

'PSAs should be freed from the fetters impeding their effective application on a wide scale'

By Andrei Konoplyanik

Production sharing agreements (PSA) are just one instrument for attracting investment in mineral resources production, along with the licensed subsoil use system, concession agreements and risk service contracts. In most countries only one subsoil use system is used, while in about a dozen countries several systems apply.

Russia belongs to the latter group - since January 11, 1996 PSAs have been an inalienable part of Russian legislation along with the licence subsoil use system.

If both parties - the state and the investor - agree on a range of parameters and find a project on PSA terms (or, on the contrary, under a licence contract) is feasible, that means that this organisational legal form best suits a particular project.

But while under the licence system the investor only has to agree or disagree with the state's terms, in the PSA case the state and the investor arrive at the decision on its applicability together.

This explains many advantages of PSAs over the licence system but this also leads to many problems related to PSAs' effective application as opposed to working under the licence system.

PSAs are more attractive than the licence system for most potential investors. Therefore, the production sharing regime fixes precisely - for each particular project - the level to which the state should improve the attractiveness of its investment regime in general, while removing excessive pseudo-protective barriers in its existing legislation.

But the opposite has happened in Russia.

Under strong pressure from part of the oil business, the state - both its executive branch and lawmakers - seems to have decided against removing barriers in investment legislation unrelated to PSAs. Moreover, it seems to have decided to abolish the PSA investment regime instead.

The lack of an alternative to the licence system in getting access to mineral resources fully corresponds to the interests of companies having a high-quality resources base, whose business strategy is aimed at extracting as much as possible of those resources within the shortest time.

Other companies want a balanced portfolio of production projects with various cost levels. In that case as easier access fields grow depleted they will be gradually, rather than overnight, replaced by fields whose development is more costly.

Those companies' demand for investment will also grow smoothly and predictably.

The state is obviously interested in companies in the latter group dominating among oil companies in Russia.

It is also obvious that long-term strategies will not be popular in the country until preconditions for long-term investment are in place.

To that end, competition between investment regimes - licensing and PSAs - may prove a

more effective instrument than a dragged-out decision-making process in the framework of the state machinery's initiatives, slowed down by clashes between various agencies and lobbies.

PSAs and society

Russia's modern history has seen several peaks and declines in the state's and the public's interest to PSAs.

Over recent months, the PSA issue has again come to the foreground - and the approach to the topic has been quite specific.

In the past, polemics around PSAs were objectively encouraged by low oil prices.

The lower the oil price the more companies are interested in accurately dividing gross profits between themselves and the state. The lower, also, those prices are, the less price rent can offset the inefficiency of the general tax system. Therefore, when prices are low (as at the end of the 1990s), all oil companies need to replace the general tax system with a different, individualised tax mechanism.

When prices are high, companies' interest in PSAs is likely to decrease.

But if, against the backdrop of high prices, a war breaks out with the purpose of destroying PSAs, some special factors prompted by the situation must be working.

While, in the past, debates on PSA problems were more or less balanced, in the first half of this year negative views have prevailed.

PSA opponents, using the mass media, appealed to emotions rather than reason. Suffice it to recall the publication, sponsored by a Russian major oil company, in a number of national newspapers of a riddle describing the 'progress of disintegration of the great country': the Soviet Union - Russia - PSA.

Appealing to reason is senseless, as rank-and-file Russian citizens have no idea of what a PSA is (this is confirmed by opinion polls).

While there is no public understanding of the problem, campaigns of that kind provide an information background required by people for making certain decisions.

In this case, it was the February decisions by the Russian Ministry of Energy's board on PSAs and those made on the same issue by a meeting chaired by the Russian Prime Minister several days later.

In this article, I am not going to argue with PSA opponents on a whole range of issues - a lot has been written about PSAs, including many articles and several books.

I will try not to repeat arguments I provided in my recent writings to explain my view of the reasons for the latest mud-slinging campaign against PSAs in the Russian press (a means of fighting foreign rivals and part of preparations for the sale of their companies to those foreign rivals in the future and at higher prices).

I have been a proponent of the creation by Russian legislation of a competitive environment - for competition among investors, including access to mineral resources, and for competition between subsoil use investment regimes for investors.

We, a group of authors of PSA legislation, proceeded from this concept when we defined the place of PSAs in subsoil use in Russia and a correlation between PSAs and the licence regime. I will consider PSA opponents' reasons from this 'prejudiced' point of view as a champion of PSAs' application as an element of an integral system of subsoil use regimes allowing the creation of an effective competitive environment in the Russian economy's mineral sectors: the battle against PSAs is a battle against taxation of unearned income.

Many Russian analysts, when considering taxation of oil production, only take account of 'price' rent, while neglecting 'mining' rent.

In particular, Oleg Vyugin, the first deputy chairman of the Bank of Russia (in my opinion, he is one of the best economists in the country), noted in his interview with the *Kommersant*

Dengi weekly in April that "while regulating, the state has been lavish in sharing rent with private companies."

He also added that "the sector of the curve where oil prices are extremely high should correspond to almost complete withdrawal of unearned income."

That is, price rent is meant, so-called 'unforeseen revenues' as a base for higher taxes on companies. In other words, they are incomes not actually earned by companies, but received due to a favourable price situation (for instance, in the first quarter of this year all major vertically integrated oil groups posted an enormous growth of profits, due to a 'price premium' for the Iraq war).

Mr Vyugin, though, said nothing about the mining rent depending on mining, geological, geographic, climatic and other field development conditions.

In a certain sense the mining rent is in inverse proportion to production costs, ensuring some oil companies higher profits than others irrespective of the price situation. They are also unearned profits, a godsend (or a 'statesend', as during the privatisation - certainly not without the state's help - those companies got the best slices of the 'oil pie').

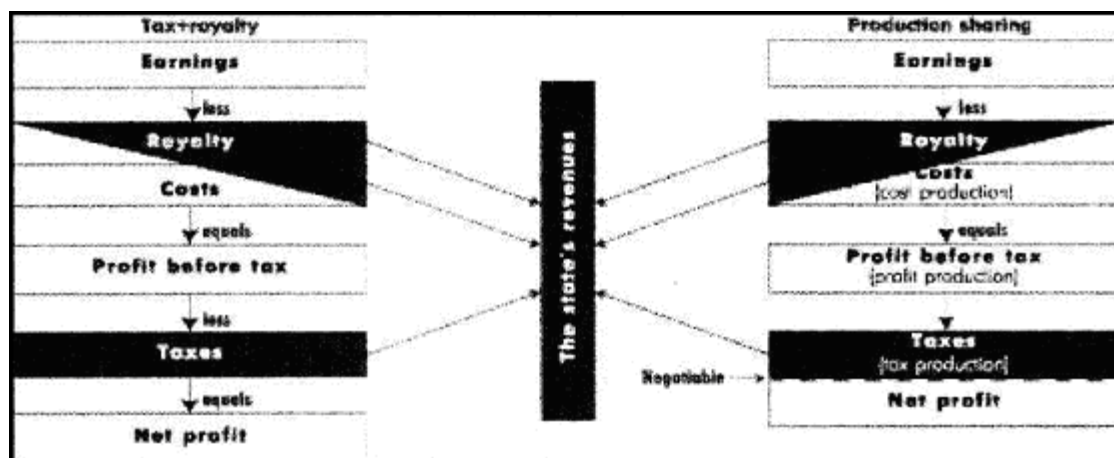
It looks obvious that the state, prepared to exact from companies super profits obtained through price rent, has real grounds to spread this approach to mining rent.

PSA and mining rent

So what is a PSA mechanism, if there are those who pay so much money for discrediting it? Who needs to fight against PSAs? Who benefits and why?

PSAs are an economic legal mechanism ensuring optimal sharing of the mining rent between the state (the owner of mineral resources) and the investor during the development of mineral deposits.

In theory, PSAs allow accurately and dynamically balancing proportions for mining rent sharing at each particular field (see Fig. 1). No mechanism for taxation of subsoil use, unilaterally fixed by the state, can give such an opportunity.



In other words, rent sharing based on administrative law cannot be optimal by definition. Therefore, PSAs are not a soft tax regime. It is a different - rent-based - tax regime for subsoil users that will always yield the state more revenues than the so-called "national tax regime" so energetically backed by PSA opponents.

As in my previous publications, rather than using the words "national tax regime," I will use a less jingoistic term - the "general tax system" (GTS).

The opinion is being enforced on the public that PSAs mean unfounded exemptions, which

result in the state's getting (companies' paying) less taxes and levies.

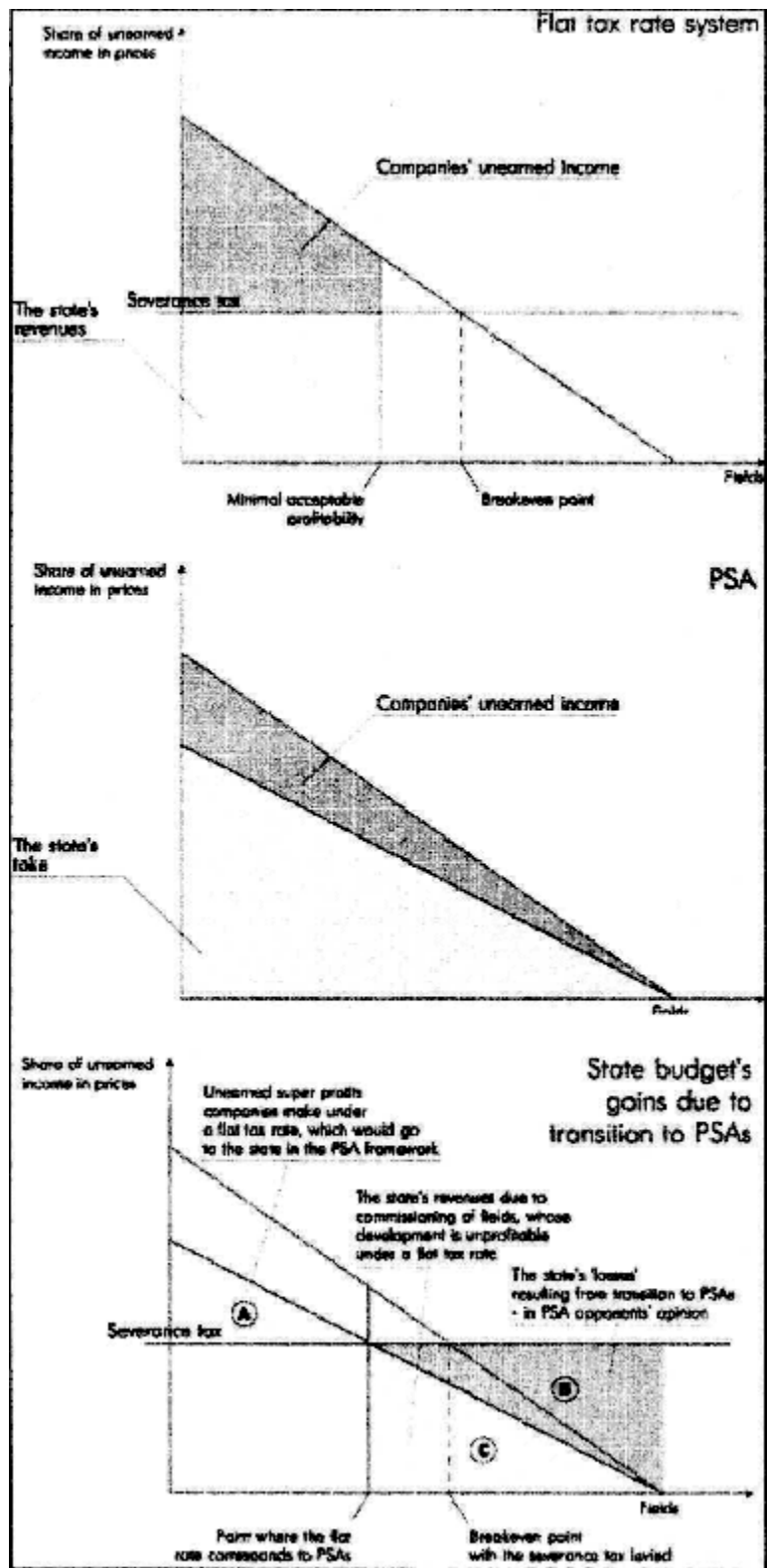
A situation has been energetically analysed, related to PSA application at fields with an insufficiently high share of rent in prices, whose development under the licence regime with the severance tax on mineral resources production cannot ensure companies the desired rate of return.

This approach is absolutely inaccurate, as field development is not the goal of investment activities - it is a means of making profits.

The effect of PSA application at such fields should be compared with zero revenues, rather than mythical tax revenues estimated on the assumption that a field would be developed with negative profitability under the general tax system. It will not be developed at all under those conditions.

As for PSAs, they allow a compromise between the state and the investor, with the latter getting an acceptable return on investment and the former getting real tax revenues. To illustrate this, let us take a look at charts. Along the horizontal axis (hypothetical) let us put all licensed fields in Russia with fields with worse quality of reserves to the right of those with better reserves.

The function of the share of rent (unearned income) in oil selling prices (for the sake of clarity, uniform for all companies) for subsoil users of those fields is represented as a straight line (**see Fig. 2**).



Obviously, to the right of the breakeven point under the existing severance tax system, there cannot be any loss of revenues by the state, if fields are shifted to PSA terms. But expecting any loss of revenues in that zone is tantamount to expecting companies to start developing fields at a sacrifice.

Moreover, it is hard to expect companies to develop fields exclusively to return their

investment. In fact, there is a certain minimal acceptable level of profitability, which serves as a watershed between developed and undeveloped fields. To the right of that watershed, the state does not lose any revenue (zone B).

What the 'grandfathering' clause does not prevent
It is commonly believed that no matter what happens around new PSA projects in Russia, the PSAs signed before the PSA Law came into effect in Russia (Sakhalin-1, Sakhalin-2 and Kharyaga) will be safely protected by 'grandfathering clauses' stipulated in the PSA Law (Article 2.4) and will not be impaired by negative developments.
Alas, this is not true.
The laws of the financial market are harsh: further financing of those projects in an increasingly unfavourable (for PSAs) economic, legal and political environment inevitably increases risks for financial institutions.
This means higher borrowing costs. As a result, the projects' financial costs grow, increasing the amount of cost production and reducing the amount of profit production shared with the state. Automatically, the state's revenues from those projects go down -and the state itself is to blame for that.

The profit threshold in field development under the general tax system may be interpreted as a point where the general tax system corresponds to the PSA system - the economy of development projects at fields in that 'border area' will only change negligibly as a result of transition from one tax regime to the other.

Zone C, to the right of that boundary, reflects the state budget's direct losses if fields in that zone are not developed on PSA terms.

Characteristically, PSA opponents have carefully tried to avoid considering the application of PSAs in another range of the resources spectrum - where the share of rent (unearned income) in prices exceeds the level of taxes under the general tax system.

In that zone, the application of PSAs would increase the tax burden on companies substantially, while retaining an acceptable rate of return for them - that is, budget revenues at all levels would grow, while the development of those fields would retain investment attractiveness.

On the chart, zone A shows the state's potential revenues due to the shifting of fields yielding 'unearned super profits' to PSAs.

The PSA regime, ideally, could be more attractive for the state than the general tax system through a whole range of fields: due to creating conditions for the development of costly fields and withdrawal of part of 'unearned super profits' from companies developing fields where oil production costs are low (**see Field for PSA application has been defined**).

Field for PSA application has been defined

The fact that the comparison of revenues the state gets from PSAs and under the general tax system speaks in PSAs' favour does not mean that the licence system should be totally rejected and the sector should move to PSAs (such proposals were actively lobbied in the 1990s by foreign oil companies working in Russia).

Various groups of risks emerging during PSA application and under the licence system make their peaceful coexistence possible.

Provided that all other conditions are similar, PSAs are more effective from the point of view of 'fair' sharing of rent, but, by definition, PSA projects are more lengthy, because they are individualised, meaning that field development usually starts later than under the licence system.

Licences are a less effective subsoil use system in many respects but it provides a more simple - because it is standardised - system for decision making. Therefore, it allows earlier start of field development.

In most cases, oil companies find it preferable to apply a non-optimal tax regime in the licence system framework. This allows starting field development earlier, rather than wasting years on negotiations with the purpose of working under an optimal regime of rent sharing in the PSA framework.

This should be clear for any individual with an economic education who knows what discounted cash flows means. So, one should not think that all potential investors would immediately start working up proposals for work on PSA terms had they been offered a choice between subsoil use systems. PSAs can only be 'piece-work' projects.

Particularly suitable for that regime are fields in the border area of the resources spectrum: the biggest (mega projects) and smallest fields. The licence regime would not work there under the general tax system.

PSAs are as good for mega projects, as capital costs are extremely high, as they are for smaller fields as their profitability is marginal. The authors of Russian PSA legislation have insisted on particular economic attractiveness of production sharing for such fields since they started work on that legislation.

Two conclusions can be drawn.

First, companies with a more favourable structure of reserves are not interested in the promotion of PSAs in Russia.

Second, importantly, those companies particularly benefit from the existing flat tax rate.

The state, while applying the flat rate, has sustained losses compared with any differentiated taxation mechanism and that is true for all zones of the resources spectrum.

This makes clear the logic of the fight against PSAs and explains the course of events in that fight which is based on the intention of a number of companies to retain their unearned super profits.

The campaign, 'reconnaissance in strength', was launched during a meeting of a number of leaders of Russia's biggest companies with the Russian President in May 2001.

During that meeting, YUKOS's chief Mikhail Khodorkovsky (speaking about ways to stop capital flight from Russia and to increase Russia's revenues from mineral resources' production) recommended that "PSA exemptions should be liquidated," i.e. he actually called for rejecting the production sharing regime as contradictory to the "national tax regime" and giving advantages to certain subsoil users.

But even the most successful lobbyists must have found it hard to fight simultaneously for a flat tax rate under the licence subsoil use system and for the elimination of PSAs.

It looked more logical and consistent to ensure the adoption of a flat tax rate first and later, while exploiting success, to focus on the fight against PSAs proper with the purpose of totally ruining rent-based (or similar) principles of taxation in the oil production sector.

All Russian oil companies now produce their oil in the country under the licence regime and the general tax system. PSAs are a regime that might or might not be used by them in the indefinite future. Therefore, they should, first and foremost, fight for today's financial flows, leaving tomorrow's flows for tomorrow.

The fight against PSAs is needed for those who would lose a lot if production sharing is applied in the country on a broad scale - namely those companies and their owners, who would have to give more to the state under the PSA regime than they give it today.

This explains why they have mustered their strength to attack rent-based taxation principles. It also explains why they have convinced the authorities to introduce the flat-rate severance tax on mineral production and why they have tried to malign PSAs.

But why does the state need this?

The need to share

The idea of easing the tax burden in sectors unrelated to oil production, while shifting part of it to the oil sector, has tended to gain popularity among the government's financial gurus.

An increase in the severance tax rate is expected to offset a decrease in the overall tax burden on oilmen due to the reduction of a number of other taxes, Russia's deputy finance minister Mikhail Motorin told the *Vedomosti* daily in March.

In his opinion, in recent years taxes have gone down for oilmen: they have benefited from the reduction of income tax rates (oil sector wages are the highest in Russia) and the unified social tax, from the repeal of turnover taxes and, substantially, from the lowering of the profits tax (the author's view of the consequences of 'tax reform' in the oil sector is different - see **New oil tax laws still lack balance, Oil & Capital, No 1, 2002**).

Let us not discuss whether or not it is worth upping the severance tax rate at all (it looks like the political decision has been made on the issue already).

But two approaches are possible for getting more severance tax revenues: a differentiated approach and increasing the rate across the board, equally for all companies. The government, clearly, prefers the latter.

"The Ministry of Finance proposes increasing the base rate of the severance tax on mineral production, starting in 2004, from 340 roubles to 357 roubles a tonne for oil production, which will yield extra revenues of 11bn roubles to the budget, Alexei Kudrin, deputy prime minister and finance minister, told the press." The report was published by RusEnergy in mid-April.

What is this fraught with for the sector?

If the severance tax burden grows uniformly for all companies, the zone of fields whose development is unprofitable will expand, while competitive advantages of companies with low-cost oil reserves will grow accordingly.

But the narrower the zone where field development is cost-effective under the severance tax regime, the greater PSA supporters companies with resources with diversified production costs should grow - as only an alternative PSA regime can let them effectively develop their fields today and tomorrow.

Clearly, under those conditions, flat rate supporters would benefit from total elimination of the PSA regime - as this way they would limit the potential for development of their rivals in Russia (both Russian and western companies).

If those efforts are backed by synergetic effects of a merger of two companies particularly interested in that course of events, the result will be further expansion of their market share - with a flat tax rate in effect and in the absence of PSAs.

So, the state could get the 11bn roubles at the price of impairing of the ability of most Russian oil companies to compete in the market.

Is this what the state needs?

But if preference is given to a differentiated approach to marking up the severance tax rates, it will turn out that the tax burden on companies with the highest share of unearned income in prices should grow, while rates for those with low shares should remain unchanged or should even be reduced.

That is, first, the flat rate should be rejected.

Second, debates should resume on the parameters of a differentiated tax scale.

Third, debates should also start on PSA application where unearned incomes are high at fields with better development conditions.

But that approach would impair competitive advantages of companies with highly profitable reserves (and, perhaps, the best lobbying teams) compared with other subsoil users. Therefore, their reaction to that proposal can be easily predicted.

But it would be good to hear the government's articulate position on the issue.

PSA: what is to be done?

In my opinion, it is hardly worth trying to mend the existing PSA mechanism with all of its drawbacks today. PSAs should be freed from all the fetters impeding their effective application on a wide scale.

In other words, the idea prevailing among Russian authorities of applying PSAs exclusively at the worst subsoil blocks and only after all other subsoil users refuse to develop them under the general tax system should be rejected.

The battle for survival of several PSA projects implemented in conditions of a 'concentration camp for PSAs', where PSA opponents have tried to drive them, is a possible way, but it leads to a deadlock.

It looks like an attempt to protect a personal section in the common bowl of soup, while the stronger eaters consume heaped spoonfuls from the same bowl.

The tramline of the fight for effective application of PSAs is the return to the idea of building a model for their use in Russia that would maximise positive economic effects for the state, while relying on reasonable benefits for investors.

To that end, it would be expedient to return to the PSA model that was initially proposed in the country (before the autumn of 1995, that is before the start of work of a conciliating commission of the Federal Assembly's two chambers) and proceed with efforts to perfect it.

Therefore, as I have constantly repeated again and again, it is necessary to reject such fundamental restrictions on PSA application as:

- the lists of subsoil blocks eligible for development on PSA terms;
- a quota of up to 30 per cent of resources for PSA projects;
- the need to adopt special laws to approve PSAs;
- a 70 per cent quota for the purchase of Russian equipment for PSA projects, whether or not that equipment can compete in the market, and an 80 per cent quota for the use of Russian workforce;
- an overly complicated procedure for the preparation of PSAs for smaller fields;
- and other similar non-economic restrictions.

It would be expedient to review the concept for the application of PSAs and reject the idea of applying production sharing exclusively at fields with unfavourable development conditions. Procedures should be developed for holding competitive rounds for the right to use mineral resources that would let companies choose a regime they would undertake to work under at particular subsoil blocks.

I hope the readers understand that the scum of insinuations related to PSAs will inevitably disappear.

Another question emerges then: why have the executive and legislative power branches taken a position of resolute rejection of that mechanism for attracting investment and subsoil use in the dispute around PSAs - a position that plays into the hands of certain representatives of Russia's oil business, rather than the whole of Russian society?

But answers to those questions go beyond the limits of this article. Still, I would be happy to see yet another mishap in the PSA history mended so I would not feel shame for the nation.

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