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Global Financial Crisis to Put The PSA Regime in Russia Back on the Agenda by A. Konoplyanik

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Global Financial Crisis to Put the PSA Regime in Russia Back on the Agenda

Andrey Konoplyanik*

In the middle of February 2009, within the framework of the Sakhalin-2 project, the first LNG plant in Russia was commissioned. The opening ceremony was attended by Russian President Dmitry Medvedev, who praised the work done by the project's shareholders and expressed satisfaction with the fact that Russia had become a member of the LNG exporters club.

It is common knowledge that the Sakhalin-2 project was implemented under the terms of a production-sharing agreement (PSA). The parties to this PSA are the Russian Federation, as the owner of the energy resources in place, and 'Sakhalin Energy Investment Company' – a so-called 'special purpose company' (or project company) established initially by a consortium of foreign investors (Gazprom is now a controlling stakeholder), to develop the Piltun-Astohskoye and Lunskeye oil and gas fields located offshore of Russia's Sakhalin Island.

The project has already survived ups and downs in the economic environment, including the default of 1998 and low oil prices of that period, highly favourable market conditions in recent years, and, several changes in the shareholders structure, etc. In spite of this, the project never 'died', and it has already generated over \$1 billion in the form of royalties and income tax for Russia's benefit. It has stimulated development of Sakhalin's economy (previously one of the most underdeveloped regions of Russia since it is so distant from the federal center), etc. In other words, the PSA regime has not only proven to be viable, but also highly stress-resistant, which is very important for subsoil users in a time of crisis, when oil prices have dropped to their previous levels of the recent past. Production costs are constantly increasing since the new fields being developed are in the more remote regions with more difficult geological and geographical conditions; and loans have become considerably more expensive and debt financing more limited.

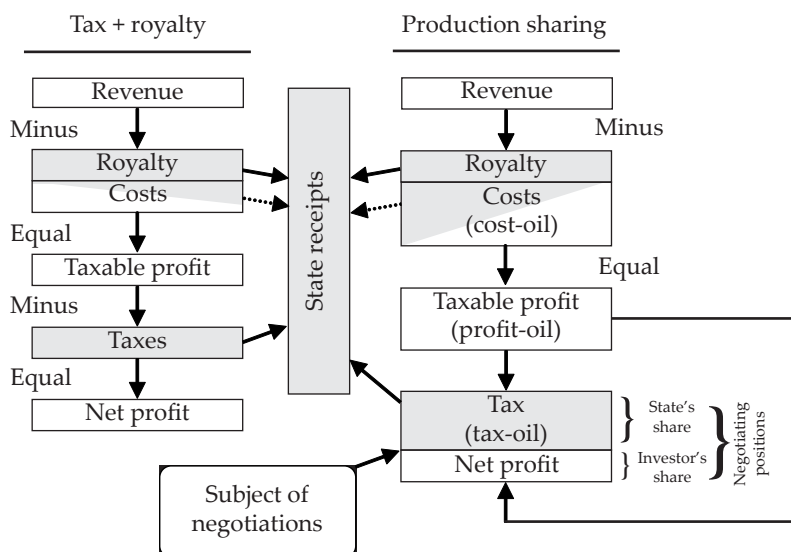
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Thus again, as in the time of previous crises, the possibility of reviving PSA (or introducing different sorts of its surrogates) is currently being discussed at different levels, in particular at the ministerial level in Russia. Government officials believe that the current situation is favorable for returning to the PSA, in particular, offshore and in Eastern Siberia, because PSAs provide (investors with) legal grounds for project stability for quite a long period of time in a low oil price environment. Not all Russian Ministries are supportive of a PSA regime; key for subsoil use – the Ministry of Natural Resources and Ecology is strongly opposed to it. Although no specific decision has been made so far, some steps in this direction are being contemplated. The question is whether bringing back PSAs would be appropriate today in Russia.

As can be seen from Figure 1, the basic economic advantage of the PSA is that it provides an opportunity for the State and investor to find an equilibrium in the splitting of oil revenues that will be mutually favorable to both parties for the long term project life. This is true if the negotiated split results in a sliding scale dependent on the economic results of project's implementation. The key legal advantage of the PSA is that it provides an enclave of stability in the unstable legal environment of the host states.

It has been statistically evidenced, that the PSA is usually implemented in countries with a lower per capita income/GDP, compared to the countries with the tax and royalty schemes (see Figure 2 below). It is usually these types of countries that provide less legal stability for domestic and international investors, and it is in this regard that PSA is so welcome by energy investors in such countries.

Figure 1: Basic Difference Between Tax Plus Royalty and PSA Regime



Source: A Konoplianik, 'Complex approach for attracting foreign investments into Russian energy', Dissertation in form of scientific presentation for Doctor of Economics Degree. Moscow, State Academy of Management named after S. Ordjonikidze, 1995, p 81.

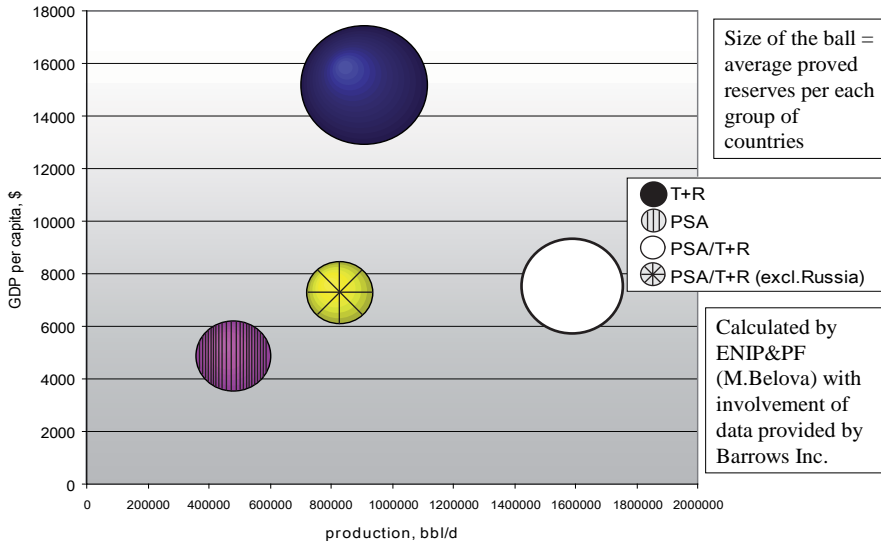
Crisis is not a reason but just an occasion

From the author's view, falling oil prices and financial and economic crisis, which, among other things, makes debt financing more difficult and costly, can arouse the lawmakers' interest in the PSA in Russia. Moreover, this demands the revival of the PSA in Russia as an investment regime for oil and gas field development equivalent to the existing subsoil use taxation regime based on MRPT¹, and not as a subsidiary or secondary one to MRPT regime. However, for me crisis is not a reason, but rather just another occasion to prove that a PSA regime, being of universal nature, works equally effectively, provided it is structured in the right way, to the benefit of the state (as subsoil owner) and investors under both low and high oil and gas prices. Through all my previous professional career (see selected bibliography at the end of the chapter), especially in mid-1990s, during the time when I have been heading the group of drafters of PSA legislation in Russia under the State Duma, I have been voting for the establishment of the subsoil

¹ MRPT = mineral resources production tax with currently flat rate since its establishment in Russia in 2002 (in Russian: NDPI = 'nalog na dobychu poleznykh iskopayemykh').

use system in my country with the two equivalent and equal investment and taxation regimes of the subsoil use: based on tax and royalty, on the one hand (now it's MRPT), and PSA, on the other hand (see Figure 3).

Figure 2: Oil Taxation Models vs. Average GDP per Capita, Oil Production and Reserves



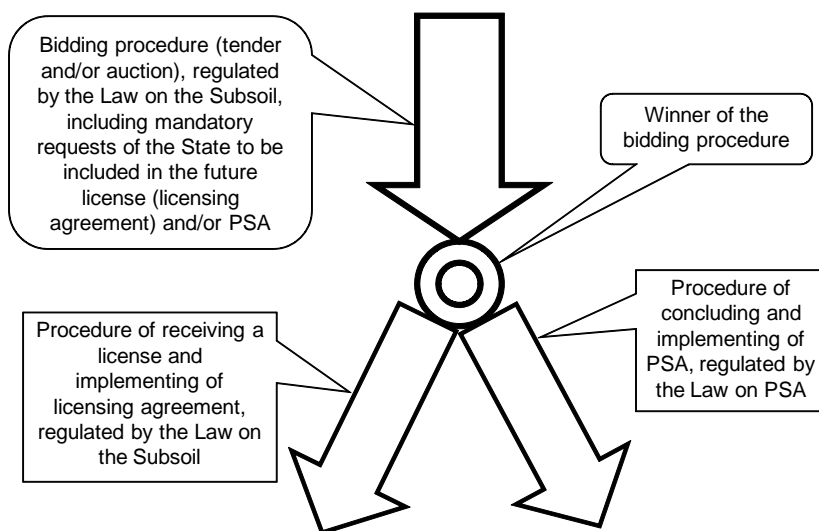
Source: A Konoplianiuk, 'Russian Oil Taxation System Development (a continuous debate between supporters of fiscal-oriented and investment-oriented approaches)', 15th International Petroleum Tax Conference, 11-12 Dec. 2004, Oslo, Norway.

Unfortunately, our drafting group and supporters in the Government and State Duma did not manage to introduce this system in Russian legislation in full accordance with our intentions, plans and drafting proposals: the opponents to the PSA regime (whose numbers were and still are rather large in my country) managed first to diminish the role of the PSA regime to the subordinate and supplementary one to 'tax and royalty' subsoil use regime. Since the very beginning the PSA in Russia was considered as an exemption to the general subsoil use regime based on tax and royalty. Later on, the PSA opponents² have managed, through amendments to tax legislation, signed by the Russian President in 2003, to factually forbid implementation of the PSA regime in Russia³. So today PSA regime de jure is present in the Russian legislation, but it is squeezed by so many administrative barriers that currently it is

² Headed by Mr. Khodorkovsky, former President of the former YUKOS oil company.

³ Motivation of the opponents to PSA is presented in the author's publications of early 2000's listed at the end of this chapter.

Figure 3: Two Equal Regimes (Author's Historical Proposal)



Source: А.Аверкин, А.Конопляник, М.Субботин. Инвестор свои деньги не отдаст. Пока не получит правового единообразия. – "Нефть и капитал", 1995, № 12, с. 10-12

totally impossible to introduce new projects on PSA grounds in Russia. To make the PSA regime workable these barriers need to be lifted.

In the existing environment, in the case of a flat MRPT rate, taxes are fixed and constant and not dependent of the natural and/or entrepreneurial efficiency of the project. This means that during an economic crisis (like the current one) the profit generated by producing companies starts to shrink sharply, which naturally holds back new projects from being developed. The government, due to its bureaucratic inflexibility, is not able to adjust a MRPT with a flat rate in line with oil price fluctuations or production cost changes. And even if a mechanism to make such adjustments is in place (as is in the case with oil export duties), the MRPT flat rate will remain uniform for all fields with different economic conditions. This means that the key disadvantage of the MRPT (from the point of view of potential investors in the Greenfields) – its universal nature and the same tax burden for fields with different production cost levels – will not be removed by the improvements of the MRPT system.

The times when we developed in Russia large fields located close to energy consumption centers are long past. This means that the costs – the so-called 'technical costs', i.e. of putting new fields on stream – are constantly increasing. Against the background of the financial crisis,

financial costs (the cost of raising external finance) are also increasing, which, among other things, is due to a lack of liquidity and more costly investment resources.

Most new fields are developed on the principles of project financing. This means that the project companies, which more often consist of consortiums of strategic investors, invest in their project's development borrowed funds (debt financing), and not their own funds (equity financing). This allows them to further mitigate risks by sharing the latter with the financial community. The source of debt repayment is the project's future profit. A package of legally binding project documents provides security for the funds raised for the development of this project. If these project documents do not show that sustained profit allowing pay-back of invested funds is to be generated during future long-term field development, no loan will be granted to the investors. Therefore, new fields will not be put on stream. Thus, high borrowing costs (costs of raising capital) appear to be one of the key disincentives for companies with respect to new field development, which consequently results in considerable delays in developing new regions.

Relatively low credit ratings of Russian vertically integrated oil companies (VIOC) also play a negative role. Today, Russia's long-term investment rating is within BB category and is one of the lowest investment ratings among the major producer countries. When Russian companies develop their projects in Russia they are bound by this rating as a ceiling. There is a general rule in project financing (and I know only one exception from this rule – and this is Qatargas LNG): the rating of the project can not be higher than the rating of the company(ies) that develop this project, which in turn, can not be higher than the rating of the country in which this project is being developed. At the same time the world's major VIOC have usually higher investment grades, including AA-AAA ratings for the super-majors. Under more or less standard conditions, low ratings mean higher borrowing costs for Russian companies, while during a crisis they just deprive them of the opportunity to borrow from Western banks and other international financial institutions. That is why for our companies, financial costs grow at priority rates. As a result, Russian companies, as majority stakeholders in new field development projects, cannot raise loans to develop the fields on favourable terms, on the one hand, and they are restricted in cooperating with foreign investors by new legislation, on the other hand. As a result new field development is suspended.

Two equal regimes

From my view, the PSA regime is to start functioning on a par with the existing tax system. I have always been opposed to a flat subsoil use tax rate, because, in my view, it is favorable only for those companies that develop the easiest fields. At the same time, complex fields, which companies would be willing to develop if the state offered a milder tax treatment, are not being put on stream (see Figure 4).

Figure 4: Comparison of Flat-Rate MRPT and PSA Systems

Figure 4.1: Flat-rate Tax System

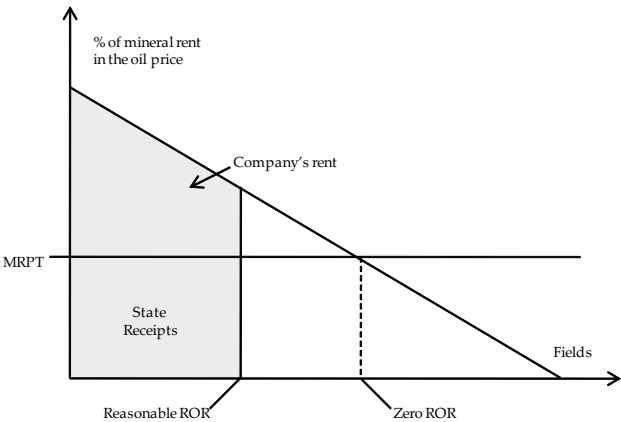


Figure 4.2: PSA

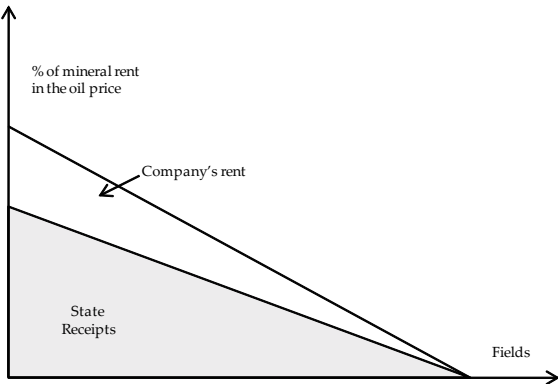
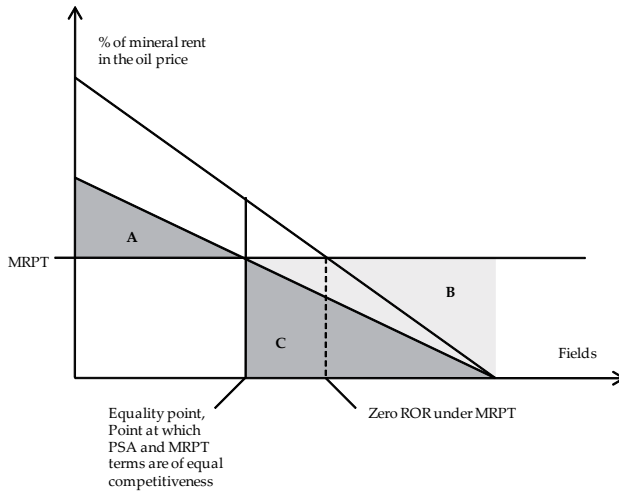


Figure 4.3: Transfer from MRPT to PSA



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: A Konoplyanik, 'A struggle for mineral rent', *Petroleum Economist*, August 2003, p. 23–24; Андрей Коноплиник: «Ухудшение экономических условий возвращает на повестку дня законодателей вопрос целесообразности реабилитации СРП». – «Нефть и капитал», 2009, № 3, с.18-23.

When oil prices have fallen from a maximum of almost \$150/bbl (which did not reflect, from my view, the fundamentals of the oil market situation),⁴ to below the level at which companies will be able to survive and start up new fields, very few tax regimes make it possible to work in such conditions. And the PSA regime is one of those few, because it ensures gross income distribution (taxes + net income) in a way that allows the state to receive maximum tax receipts, while leaving an acceptable profitability rate for the companies. This means that companies do not generate income based on the leftover principle, and the state does not collect maximum paper income, while actually benefiting from the fact that projects are operating (see Figure 1).

In my view, deterioration of the economic environment puts the issue of returning to PSAs on the lawmakers' agenda in order to remove the encumbrances of the tax treatment introduced in 2003-2004, which actually disabled it.

⁴ The author has argued this thesis in a series of his articles, published recently in Russia and Ukraine: 'Кто определяет цену нефти? Ответ на этот вопрос позволяет прогнозировать будущее рынка «черного золота»', *Нефть России*, 2009, № 3, с. 7-12; № 4, с. 7-11; 'О ценах на нефть и нефтяных деривативах', *Экономические стратегии*, 2009, № 2, с. 2-9; 'О причинах взлета и падения нефтяных цен', *Нефть и газ*, 2009, № 2, с. 2-4, 6-8, 10-11 (Украина); 'Нефтяной рынок необходимо реформировать', *Время новостей*, 12 декабря 2008 г.

There is of course no guarantee that if PSAs are reintroduced investors will prefer to invest, rather than take a wait and see attitude in a crisis environment. But there is a system of economic incentives. It is quite evident that those investors aiming to maximize short-term financial effects and those regarding the oil business as just a part of a wider investment strategy will play a waiting game.

PSAs are designed for another category: investors who do not intend to leave the industry under any circumstances — here I mean VIOC in the first place — and are aiming at efficient recovery and replacement of reserves. They are aware of the fact that the infrastructure they set up must function at maximum efficiency. That is, they are interested in stable production volumes (at maximum efficient recovery rates) from existing fields and putting new fields on stream with a certain lag to ensure the process of expanded reproduction at minimum costs.

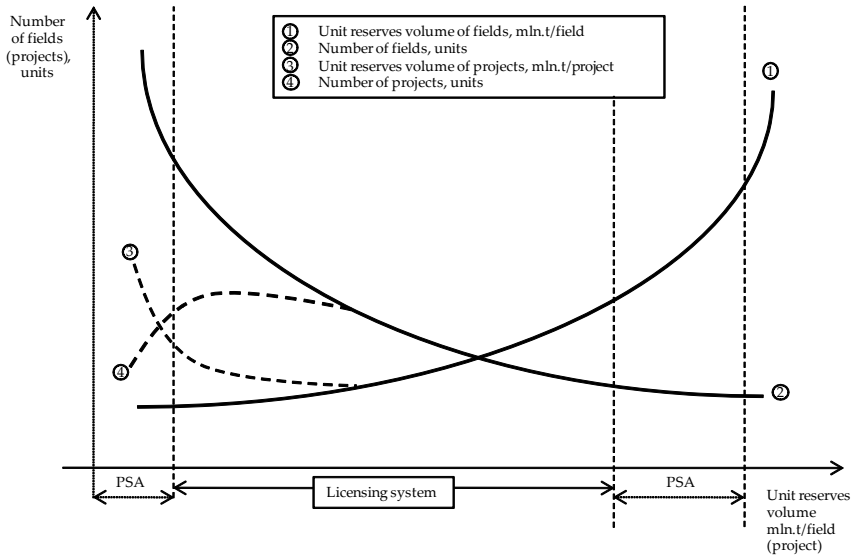
This is a key issue. I believe that the companies benefiting from waiting now will lose in the long-term outlook, because they won't be able to avoid the continuing decline in production at developed fields. And instead of gradual and relatively regular investment, they may face the need for increasingly expensive financing in the context of sharp fluctuations in demand for investment. Therefore, companies operating in the oil business rely on long-term mechanisms, not on immediate considerations. And a PSA allows them to predict developments and adapt to changing external conditions for implementation of their projects.

Who will benefit from the PSA?

The PSA regime is also interesting for developers of minor fields, who are cut-off from field development by the current MRPT regime (Figure 5). Providing a sliding scale of production-sharing, such treatment provides a means of developing such fields and thus expanding the resource base utilized by the state. Naturally, the income for the state from developing minor fields under a PSA will be less than the Ministry of Finance could calculate under a flat rate tax scheme (Figure 4). However, the income calculated, as if collected within MRPT regime with the flat rate, will only look good on paper, because if a company does not foresee an acceptable rate of return, it will choose not to implement the project. If minor fields are put on stream on PSA terms, the state will get the maximum resource rent it can realistically receive from them.

Who develops minor fields? Small and medium-sized companies. That is, by authorizing PSA for minor fields, we set up a base for the development of such companies. In most cases, these are regional structures, which can expand resource flows to the domestic, not foreign

Figure 5: PSA Preferential Application Zones



Source: A Konoplyanik, 'The Fight Against PSAs In Russia: Who is to Benefit and Why Not the State?' (October 2003) 10 *International Energy Law & Taxation Review* 277-286.

markets, filling in the niches in which VIOC are not interested. By the way, this is a way to promote demonopolization of the Russian oil and gas industry.

As for the MRPT treatment, it may appear to be preferable for fields located in developed regions with well-developed infrastructure. In this case, the lower efficiency of the MRPT compared to PSA may nevertheless be compensated by the lower costs of introducing MRPT, because it will allow a project to be launched within a shorter period of time than in case of a PSA. And the smaller the project, the greater the weight for calculating discounted cash flow the time factor has.

In my view, all projects not easily accessible deserve a PSA: offshore, Arctic offshore in the first place, Eastern Siberia and other remote regions. Any place where each project not only implies field development, but also requires setting up macroeconomic infrastructure and thus acting as regional development instrument through its multiplier effects, deserves a PSA.

Another category includes groups of minor fields that are currently not being developed. An example is the Udmurt project in the center of Russia, which I was once involved with: 10-15 minor fields are located

within the area with already existing infrastructure in the center of a developed region; however, their individual development is capital intensive (in terms of unit costs per field due to small size of each field). However, in order to launch such projects under PSA terms, one should redistribute authority, because it is quite difficult to initiate, control and regulate projects from Moscow. Initiatives must be redistributed: megaprojects should be initiated and regulated by the center; and minor projects, at the regional level. Further adaptation of the 'one key' principle might be required: its distribution between federal and regional authorities depending on the class of assets (e.g., volume of reserves). And, in my view, it should be legally possible to unite several minor fields within the framework of one project in order to reduce the profitability threshold of developing them (by implementing an 'economy of scale' approach).

The state will benefit from this solution, first of all, through resource base expansion. Furthermore, PSAs allow the state to cut excess resource rent (windfall profits) from those companies that generate higher profitability under a flat MRPT rate than the level of profitability in the industry on average (Figure 4). These highly profitable companies might be in the privileged position due to the fact that they, for instance, have received in the course of privatization in the 1990s (especially in the course of 'loans for shares' deals) already pre-developed or already developed fields for free (or almost for free) from the state. In the first place, these include companies operating simple fields and placing their products on the export market. Under the PSA, such windfall profits (i.e. generated from field development that is not justified by business activities) can be withdrawn, in part or in full.

What changes are needed?

It is clear that the reintroduction of the PSA will require tangible changes in the laws. I am convinced that we need to set up a licensing system that will allow companies to choose between the existing regime of subsoil use (tax and royalty, means MRPT) and the PSA. Naturally, the state will have to evaluate (pre-calculate) the relevant terms and conditions for each project to be licensed beforehand and offer the companies a licensing regime that meets their mutual interests (the host state and investor) as far as possible. The state will have to establish key (threshold) parameters for developing specific fields based on their most efficient recovery rates, below which companies may not go when submitting their bids, nor when the winner will implement this project (Figure 3).

At the same time, the PSA should not be a mechanism of ‘exemption from acting legislation’, as PSA opponents have always tried to present it and as, regrettably, it is arranged and functioning today. An exemption regime, especially when it is fixed as a resource quota (say, no more than 30% of the country’s proven reserves, as was the case in the 1990s in regard to the PSA), on the one hand, promotes speculative demand, which is not economically justified, and, on the other hand, expands the grounds for potential abuses on the part of decision-makers with respect to including projects in this quota.

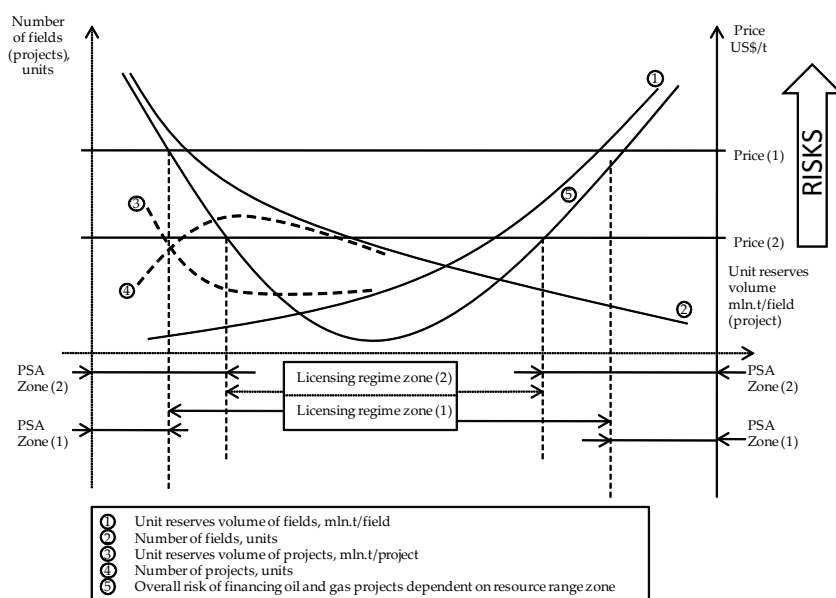
When we are speaking about simple fields, an auction system is justified. It assumes payment of a one-off bonus — which represents a kind of expensive entrance ticket and a further operation under the universal rules of the existing tax system. This is quite natural in places where the geological structure is not complicated and where there is no need to build macroeconomic infrastructure. In the case of difficult and large fields, where discounted cash flow is to be calculated for the long-term outlook, a tender system should be in place in my view. And in this case, a high ‘entrance ticket’ price (direct upfront cash payment to the state) is often not enough to ensure maximum discounted cash flow for the state through the entire period of field development.

The question here is what is more important for the state: to get a maximum one-off payment and many times less during the entire period of field development, than possible, or vice versa? The first option can also be justified, when, let’s say, people have nothing to eat and one has to feed them today at any cost. Today we are not in a situation like this, which is why long-term income for the state is more important, despite the fact that we are facing a global financial crisis.

I think that for minor regional fields, an option including the PSA and an auction system of acquiring subsoil use right may be suitable. A license agreement correctly drawn up by government authorities requiring early field development should be a guarantee that a major VIOC will not buy these projects for future use (and now will put them on hold) or financial structures will not buy them for resale. When choosing the subsoil use regime and acquiring a subsoil plot in accordance with these conditions, the company shall be obliged to follow it and there should be no possibility of transfer to another regime after it won the bid (Figure 3).

Furthermore, a mechanism should be set up to protect the parties’ interests for any license regime. An appropriate example here may be the practice of long-term gas export contracts (LTGEC). They do not fix the price in the LTGEC, they provide a pricing formula and mechanisms

Figure 6: Evolution of PSA Zones with Oil Price Fluctuations



Source: A Konoplyanik, 'The Fight Against PSAs In Russia: Who is to Benefit and Why Not the State?' (October 2003) 10 *International Energy Law & Taxation Review* 277-286; Андрей Конопляник, 'Ухудшение экономических условий возвращает на повестку дня законодателей вопрос целесообразности реабилитации ЦРП', *Нефть и капитал*, 2009, № 3, с.18-23.

for price review for the entire contract period (which should be at least as long as in case of field development). This mechanism works between many pairs of economic entities, so why shouldn't a similar adaptation mechanism work between the state and a subsoil user?

Speaking of the PSA, the contract must stipulate the terms and conditions under which the revenue distribution mechanism (production sharing) changes. A standard PSA and a standard license agreement subject to MRPT should be prepared in which all issues indicated above should be specified. These documents must be offered to potential subsoil users at the beginning of their participation in the bidding for subsoil use right. That is, I repeat, a licensing system providing for two equally valid investment regimes of subsoil use should be set up (Figure 3).

If the subsoil tax regime and PSA are applied on an equal basis, the boundaries between the areas of their preferred application will be flexible and may change depending on the pricing environment (see Figure 6). In case of high oil prices, companies will have more incentives

to apply the MRPT, since, all other things being equal, for 'average' fields (the median sector of the resource range) high prices will compensate for the relative inefficiency of the MRPT in resource rent distribution. And, conversely, in case of falling oil prices, the importance of optimal resource rent distribution for each specific project will increase; and, therefore, the importance of the PSA as an instrument for ensuring such distribution will also increase. Therefore, under these conditions the area of its application will logically expand. That was, by the way, proven by the historical changes in the level of support for PSAs in Russia: one of the highest it was in 1998, when the global oil market collapsed and prices fell below \$10/bbl, and the PSA was frozen in 2003-2004 when the oil price rise started and it was expected that it would be a long-term upward oil price trend. Therefore, the areas of subsoil tax and PSA application will be able to (and will) change as a result of economic incentives having an effect on the companies, not as a result of administrative pressure.

The above-described scheme for improving the licensing system will create the conditions for competition between two investment regimes for the subsoil user, which will have a positive impact on the efficiency of the Russian subsoil use system as a whole.

It should be noted that the PSA will become an instrument for ensuring optimal distribution of resource rent within the framework of each project only if the relevant legally binding documents are correctly prepared by authorized government bodies and negotiations are competently conducted. In turn, this puts forward additional requirements for the level of professional training of the experts for governmental authorities (this may be one of the reasons why some government officials, especially from the key for the subsoil use Ministry of Natural Resources and Ecology, are opposed to the PSA).

Not to repeat mistakes

This is needed to avoid situations similar to the ones that have taken place, for example, with the Sakhalin-2 PSA. At that time, in 2003-2004, under conditions of rising oil prices, the absence of a 'cost stop' parameter in the agreement might not result in an increase of tax portion from the 'profit oil' for the benefit of the state (so-called 'tax oil' – Figure 1). This was, in my opinion, the actual economic reason for the subsequent requirement by the state to revise the terms and conditions of the agreement and to change the shareholder structure of Sakhalin Energy Investment Company.

In order to force foreign shareholders to revise the terms and conditions of the agreement, 'an ecological stick' was used in place of transparent and sound arguments related to material changes of the terms and conditions of the agreement (similar to the above-mentioned long-term gas export contracts), which were within the sphere of international law. Once again, instead of the 'force of argument', the 'argument of force' was used...

By the way, if Russia had chosen the first way of eliminating deficiencies in the agreement, it would not have had to face strong criticism of the methods used to resolve Moscow's valid concerns about the Sakhalin-2 project. Similar international criticism could have been avoided by Kazakhstan, which stepped on the same rake some time later with a PSA project on the Kashagan field — for choosing methods to protect the valid interests of a sovereign state as the owner of subsoil and non-renewable natural resources. But that's another story.

PSA opponents may object: why return to the PSA, if MRPT tax holidays have already been provided for offshore fields in Eastern Siberia, Yamal and northern regions of Timano-Pechora? And it is also expected that export duties for Eastern Siberia will be abolished. Will tax treatment be worse than PSA in this case? But from my view all these reasonable lightening of MRPT regime (like tax holidays) will not have such an overall effect as the introduction of the PSA. These slight improvements to the MRPT regime are a single incentive granted unilaterally for various fields of one and the same region.

It does not represent an agreement optimized with consideration of specific project features, which is reached as a result of negotiations between the parties (host state and investor) and provides for such a legally binding distribution of resource rent, where the state gets its maximum portion of the rent and the investor gets a rate of return acceptable to it.

Thus, the abolition of export duties may be of interest to the companies exporting a considerable share of extracted hydrocarbons, whereas this measure makes no difference to companies operating in the domestic market ...

Furthermore, for me application of the PSA is not to be based on the geographical principle. It is not a question of setting up of centers of potentially favorable subsoil investment treatment ('potential' — because I don't know what we will have in the end) in specific regions. It is a question of applying the PSA across the entire country, on a competitive basis and on par with the MRPT tax treatment, in cases where it is justified from the economic point of view.

Earlier publications of A.Konoplyanik on PSA in Russia which were used for preparation of this chapter:

Monographs:

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