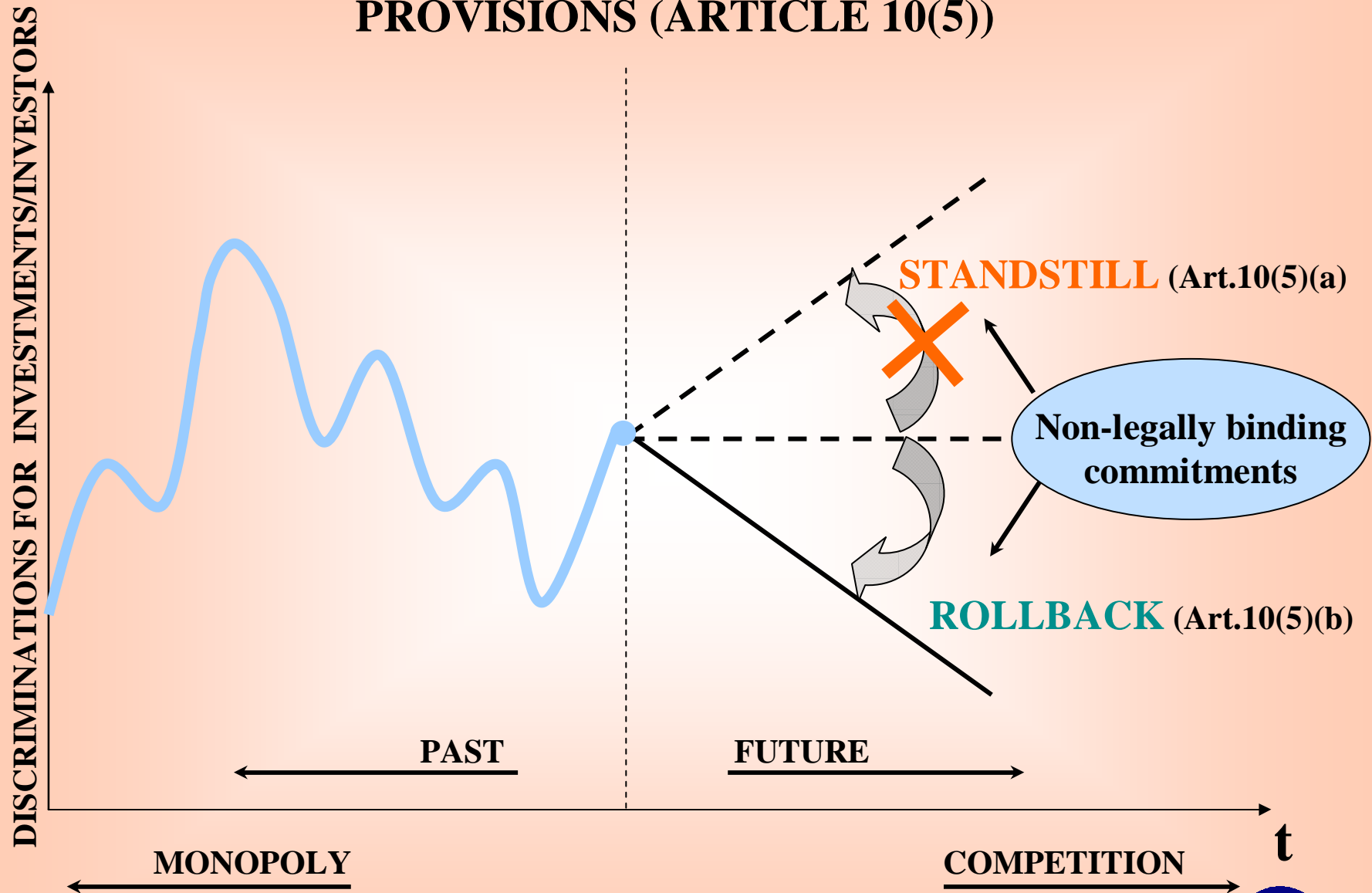


ESTABLISHMENT RIGHTS FOR FOREIGN INVESTORS UNDER THE ECT – CURRENT SITUATION

- **“Best-efforts” commitment of CPs to grant foreign investors non-discriminatory access to their domestic market;**
- **Non-legally binding commitment (1) not to introduce new restrictions for foreign investors concerning their establishment [“standstill”] and (2) to progressively reduce existing restrictions [“rollback”];**
- **Obligation to extend the principle of non-discrimination in a legally binding manner to the pre-establishment phase through negotiation of a “Supplementary Treaty”.**



ECT INVESTMENT REGIME: STANDSTILL & ROLLBACK PROVISIONS (ARTICLE 10(5))

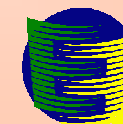


EXCEPTIONS IN THE ECS “BLUE BOOK” RELATING TO THE MAKING OF AN INVESTMENT

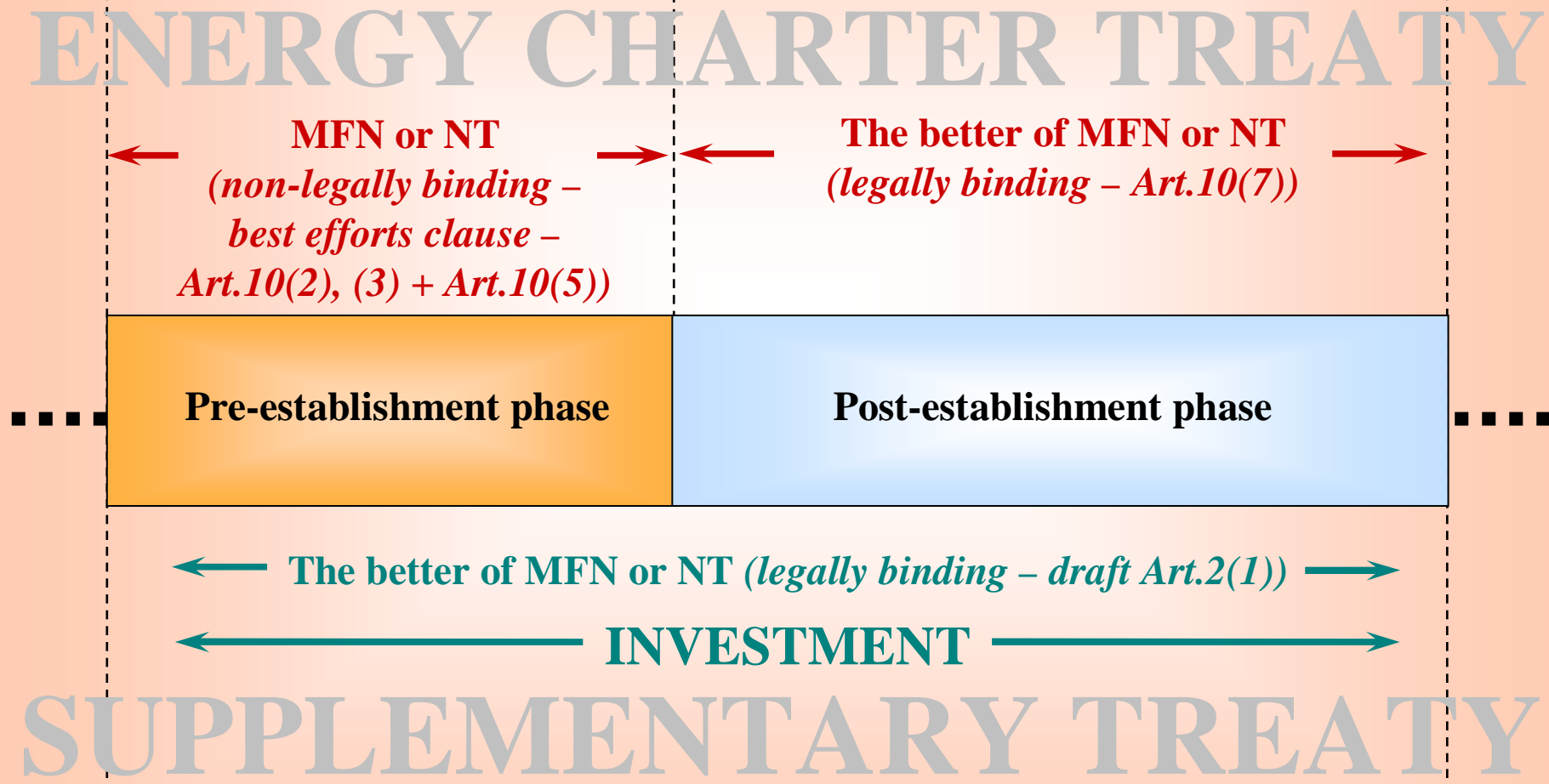
	1997	1998	1999	2000	2001	2002	2003
Total: 37 CPs with exceptions*, incl.	109	115	118	127	113	99	101
Russian Federation	9	11	13	18			11

* 15 CPs have no exceptions

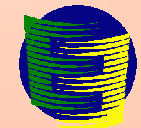
Source: Transparency Document on Non-conforming Measures Maintained by Contracting Parties Regarding Investment (“the Blue Book”), Energy Charter Secretariat



ECT ARTICLE 10(1): Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area.



MFN = Most favored nation treatment
NT = National treatment



FINANCING ENERGY PROJECTS: FROM EQUITY TO DEBT FINANCING

Equity/debt financing ratio:

Pre-1970's = ~ 100 / ~ 0

Nowadays = ~ 20-40 / ~ 60-80,

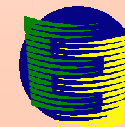
f.i. most recent:

BTC pipeline = 30 / 70

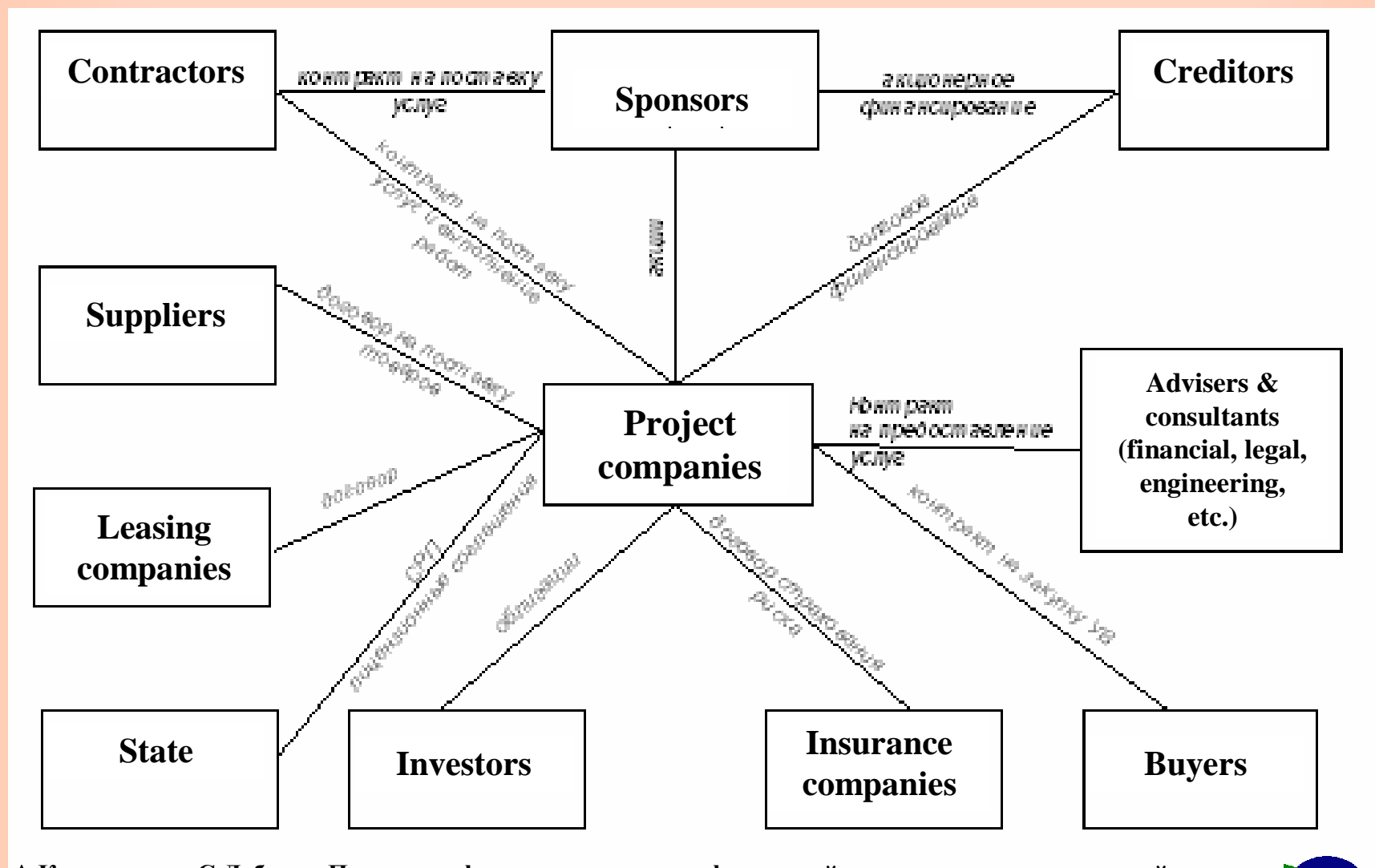
Sakhalin-2 (PSA) = 20 / 80

(2 fields+pipeline+LNG plant)

- ➔ Increased role of financial costs (cost of financing) of the energy projects
- ➔ Availability and cost of raising capital = one of major factors of competitiveness with growing importance in time

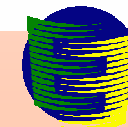


A SIMPLIFIED STRUCTURE OF PROJECT FINANCING RELATIONS BETWEEN DIFFERENT LEGAL ENTITIES



А.Конопляник, С.Лебедев. Проектное финансирование в нефтегазовой промышленности: мировой опыт и начало применения в России. – «Нефть, Газ и Право», 2000, № 1-2

Dr. A. Konoplianiuk, "Russian Oil" - 16-17.10.2003, Paris - Figure 17

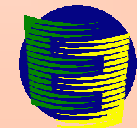
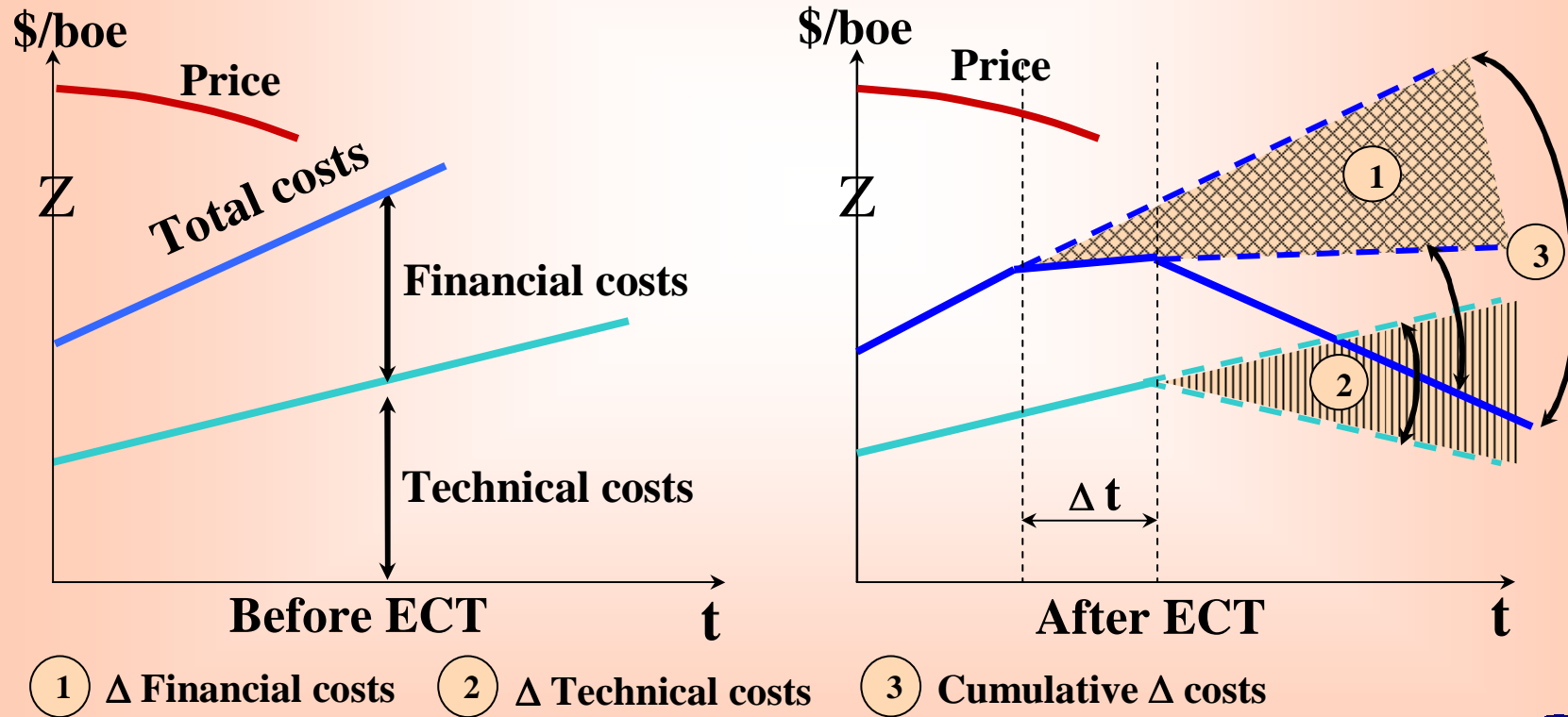


www.encharter.org

ECT IS BUSINESS-ORIENTED TREATY

ECT/Legislation → ↓ risks → ↓ financial costs (cost of capital) = ① →
 ↑ inflow of investments (i.e. ↑ FDI, ↓ capital flight) → ↑ CAPEX → ↓ technical costs = ② →
 ① + ② = ③ → ↑ pre-tax profit → ↑ IRR (if adequate tax system) → ↑ competitiveness →
 ↑ market share → ↑ sales volumes → ↑ revenue volumes

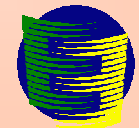
ECT provides multiplier legal effect in diminishing risks with consequential economic results in cost reduction and increase of revenues and profits



RUSSIAN OIL AND GAS FOR EUROPE AND ASIA

Competitive disadvantages (distances, natural conditions of producing areas) as a rule

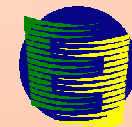
- **Highest stimuli to diminish technical and financial costs of production and transportation**
 - (a) **technical costs ← investments ← legal environment in host & transit countries**
 - (b) **financial costs ← cost of capital ← credit ratings (sovereign, corporate, project) ← legal environment in host & transit countries**
- **ECT and related instruments =
= common legal environment, minimizing risks and technical and financial costs**



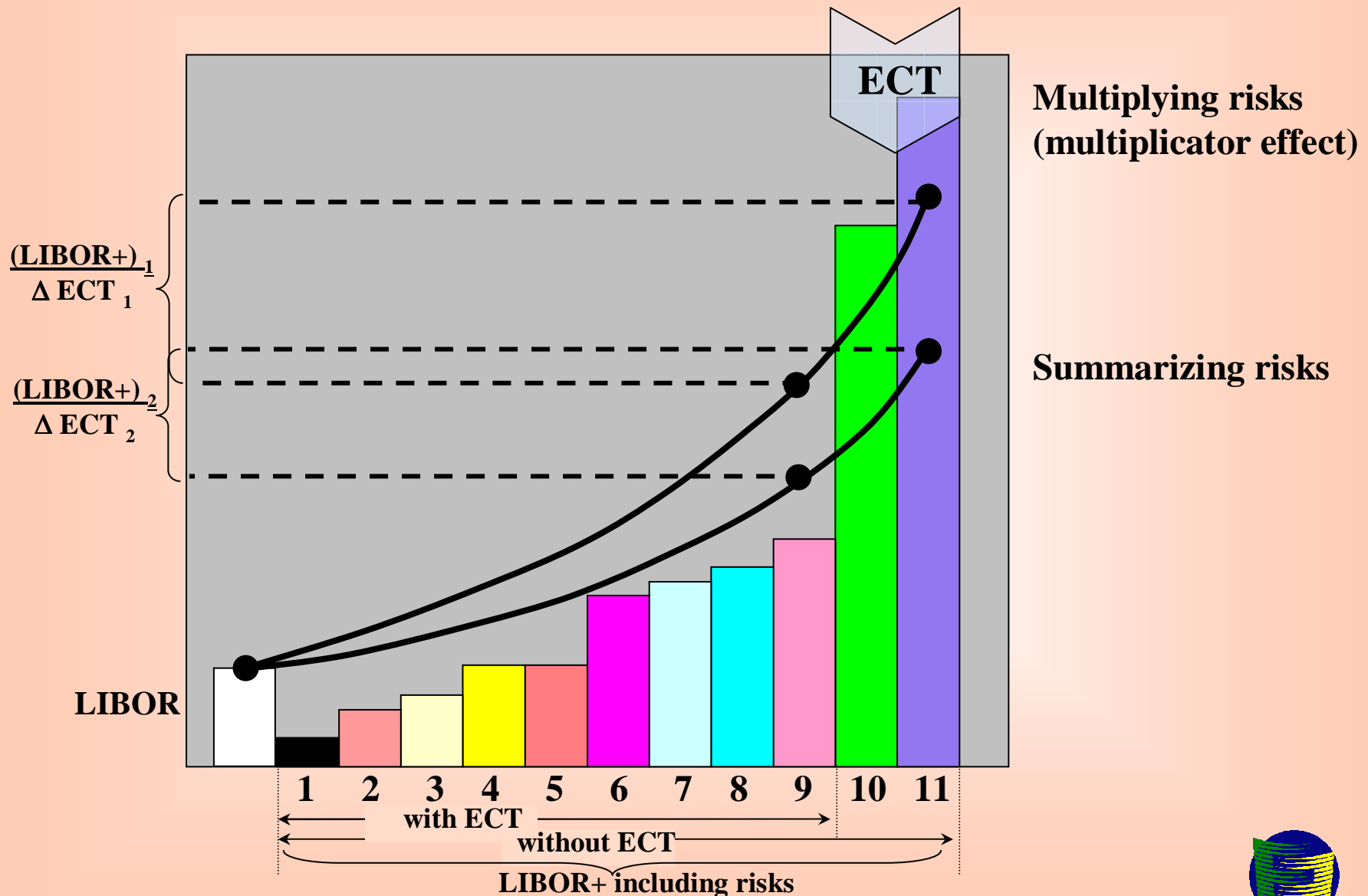
PROJECT FINANCING RISKS APPROXIMATE DISTRIBUTION IN RUSSIA (Sakhalin-2 project as a case-study)



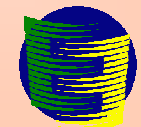
Source: А.Конопляник, С.Лебедев «Анализ рисков финансирования нефтегазовых проектов: рейтинговая оценка рисков», - Инвестиции в России, 2001, №9; они же «О рисках финансирования нефтегазовых проектов», - Минеральные ресурсы России, 2001, №4



ECT INFLUENCE ON THE PROJECT FINANCING RISKS DISTRIBUTION AND ON COST OF EXTERNAL FINANCING (LIBOR+)



Dr. A. Konoplianiuk, "Russian Oil" - 16-17.10.2003, Paris - Figure 21



4. Investment related legislation trends worldwide and in Russian subsoil regulation

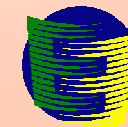
CHANGES IN NATIONAL REGULATIONS OF FDI, 1991-2002

Item	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Number of countries that introduced changes in their investment regimes	43	57	49	64	65	76	60	63	69	71	70
Number of regulatory changes	79	102	110	112	114	151	145	140	150	208	248
of which:											
More favourable to FDI ^a	79	101	108	106	98	135	136	131	147	194	235
Less favourable to FDI ^b	-	1	2	6	16	16	9	9	3	14	12

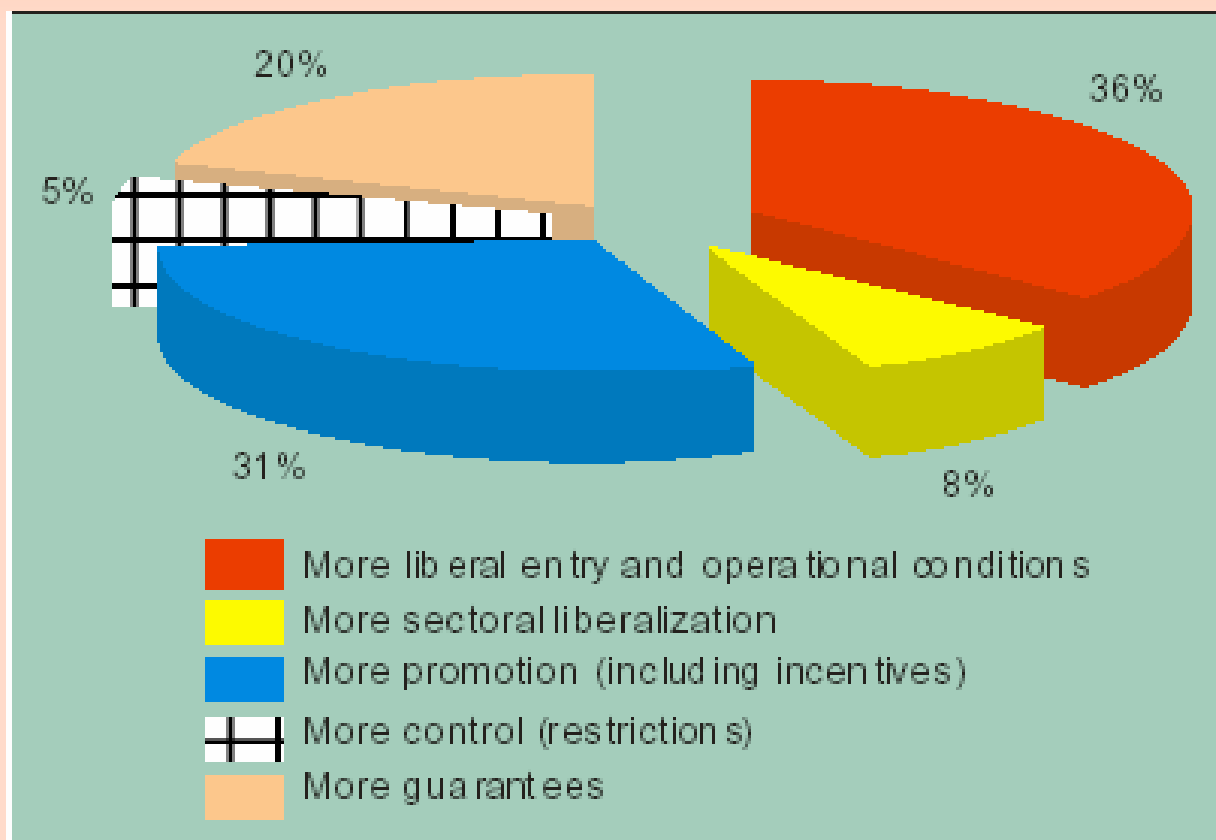
Source: UNCTAD, based on national sources.

^a Including liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives.

^b Including changes aimed at increasing control as well as reducing incentives.

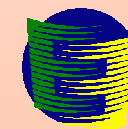


TYPES OF CHANGES IN FDI LAWS AND REGULATIONS, 2002^a



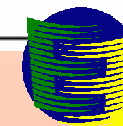
Source: UNCTAD, based on national sources.

^a Based on 248 changes.

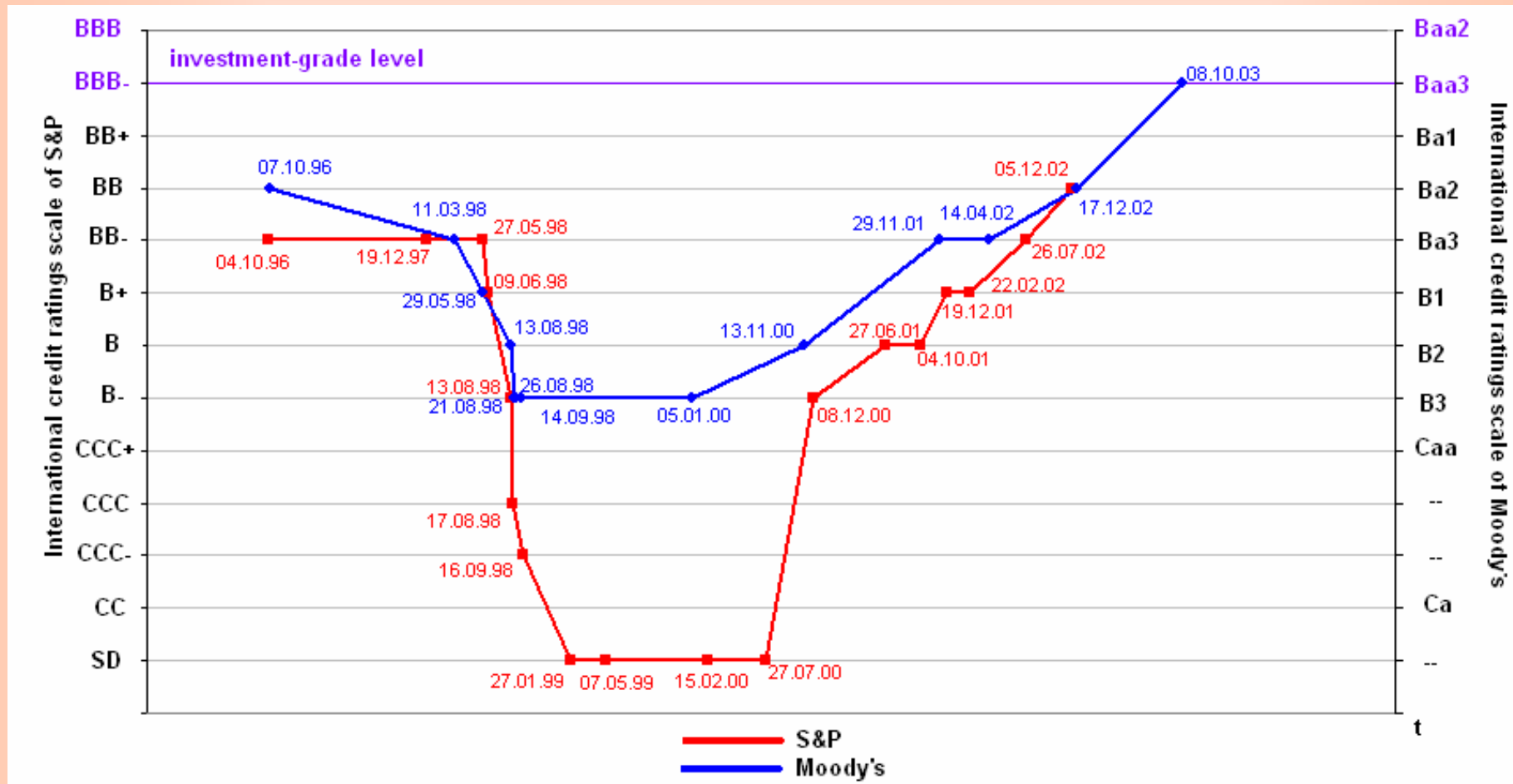


CURRENT POSITION OF RUSSIA AT THE RATING'S SCALE OF MAJOR RATING AGENCIES (long-term credit ratings)

	Moody's	Standard and Poor's	Fitch IBCA	Краткое описание
"Investment" ratings	Aaa	AAA	AAA	Максимальная степень безопасности
	Aa1	AA+	AA+	Высокая степень надежности
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	Степень надежности выше средней
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	Степень надежности ниже средней
Baa2	BBB	BBB		
Baa3 (РОССИЯ: рейтинг присвоен 08.10.2003)	BBB-	BBB-		
"Speculative" ratings	Ba1	BB+	BB+ (РОССИЯ: рейтинг присвоен 13.05.2003)	Неинвестиционная, спекулятивная степень
	Ba2	BB (РОССИЯ: рейтинг присвоен 05.12.2002)	BB	
	Ba3	BB-	BB-	
	B1	B+	B+	Высокоспекулятивная степень
	B2	B	B	
	B3	B-	B-	
	Caa	CCC+	CCC	Ощущенный риск, эмитент в тяжелом положении
	--	CCC	--	
	--	CCC-	--	
	Ca	CC	--	Сверхспекулятивная степень, возможен отказ от платежей
	C	C	--	
	--	--	DDD	Отказ от платежей
	--	SD	DD	
--	D	D		
--	--	--		



COMPARATIVE RATING HISTORY OF RUSSIA (Standard & Poor's and Moody's)

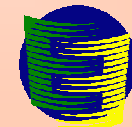


ECONOMIC AND LEGAL FRAMEWORK FOR INVESTMENT REGIMES IN RUSSIAN SUBSOIL USE

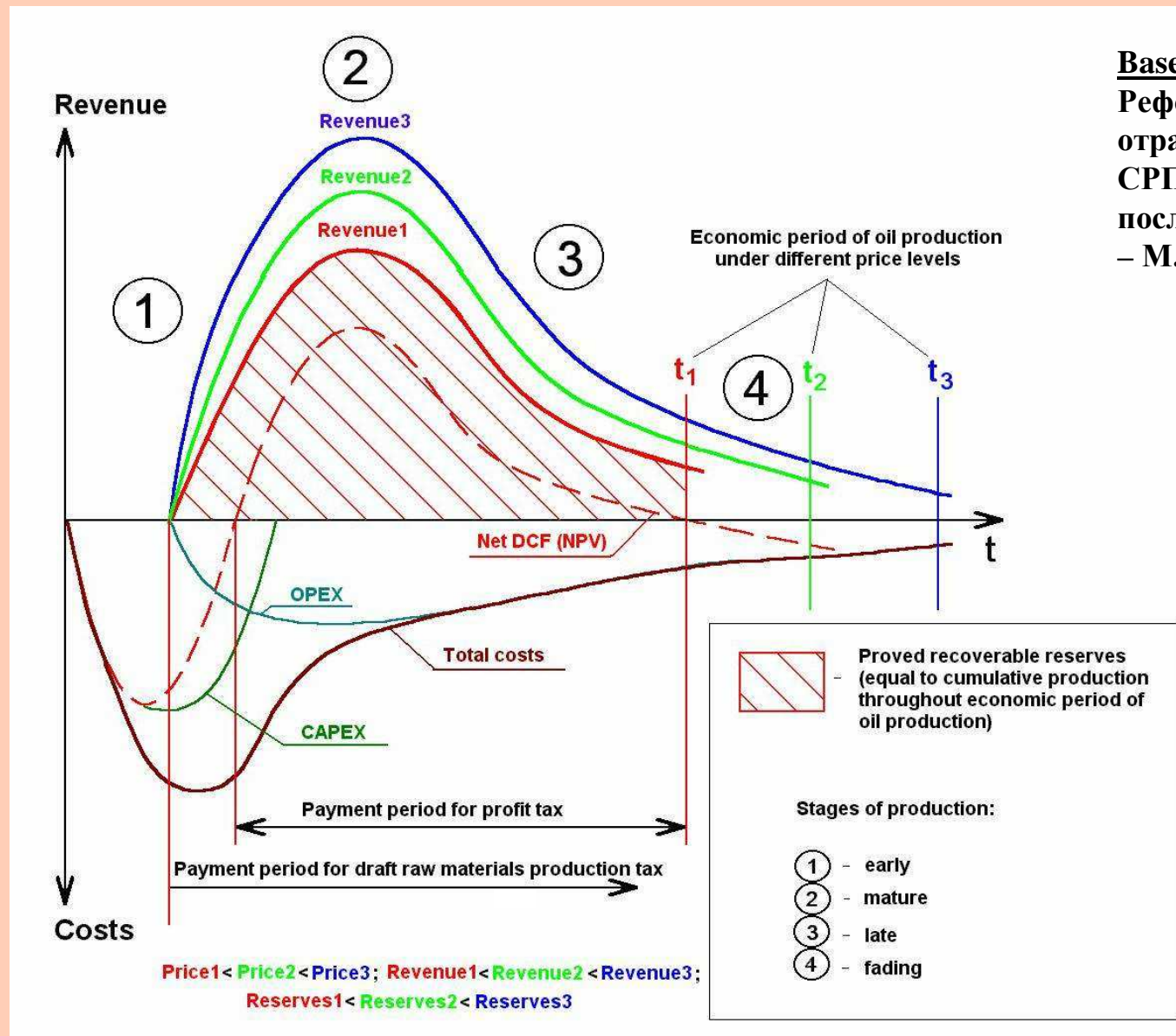
		Legal system	
		Administrative	Civil
Tax treatment	General (common)	License	Concessions
	Special (incl. individualised)	License plus tax benefits	PSA

There is no must to have only one legal regime for subsoil use in Russia especially taking into consideration its huge geographical dimensions and geological complexities in different areas of the country

- Russia is among a dozen of oil-producing countries worldwide that has more than one legal regime for subsoil
- USA has both private and state ownership for subsoil

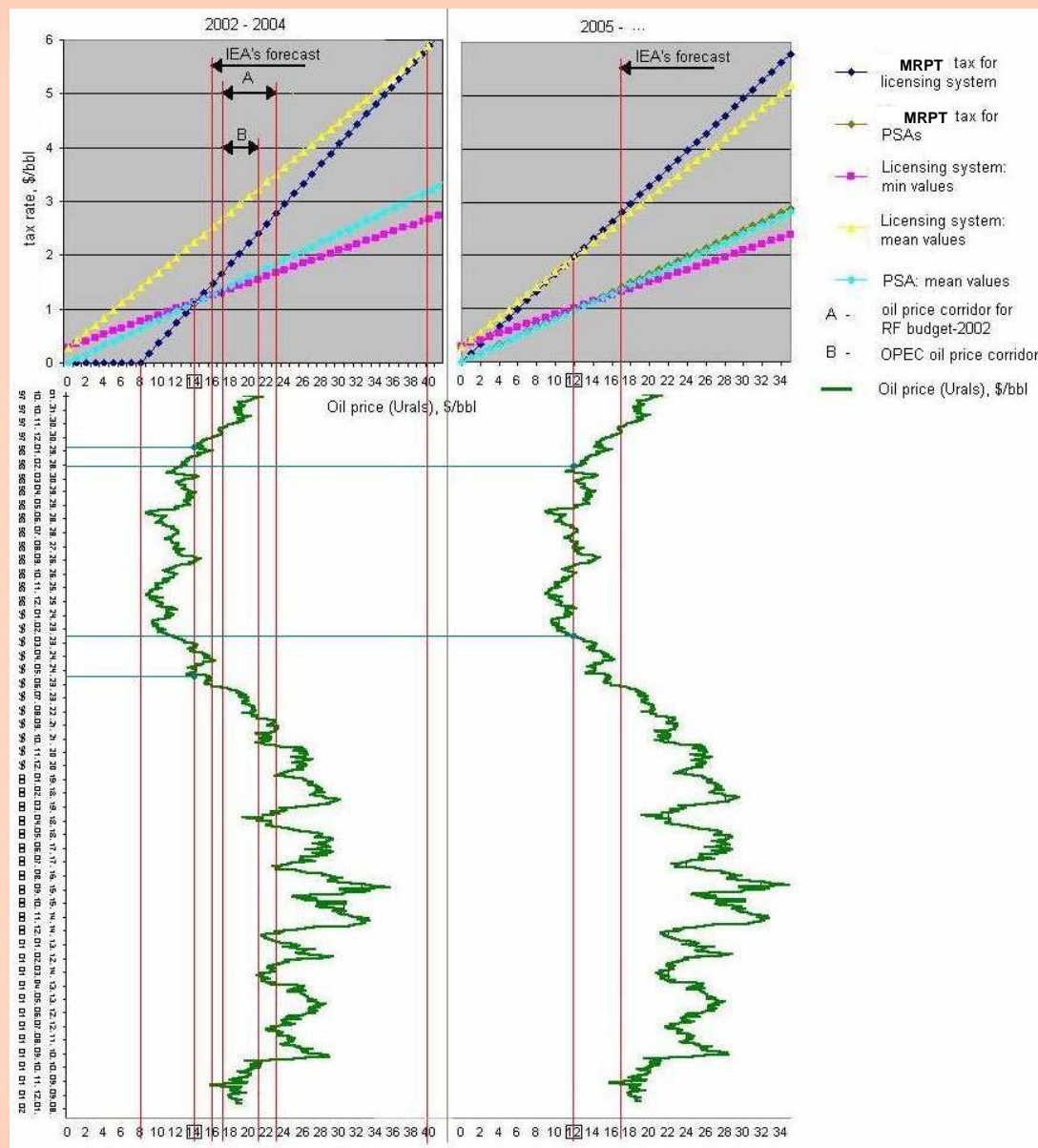


FINANCIAL FLOWS DURING THE OIL-FIELD INVESTMENT PROCESS



Based on: А.Конопляник.
Реформы в нефтяной
отрасли России (налоги,
СРП, концессии) и их
последствия для инвесторов
– М.: «Олита», 2002

COMPARATIVE ANALYSIS: MRPT VS. PAYMENTS REPLACED WITH IT



Based on: А.Конопляник.
Реформы в нефтяной
отрасли России (налоги,
СРП, концессии) и их
последствия для инвесторов
– М.: «Олита», 2002

FLAT-RATE TAX SYSTEM, PSA AND TRANSFER FROM MRPT TO PSA

Figure 1: Flat-rate tax system

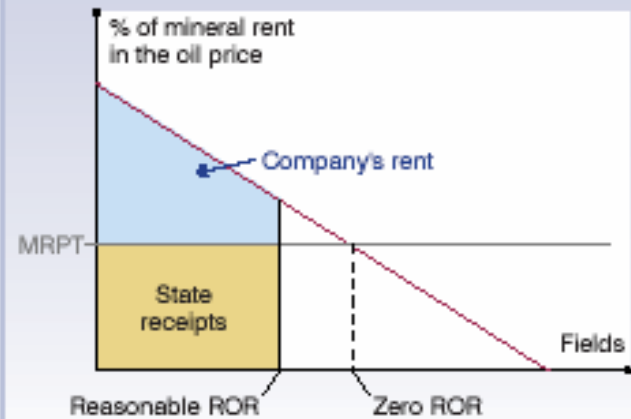


Figure 2: PSA

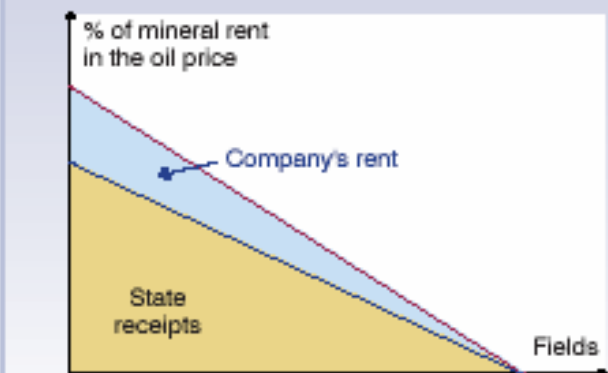
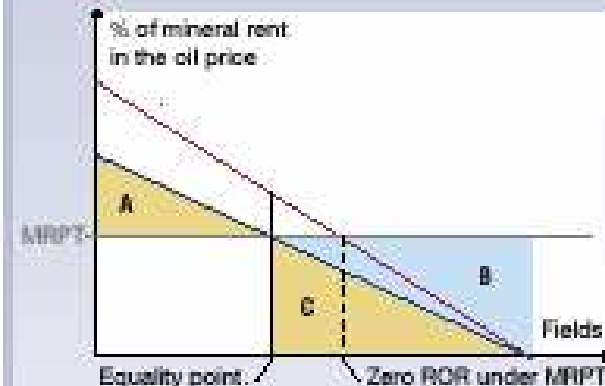


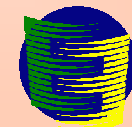
Figure 3: Transfer from MRPT to PSA



Equality point
Point at which
PSA and MRPT
terms are of equal
competitiveness

- A: Companies' incremental rent-type earnings under MRPT, which transferred into state take under PSAs
- B: Revenues that the opponents of PSAs wrongly claim are lost to the state under transition to PSAs
- C: Incremental state earnings under PSAs through development of non-profitable fields under MRPT with flat rate

Source: А.Конопляник. Борьба против СРП: кому она выгодна и почему. – «Нефть и капитал», июнь 2003, № 6;
А.Конопляник “A struggle for mineral rent”, -Petroleum Economist, August 2003



AVAILABILITY OF INVESTMENT-RELATED STIMULI IN TAXATION OF OIL PRODUCERS IN RUSSIA: RECENT TRENDS

Stages of oil field development	Pro-investment stimuli in oil producers' taxation under the concept of its efficient (non-fiscal) formation	Presence of pro-investment stimuli in taxation of oil producers:	
		In pre-2002 Russian tax legislation	In post-2002 Russian tax legislation
Early	Diminishing of tax burden, especially of revenue-based taxes, shift of tax burden from early to mature stage: tax holidays, tax credits & tax-related uplift at oil field investment stages	Partly existed (investment-related concession on profit tax up to 50% of the tax-base of the latter)	No
Mature	Sliding scale (project-to-project differentiation) of taxation linked to the factors of mineral rent formation	Partly existed in indirect form through negotiable character of establishing royalty value in licensing agreement	Basically no, except one factor (reflecting changes in world oil prices, i.e. Brent spot dated) which does not consider stages of field development, different oil qualities, domestic price changes, real export quotas, etc.
Late	Reserves depletion allowance, dependent on system of factors	Basically no. Few regions (i.e. Tatarstan) has been using it for marginal wells/fields via mechanism of diminishing a regional portion of the profit tax	No
Fading	Reserves depletion allowance, dependent on system of factors, up to zero rate of special oil taxes		No

Based on: А.Конопляник. Реформы в нефтяной отрасли России (налоги, СПП, концессии) и их последствия для инвесторов – М.: «Олита», 2002

