

# Kremlin prepares to grab more cash from Russian oil producers

**Andrei Konoplyanik**

is Deputy Secretary-General,  
Energy Charter Secretariat

*The opinion voiced in this article reflects the author's personal point of view and is not the expression of the Energy Charter Secretariat's position or the position of any of 51 Energy Charter member states.*

The commission for delimiting authority among branches of power, led by the Russian president's deputy chief of staff, Dmitry Kozak, has proposed a revolution in Russia's subsoil use system.

In particular, the commission proposes rejecting the 'two-keys' principle fixed by Article 72 of the Russian Constitution and putting underground resources in exclusive federal ownership (except widespread minerals which the commission proposed putting under Russian regions' control).

This proposed change in the fundamental principle leads to equally revolutionary proposals such as separating geological exploration from mineral production, replacing licences with contracts (in part of geological exploration and prospecting) and concessions (in part of production) and transferring produced minerals into state ownership.

Several days later, after the public opinion was tested, the most odious of the Kozak commission's proposals was dropped: the commission no longer proposes expropriating - or nationalising - produced energy resources. But all other innovative proposals related to replacing licences with concessions have remained basically unchanged.

The Kozak commission's proposed amendments are fully in line with the latest thinking in the Russian authorities' modern domestic policy and, therefore, there is a chance that the amendments to relevant Russian legislation will be made.

For the oil and gas industry, this will mean at least the toughening of fiscal pressure on 'producing organisations' (as they are referred to in explanatory notes to proposed amendments).

In world practices, the point of a concession contract is that the host state hands over to the concessionaire the right to use mineral resources on risk terms concerning geological exploration and prospecting. The state gets a fixed share of rent as a previously agreed share of revenues from the sale of products, while the rest goes to the concessionaire: gross profits used to offset its costs and net profits, whose level depends on the concessionaire's abilities and skills (see **By way of compensation**).



### By way of compensation

The distribution of revenues between the concessionaire and the host government depends on the level of risks involved in investment activities in a particular country in particular historic conditions. The higher the risk, the bigger is the compensation, the higher share of rent the investor gets. In today's world, comparative levels of compensation are determined by the market via mechanisms for defining the cost of borrowing (ratings agencies and the like), rather than by the host country's officials.

According to the world's three leading ratings agencies, Russia has recently returned to the BB- long-term credit rating it was given when it was first awarded a rating in October 1996. But this is a speculative grade, three grades below the lowest investment rating, meaning that investment in Russia is highly risky.

### More than a century

Concessions are the oldest of existing forms of relations between the host country and the investor. The first concession in the oil industry was granted in Persia in 1901 (the d'Arcy concession). The discovery of an oil field under the concession (which covered more than half of modern Iran's territory) led to the emergence in 1909 of the Anglo-Persian Oil Company, later renamed as British Petroleum (BP).

In the first half of the 20th century, the concessionaire's payments to the host country included only royalty, i.e. payment for the right to use natural resources.

In 1948, in addition to royalty, Venezuela introduced the profits tax to be paid by the concessionaire, which led to the emergence of modified concessions.

The mechanism has intensively developed since, especially in part of payments to be made by the concessionaire.

Substantially later, in the 1960s, there emerged production sharing agreements, and years after that risk service contracts came into being.

At each stage of development, the terms of concession agreements reflected the balance of interests and power of host governments and investors in particular historic conditions. Initially, the balance was reached with smaller, often symbolic payments by the concessionaire to the host country.

But as demand for energy resources was growing, market competition emerged (both in commodity and capital markets) and rivalry among investors for access to natural resources toughened, the share of rent received by host countries tended to grow. This is also the case today.

As a rule, a modern concession agreement is signed for a period comparable with the

duration of field development and only covers the area of the subsoil block under development. In most cases, a concession fixes serious mechanisms (down to termination of a contract) for the host government's control of the observance of contractual terms fixed for the development of subsoil blocks for which concession is granted, return of unused blocks etc.

As for tax payments, a modern concessionaire usually pays three types of regular payments - royalty, the profits tax and rentals (regular payments for the use of a leased area) - and diverse unsystematic payments (bonuses), whose number may be great enough.

Concession agreements are often referred to as licence contracts (licences) or tax-plus-royalty contracts today. While they look similar, there is a substantial difference: a licence contract is made and applied in the administrative law framework, while a concession is regulated by the civil law (see the chart).

### The world's preferences

An analysis of oil legislation of 116 nations, conducted by Barrows Company in 1995, showed that PSAs have been applied in 52 countries and concessions/licences in 62 countries.

In developing countries, PSAs have been used as often as concessions. In Europe and America, licence subsoil use systems prevail.

According to Petroconsultants (1996), out of 49 countries producing 2.5 m tonnes and more oil a year, PSAs are applied in 22 countries and tax plus royalty in 24 countries.

Out of the world's 24 biggest oil-producing nations (producing 30m tonnes a year and more), PSAs have been used in 13 countries and licences in ten countries, while dual subsoil use systems have been legislatively fixed in two countries: licences and risk service contracts in Venezuela and licences and PSAs in Russia. Under concessions/licences, the host country maximises its revenues in cash, i.e. in taxes levied in national currency.

Under PSAs, it can get its share in kind (in oil), minimising currency-related risks. This is important, if a host country's currency is not convertible. This explains why PSAs are more popular in developing nations and states with economies in transition, while concessions and licences (tax plus royalty contracts) have been used in stable economies with well-established economic and legal systems.



## Concessions in Russia

Russia, according to Petro-consultants, is the only major oil-producing nation where the licence-based subsoil use system and PSAs coexist (but it is not the only country where more than one subsoil use regime is applied - see **The world's preferences**).

Concessions are not new in Russia: they were broadly applied in Soviet Russia in the 1920s, during the so-called NEP (New Economic Policy) period.

"The practical goal of our new economic policy was getting concessions," Vladimir Lenin wrote.

The concessions policy, according to Lenin, is not the form of exploiting natural resources, but rather a way to attract foreign capital for mutual benefit for the

development of all productive forces in the country.

"What is a concession? The state's agreement with a capitalist, who undertakes to arrange or perfect production (for example ... production of coal, oil, ore etc), while paying to the state a share of produced products and getting the rest as profits," he wrote.

Given that, using the modern terms, Soviet Russia's investment rating was catastrophically low after the civil war, the Soviet leader was ready to let the concessionaire pay to the host government a mere 2-3 per cent of products, getting the rest as profits.

Between 1922-1927, Soviet Russia received 2,211 concession offers, and 163 were realised under concession agreements.

		System of law	
		Administrative	Civil
Tax regime	Common	Licence	Concession
	Special	Licence with tax breaks	PSA

Two years after the NEP policy was proclaimed, more than 3,300 enterprises in European Russia worked in the concessions framework.

Concessions were an important element in the development of Russia's heavy industry, including in implementing the State Plan for Electrification of Russia. Plans called for getting one-third of investment for electrification purposes from foreign capital through concessions and long-term loans.

For clear reasons, problems related to concession practices were not topical during the Communist construction period in Russia (the Soviet Union). The concessions idea remained unclaimed until Russia rejected Communist ideology in favour of market-based economic development.

Slightly more than ten years ago, as a recently appointed deputy fuel and energy minister in the Yegor Gaidar-led cabinet, I addressed the Russian parliament on the government's behalf during debates on the draft.

Law on Underground Resources. I tried to convince parliament members of the need to add another article to the law, which would allow concession agreements, production sharing agreements and other forms of contractual relationships in subsoil use.

As a result, the first version of the Law on Underground Resources of February 21, 1992 was

supplemented with part 2 of Article 12, reading that "a licence granting subsoil use rights shall fix the form of contractual subsoil use relationships, including concessions, production sharing agreements, service contracts (on risk terms and otherwise)." The provision remained in the amended version of the law adopted on June 26, 1992.

In pursuance of Article 12 of the Law on Underground Resources, in 1993 and 1994 the State Duma prepared draft laws on concession agreements and on production sharing agreements (I had the honour of leading working groups for both bills).

In November 1994, they were submitted to the State Duma for the first reading. The Duma voted for the PSA law, but it rejected the law on concessions.

This was partially due to antagonism between the executive and legislative power branches in Russia during that period (the thing is that our version of the PSA law, prepared under the aegis of the State Duma's Committee for Economic Policy, was proposed as an alternative to a draft PSA law prepared by the Russian president's office). Perhaps, the other reason was the parliamentarians' negative attitude to the very notion of 'concession', which Soviet propaganda used to firmly link with the 'accursed legacy of colonial past'. Even Communists in the State Duma did not know or were reluctant to recall Vladimir Lenin's concessions of the NEP period.

Anyway, the term concession was dropped from Article 12 in the version of the Law on Underground Resources of March 3, 1995 and was not mentioned in later versions.

As for the draft law on concession agreements, the State Duma has moved it from schedule to schedule of lawmaking activities for the seven years running. Sluggish work on it continues, but until recently it had few chances to ever be completed.

Amendments to the Law on Underground Resources, proposed by the Kozak commission, will obviously speed up work on the concessions law. But the subject matter is important, rather than the headline of the law, not the very term 'concession', but the economic meaning lawmakers give it.

### **Like master, like man**

World history of concessions has one peculiar feature. The state's approach to granting concessions has always been the quintessence of interests of the upper crust.

The Persian shah granted the concession to d'Arcy only because the latter agreed to pay much money, while having absolutely no guarantees that he would find oil or go bust during exploration.

For Vladimir Lenin, industrial development, objectively impossible without foreign investment, was a matter of life and death for the young Soviet state.

In today's Russia, the situation is different, but only in details.

In my opinion, the adoption of concession-related amendments proposed by the Kozak commission could let the state achieve four things, directly or indirectly seen behind the dry letter of the legislative initiatives.

First, it would allow launching a new stage of redistribution of property.

Second, the federal authorities would continue strengthening their positions at the expense of regions.

Third, it would allow increasing budget revenues at mining companies' expense.

Fourth, new conditions would be created for making subsoil use more efficient.

I would particularly note that the Kozak commission's proposed amendments organically fit in the global logic of evolution of economic policies in states in transition with a multi-sectoral economic structure and a high share of industries with a natural rent. But they are also in line with the latest trends in Russia's current domestic policy.

In the 1990s, as a result of Russian privatisation specifics, the main assets of Russia's most attractive industries went cheap to a limited group of individuals, now described as 'oligarchs'.

Those assets were used as payment to big (by Russian standards) business for its loyalty to new authorities, for the outcome of the 1996 elections etc.

Naturally, many people in the country have been displeased with that, including new players having come to power relatively recently, having come too late to take part in the large-scale privatisation or in later rounds of property redistribution.

Having settled ownership issues, introduced effective corporate management and made capital investment, mining industries have now entered a growth stage. That is, time has come to reap the dividends on all kinds of investment.

Meanwhile, the state has grown strong enough to be able to decide which of the 'oligarchs' deserves what treatment. There is a temptation to restore 'historic justice' - or rather under the pretext of restoring historic justice, to take part in a new redistribution of property.

This has led to debates on redistribution of mineral rent and/or return of its sources into state ownership. While only Communists voiced such proposals in the past, they have now lost their former political clout, and such initiatives are generated by the president's staff - they have retained their influence.

A clear trend is also seen in the federal authorities' relations with regions.

In the early 1990s, weak Russian federal authorities needed support in regions. This was the time when President Boris Yeltsin made his legendary declaration: "Take as much sovereignty as you can."

Legislation passed in 1992 called for the sharing of payments for the right to produce hydrocarbons as 40:30:30 among the federal budget, the regional budget and the local budget.

Later, federal authorities clearly tended to increase the tax burden on businesses and to redistribute tax revenues in their own favour.

Under the current budget, 80 per cent of the severance tax on the extraction of mineral resources, introduced this year, will go to the federal budget, with just 20 per cent going to regional budgets (for a region with a complex structure, the proportion is 74.5:5.5:20 for the federal, regional and local budgets). So, unlike in the early 1990s, the bulk of tax revenues from hydrocarbons production goes to the federal budget.

Changes in the sharing of tax revenues reflect the current thinking in Russia's current domestic policy in the economic sphere. In the political sphere, they are manifest in the emergence of federal districts, reform of the Federation Council and the like.

The Kozak commission's concession-related innovations may be regarded as a continuation, as a practical implementation of that new domestic policy.

The commission proposes federal ownership for mineral deposits (except widespread minerals) and striking out of the Law on Underground Resources provisions concerning joint authority of the Federation and regions in the subsoil use sphere - "for lack or impossibility of creating a clear mechanism for realising that authority." Hardly any comment is required...

But Russia's practice shows the efficiency of delegating to regions the right to define subsoil use rights at smaller and depleted fields, which generate tax revenues, create jobs and do other good things for regions, compensating - through the expansion of the tax base - special regional tax preferences required for extending the period of cost-effective development of those fields.

Suffice it to recall the growth in oil production in Tatarstan in the second half of the 1990s, which was attained exclusively due to a soft tax regime established by the Tatarstan government for Tatneft. It yielded effects in all economic sectors (especially with account of the multiplicative effects of investment), which by far surpassed 'missed' (due to soft taxes) tax revenues at the regional level.

But federal authorities now obviously have different priorities. They are so different that it is impossible to create a clear mechanism for delimiting authority in their framework.

The Kozak commission's initiatives launch yet another stage of re-routing financial flows

generated by mineral producers to the federal centre and shifting control of them from regions to federal authorities.

This will inevitably weaken regions in economic and, therefore, political terms.

To have a full picture, it is worth analysing changes in the tax burden on 'producing organisations', which may take place if concession-related amendments are adopted.

The introduction of concession agreements will obviously increase the tax burden on investors in oil and gas projects as another payment 'for concession' will be introduced (under the latest variant proposed by the commission, it will be equal to the tax on extraction of mineral resources at a current rate), while profits will be reduced to a 'normal' level (payment for risk, which is a base for entrepreneurial activities, will be rejected).

As for the growth of the tax burden on oil companies due to the introduction of the severance tax on extraction of mineral resources, I wrote about it earlier (see [New oil tax laws still lack balance. Oil & Capital, No 1,2002](#)).

### **A mechanism for insuring against expropriation**

The initial version of the Kozak commission's proposals called for expropriation of mineral producers revenues without compensation. Had those proposed amendments become law, Russian business would have found itself unprotected against the state's arbitrary action.

But well-tested norms protecting investors against the threat of expropriation (nationalisation) without compensation have been developed in the international contractual practices.

In particular, in 1938 the US Secretary of State, Cordell Hull, proposed a formula for prompt, adequate and effective compensation for expropriated property. It has since been applied in many bilateral investment contracts and in multilateral investment agreements, in particular, the Energy

Charter Treaty, whose member states are 51 Eurasian states, including Russia. True, Russia has signed the Treaty, but has not ratified it so far (due to opposition by Gazprom and the parliament members it backs).

Had Russia ratified the Energy Charter Treaty, Russian and foreign businesses working in Russia would get international legal protection, because under Article 13 of the ECT, expropriation is only possible on the Hull formula terms, that is where such expropriation is:

- (a) for a purpose which is in the public interest;
- (b) not discriminatory;
- (c) carried out under due process of law; and
- (d) accompanied by the payment of prompt, adequate and effective compensation."

### **There is a positive aspect**

The Kozak commission easily gave up the idea of nationalising produced minerals, which gives grounds to suggest that the idea is not part of the state's economic strategy. They just tested the public opinion and dropped it.

Now that the proposed amendments have been altered, they just represent an attempt to offer yet another variant of reform in subsoil use licensing, whose need is obvious.



That the situation in this sphere leaves much to be desired is clear from the fact that a moratorium is still in effect on the issue of new licences. The Ministry of Natural Resources froze the process last year, and only poorly informed optimists today hope to sign PSAs for projects whose list was approved by authorities several years ago.

Regular audits by various agencies of the observance of licence contract-s by subsoil users add gravity to the issue. Virtually all auditors have found breaches, but no licence has been withdrawn on those grounds so far.

The combination of those factors allows drawing the conclusion that state policy concerning subsoil use in Russia has come to an ideological deadlock, and Russian authorities have to do something out of the ordinary to move out of the deadlock. For example, shifting to concessions.

That this shift has been proposed may mean that the authorities have realised the impossibility of radically improving the existing licence system in subsoil use and are willing to start building a new subsoil use system from scratch.

As for a shift proper, it has numerous reefs and rocks, and the interest-s of certain subsoil users will be inevitably impaired.

But this is the main (perhaps, the only one) positive element in the commission's proposals, because it allows shifting all subsoil use to civil law terms.

The licence system existing in Russia is based on public law, in which the state is always superior to the investor. This could be a decisive factor in resolving disputes between them, especially in courts within national jurisdiction, and provides additional investment risks.

Only detailed legislative regulation of all mechanisms and procedures can reduce the investor the risks of work under a system regulated by public law. This transparency usually characterises stable economies which could develop and perfect their legal systems over a long period. As examples, it is possible to cite the United States, Britain and Norway, where oil and gas companies work on the basis of permit-based (licence) procedures.

True, even in those countries investors are not insured against the state's attempts to get an extra share of rent after they have made capital investment and, therefore, have no room for manoeuvring during talks with the state. For instance, in the mid-1980s (after the bulk of investment was made in oil production in the North Sea and their projects started yielding profits to companies) Britain introduced an additional tax on oil revenues.

Unlike Britain, Russia is at a much earlier stage of formation of its economic legislative environment. Any court case concerning control of attractive assets may confirm this.

Higher risks in the licence system framework are an inalienable element of activities. From this point of view, the Kozak commission's concession-related proposals that would shift subsoil use to contractual relationships, to regulation by civil law can be regarded as a measure reducing investment risks involved in natural resources development in Russia.

But it is a pity that overall changes in subsoil use regulation, proposed by the commission, lead in the opposite direction. Rather than the 'higher risks - higher profits' principle clear to all investors, they propose a new one: 'different risks - normal (equal for everyone?) profits'. Having no parallel in world practices, this approach looks absolutely unacceptable for private investors.