

Multiple Investment Regimes for Russian Subsoil Resources: Work in Progress or Utopia?

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1 Introduction

This chapter presents the summary of academic views and results of some of my practical experience with regard to the creation of a friendly climate for Russian subsoil investors.¹ Over the past 20 years I have argued in favour of the creation of multiple Russian subsoil investment regimes based on the development of a legal *investment menu*, *i.e.* a set of investment regimes for subsoil use to be available within Russia for investors seeking to develop Russian oil and gas resources.² These regimes, to be established by law, should present to the investor/potential subsoil user different combinations of legal stability and tax advantages allowing the subsoil investor to select the most appropriate regime, from the investor's point of view, for various future investment projects based on the investor's evaluation of potential risks and rewards in developing a particular project.

I argue that the investment menu should consist of four major investment regimes with different combinations of legal and tax components:

- (A) Current licensing regime, a legal reality since 1992 despite my rather critical attitude towards it;
- (B) Licensing regime with exemptions for individual projects and groups of similar projects and specific geographical areas, which is the dominant strategy for improvement of the existing investment regime;
- (C) Regime based on concessions, which is not legal in Russia at presently allowed and needs to be introduced into subsoil legislation; and
- (D) Regime based on production-sharing agreements (PSA), which has existed in Russian legislation since 1996, but implementation of this

¹ See my publications and presentations on these issues, all available at www.konoplyanik.ru.

² Since Art. 6 of the Russian law "On Foreign Investments" (1991) established a national system for all investors and investments, I will not distinguish between foreign and domestic investors in my arguments and will refer to investors-subsoil users for the remainder of this chapter.

regime has been artificially limited to situations made almost impractical by the Russian tax legislation reform of early 2000s and, in particular, by amendments to Chapter 26 of the Tax Code effective June 2003.

Regarding the legal component of the investment regime in subsoil, two regimes – (A) and (B) – have been developed within administrative law procedures while (D) was developed within the area of civil law which will also provide the framework for (C). Regarding the tax component of the investment regime of subsoil use, regime (A) presents (and regime (C) can present) a unified, single tax regime for all fields/projects, while (B) and (D) present differentiated/individualized tax regimes. The principal difference between (B) and (D) regimes, in respect of the tax regime, is that (B) has been developed as a centrally-determined (upside-down) set of individual exemptions to the tax treatment of individual projects, while (D) should be organized (based on existing but to-be-improved PSA law) as the regime that will provide opportunity for the resource owning host state and an investor-subsoil user to reach mutually beneficial and balanced sharing of resource rent based on negotiations on the specific PSA terms with sliding scales linked to financial and economic parameters of fields development. In the case of such improvement of the PSA regime and its non-restricted presence in the Russian legal system, no deviations from tax rules should be needed since this PSA model provides a mechanism for negotiation and achievement of bilateral agreement between the host state and an investor-subsoil user for optimal mineral rent-sharing.

This is a different approach compared to the single investment regime for subsoil use that has been dominant in Russia since the early 2000s. It is based on a licensing system with a flat-rate mineral resource production tax (MRPT) and an export customs duty (ECD), which was later supplemented by an open-listed number of individual exemptions from this basically unfriendly investment regime. These exemptions from the general rules are organized in the form of individual tax exemptions for individual projects, regions, and areas provided in a “handy” manner by government ordinances, which, *inter alia*, creates the risk that such decisions are arbitrary, under the table, discretionary, irregular, and, finally, corrupt.

Today’s licensing investment regime for subsoil exploitation presents a very inflexible system of oil taxation (inflexible in regard to project economics, not with regard to world oil price fluctuations) and a legal system based on administrative law where the state always dominates over the investor. If the investor (regardless of whether it is a foreign investor or a Russian state or private company) seeks to realize a reasonable rate of return (RROR) within this inflexible

and fiscal-oriented tax system, he has no choice except to approach authorities (now only federal) with requests for tax exemptions for his project.

In my opinion, the practice of providing individual exemptions within a basically unfriendly and inflexible investment regime is not the most effective way to encourage investment. Individual exemptions given by the state in a "handy" manner do not provide investment and legal stability for investors since they can be taken away at any moment in the same handy manner as they were given. A far better alternative would be to enact into law a flexible and adaptable investment regime where not only today's fiscal interests of the state are on the top of the agenda, but also the long-term investment aim of maximization of resource rent from project development and its fair sharing between the state and an investor. The latter means, in my view, that an investor receives RROR including adequate risk premium, which should be different for different fields/projects, and the state receives the remainder of the resource rent. This remaining portion will present the maximum possible government share of resource rent that will still leave for the investor adequate stimuli to develop the project based on his assessment of risks and rewards. And this aim can be best achieved when the state and the investor have multiple legal and tax models from which to structure an effective and balanced combination for any single project, *i.e.* when competition between the different investment regimes is available to an investor in the host state.

The argument in favour of multiple investment regimes in Russian subsoil is justified by the extensive geography of this country with major differences in geologic formations of its non-renewable energy resources. Such distinctions become more and more evident with further developments both onshore and offshore, which means that one single investment regime for subsoil use (especially the current inflexible purely fiscal-oriented licensing regime of flat-rated MRPT + ECD) cannot provide optimal (meaning investment-oriented) rent sharing for diverse capital-intensive and highly risky upstream projects. The optimal investment regime for an upstream investment project (*i.e.* balancing perceptions of risks and rewards both for the host resource-owning state and for the investor-potential subsoil user), within one area in Russia *e.g.*, in the center of such a "mature" area as Western Siberia with rather well developed infrastructure, might not be optimal for another project in a pioneer area such as onshore in Eastern Siberia with no infrastructure at all or in the Arctic offshore, where a totally different organization of oil and gas production should be developed.

I think the trend for Russian oil production to move into more remote provinces, with severe and diverse natural environments, calls for a shift in

the institutional structure, including the transition of investment regimes for subsoil use from a single, basically non-investment friendly fiscal-oriented regime with individual exemptions to make projects profitable, to a system of different and competitive investment regimes providing an opportunity to an investor–potential subsoil user to choose an – in his view and for his specific project – optimal regime from the regulatory menu.

In the next section of this chapter I will briefly explain the trends and tendencies during the past 20 years in the development of investment regimes in Russian subsoil starting with the subsoil law adopted in 1992.³ Article 12 of this law initially allowed a spectrum of investment regimes in the subsoil based on different types of petroleum arrangements: concessions, PSA's, and risk- and pure service contracts. Since then, a search for the most effective model of investment regime in the subsoil looked like a U-curve, at least in its most important tax component. The curve moved from an initial limited differentiation of oil taxation presented in the 1992 subsoil law to upwards to additional tax flexibility provided by a PSA law enacted in 1995,⁴ then to total resignation of differentiation in taxation in 2003–2006 as a result of the Tax Code Chapter 26 amendments⁵ and, returning to slow, step-by-step implementation of limited, non-systematic differentiation.

2 Implementation of Subsoil Resource Investment Regimes Worldwide

Let's start with some worldwide experience. Usually (at least in my country) when people begin to discuss, examine, and try to understand something new to them or non-traditional, (and the concept of multiple investment regimes sounds like non-traditional philosophy to quite a few people) they would like to find international and/or historical precedents. Such evidence provides a

3 Federal Law "On Subsoil," No. 2395-I (Feb. 21, 1992), restated as Federal Law "On Subsoil," No. 27-FZ (Mar. 3, 1995).

4 Federal Law "On Production Sharing Agreements," No. 225-FZ (Dec. 30, 1995).

5 The amendment of Tax Code Chapter 26, signed in June 2003, can be surprisingly called a "Putin-Khodorkovsky" law, since it was developed and sponsored primarily by Yukos company and its CEO M. Khodorkovsky in the early 2000s and was almost immediately signed by then-President V. Putin (А. Конопляник. «Ошибка президента. В чьих интересах в России фактически ликвидирован режим СПИ?». (А. Конопляник. "The mistake of the President. In which interests the PSA regime is de facto liquidated in Russia?") *НефтьРоссии*, (*Oil of Russia*) 9 (2003) 62; 10 (2003) 47).

framework for discussion with no obligation to agree with a concept or accept a proposal for change.

To explore this further, the natural first question that arises is whether international experience provides evidence of functional multiple investment regimes. Are there some countries that have more than one investment regime for subsoil resource exploration and exploitation, *i.e.* more than one type of national petroleum investment arrangement offered to would-be investors? The answer to this question is presented in Table 2.1, based on data kindly presented to the author by Gordon Barrows, Vice President of the Association of International Petroleum Negotiations (AIPN) and the owner of Barrows Company, Inc. which, according to the quite broad spectrum of views within the professional community, including my own, provides one of the best – if not the best – collection of petroleum arrangements and legislation worldwide.

Data provided by Gordon Barrows shows that worldwide there are about 180 countries with existing petroleum legislation. About half of them are oil-producing countries. And there are 11–12 states that possess at least two types of petroleum arrangements, if the tax component of the petroleum investment regime is taken into consideration: 1) a “tax plus royalty” (which means licensing and/or concessions) and 2) PSA. This means that about 10% of oil producing countries offers more than one regime to would-be investors in domestic subsoil resources. This can be considered one precedent.

Moreover, our analysis shows that in the countries where the single investment regime is applied, there is a clear correlation between the state of

TABLE 2.1 Comparative data on implementation of subsoil use tax/investment regimes worldwide, 2003 & 2009

	2003		2009	
Number of States in analysis, incl.:	180		177	
Oil producing states, using:	91		104	
– Tax + Royalty (T+R)	113	45	111	55
– PSA	54	34	55	38
– Both T+R & PSA	13	12	11	11

SOURCE: А. КОНОПЛЯНИК. СРЕДСТВО ОТ «ПРАВОВОГО ВАКУУМА». УРОВЕНЬ ЭКОНОМИЧЕСКОГО И ПРАВОВОГО РАЗВИТИЯ ГОСУДАРСТВА ОПРЕДЕЛЯЕТ ВЫБОР ИНВЕСТИЦИОННЫХ РЕЖИМОВ В НЕДРОПОЛЬЗОВАНИИ – «НЕФТЬ РОССИИ», 2012, NO. 8 С. 20–24; NO. 9, С. 26–29; NO. 10, С. 16–23. BASED ON DATA, KINDLY PROVIDED TO AUTHOR BY GORDON BARROWS (BARROWS INC./AIPN).

development of the host state and the dominant investment regime. If the oil taxation component is used as a distinct parameter to compare the regimes, then both 'tax plus royalty' (concessions and/or licenses) and PSA regimes are characterized by bell-type distribution curves with upper extremes, where the peak for PSA is located in the zone for less economically developed states (lower per capita GDP) and the peak for "tax plus royalty" schemes, in the zone of more economically developed states.⁶ This is because the PSA regime is, basically, more project-oriented than a licensing system, and is better adjusted to the risky legal environment associated with less economically developed states rather than the licensing regime, especially if the latter is constructed in a non-flexible manner like the current flat-rated MRPT-based regime in Russia.

3 Historical Development of Russian Subsoil Legislation (Including Variations with Respect to Petroleum Taxation)

My former colleague within the group of drafters of the PSA law in Russia in the mid-1990s, Dr. Elena Diachkova, in her recent book,⁷ identified five major periods in development of subsoil legislation in post-Soviet Russia since 1991 up to the present, with the oil taxation component as a key element. This corresponds to my own vision that I have analyzed in detail at least through the mid-2000s.⁸ The major characteristics of the periods according to Diachkova and Konoplyanik⁹ are:

6 А. Конопляник. «Средство от «правового вакуума». Уровень экономического и правового развития государства определяет выбор инвестиционных режимов в недропользовании» (А. Конопляник. "The mean against the legal vacuum. The level of economic and legal development of the state predetermines selection of investment regimes in the subsoil"). *Нефть России (Oil of Russia)*, 8 (2012) 20, 9 (2012) 26, 10 (2012) 16.

7 Е. Дьячкова, Экономическое регулирование нефтегазовой отрасли в постсоветской России (Москва: Геоинформмарк, 2011). (E. Diachkova. Economic regulation of the oil and gas industry in the post-Soviet Russia. Moscow: Geoinformmark, 2011)

8 А. Конопляник, Реформы в нефтяной отрасли России (налоги, СПИ, концессии) и их последствия для инвесторов (Москва: Олита, 2002) (А. Конопляник. Reforms in the oil industry of Russia (taxes, PSA, concessions) and its consequences for the investors. Moscow: Olita, 2002); А. Конопляник, Alternative Investment Regimes for Direct Foreign and Domestic Investments in Russian Subsoil *The Harriman Review Occasional Paper Jan 2013*, vol. 19 (1) (2013).

9 I will not discuss in this chapter the pre-1991 developments of subsoil legislation both in pre-Soviet Russia, as well as in the USSR. My vision on this is presented in: А. Конопляник and А. Kursky 'State Regulation and Mining Law Development in Contemporary Russia' –

First Period (1991–1996): Development of oil legislation and oil taxation system within the market-oriented economy was started under the authority of the then-Supreme Soviet of the Russian Federation (USSR). The World Bank was deeply involved in this with the University of Houston – winner of the corresponding World Bank grant – as a major consultant. A licensing system for subsoil use was introduced, developed mostly by the representatives of the geology industry. The law “On Subsoil” adopted in 1992, allowed implementation of multiple investment regimes with different taxation models (Art. 12). Payments for subsoil use (royalties) were introduced with differentiated levels. The law “On concessions and other petroleum agreements with foreign investors” (although the law “On foreign investments” introduced previously provided national treatment for these investors and their investments which means that concessionary law should also and equally have addressed both foreign and domestic investors based on national treatment of investors and their investments provided for by the foreign investments law) was first approved by the Supreme Soviet but then vetoed by the President of Russia in June 1993. A PSA regime was established first by a Presidential Decree effective December 1993 and the law “On PSA” was introduced and adopted by the State Duma in December 1995 and became effective in January 1996. The Law “On Concessions” in its second version – for foreign & domestic investors, based on the concept of national treatment – was incorporated in the same package with the PSA law (within the concept of multiple investment regimes for Russian subsoil use) but was not passed by the State Duma in the first reading in 1995 for political reasons. Tax legislation was not codified during this period.

Second Period (1997–2000): Tax Code was introduced and the “tax on incremental earnings” (windfall profit tax) was adopted in the first reading. A differentiated tax regime was *de facto* in place under the licensing system with differentiated royalty. The PSA regime was further developed by supporting documents correlating this tax with corresponding pieces of legislation.

Third Period (2001–June 2003): Period was characterized by transition from a differentiated tax regime back to a unified one. The reform in oil taxation undertaken in this period led to the substitution of royalty, VMSB (the tax for

in *International and Comparative Mineral Law & Policy: Trends and Prospects*, ed. E. Bastida, T. Wälde, T. and J. Warden-Fernández (The Hague: Kluwer Law International, 2005) 969; A. Konoplyanik and A. Kursky, ‘State regulation and Mining Law Development in Russia from the 15th Century to 1991’, *Journal of Energy and Natural Resources Law* May 2006, vol. 24 (2) pp. 73–106.

reproduction of mineral-resource base, or so-called geology tax) and excise tax with the flat-rated MRPT. The introduction of systemic oil customs export duty took place in this period. The PSA regime was still in existence.

Fourth Period (June 2003–2006): *De facto* cancellation of the PSA regime in Russia took place under the amended chapter 26 of the Tax Code. A single and unified tax regime was established. A law on infrastructure concessions was adopted in 2006, but excluded subsoil use.

Fifth Period (2007–present): Differentiation of MRPT-based tax regime started. Introduction of tax allowances of two types (regional and for individual projects) began to take place, which can be considered a slow start to deviation from a unified tax regime, though quite chaotic in nature and through a “handy” management.

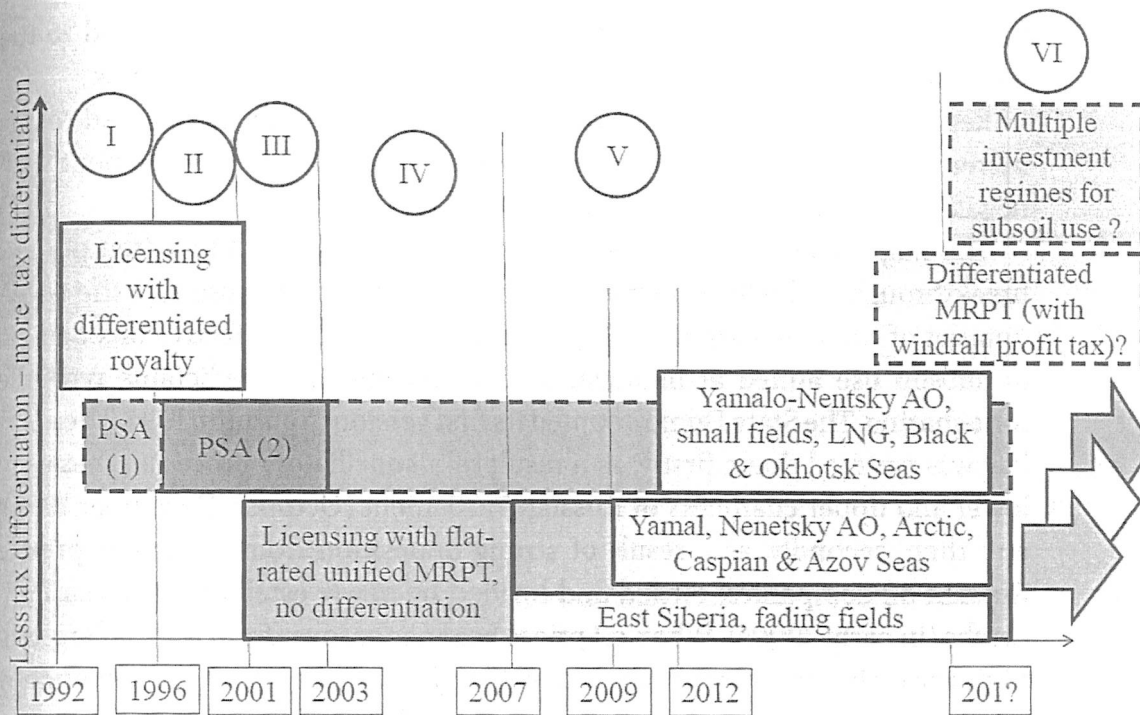
Sixth Period (sometime in the hopefully near-future and onwards): Further differentiation of tax regimes for subsoil use (based on economically justified logic incorporated into the legal system), including, hopefully, multiple investment alternatives for subsoil resource developers.

Figure 2.1 illustrates the U-curve type evolution of investment regimes for subsoil use in Russia, taking into consideration the changing character of the tax component (from more to less and back again to more differentiation of oil tax regimes within licensing system).

Figure 2.2 presents my vision of the changing overall attractiveness of multiple Russian subsoil investment regimes, if both legal and tax components are taken into consideration within the evolving government system of Russian subsoil management. The unfortunate tendency, in my view, in the 20-year long development of the subsoil legislation in Russia, is that it has been dominated by a purely fiscal, instead of a balanced fiscal v. investment, approach.¹⁰ This is one of the major reasons why the state’s preferred alternative for managing Russian subsoil use always worsened the oil and gas investment climate.

Neither version of proposed subsoil concession law (for foreign investors only and for both domestic and foreign investors), drafted and approved through legislative procedures in 1991–1993 and 1994–1995, respectively, has succeeded in becoming law: the first one was vetoed by the President, the latter has not passed even the first reading in the State Duma (lower house of the Federal Assembly of Russia). These laws were intended to introduce into the

¹⁰ See my publications and presentations on this issue at www.konoplyanik.ru.



(i) PSA(1) = 3 acting PSA projects in Russia signed before PSA law: PSA(2) = period of factual action of PSA Law;
 (ii) Roman figures in circles – periods
 Based on: Е. Дьячкова. Экономическое регулирование нефтегазовой отрасли в постсоветской России. – М.: ООО «Геонформмарк». 2011; А. Конорьяник. Alternative Investment Regimes for Direct Foreign and Domestic Investments in Russian Subsoil. – “The Harriman Review Occasional Paper Jan 2013”, vol. 19, no. 1 (2013).

FIGURE 2.1 Six periods in the evolution of a differentiated Russian oil tax regime

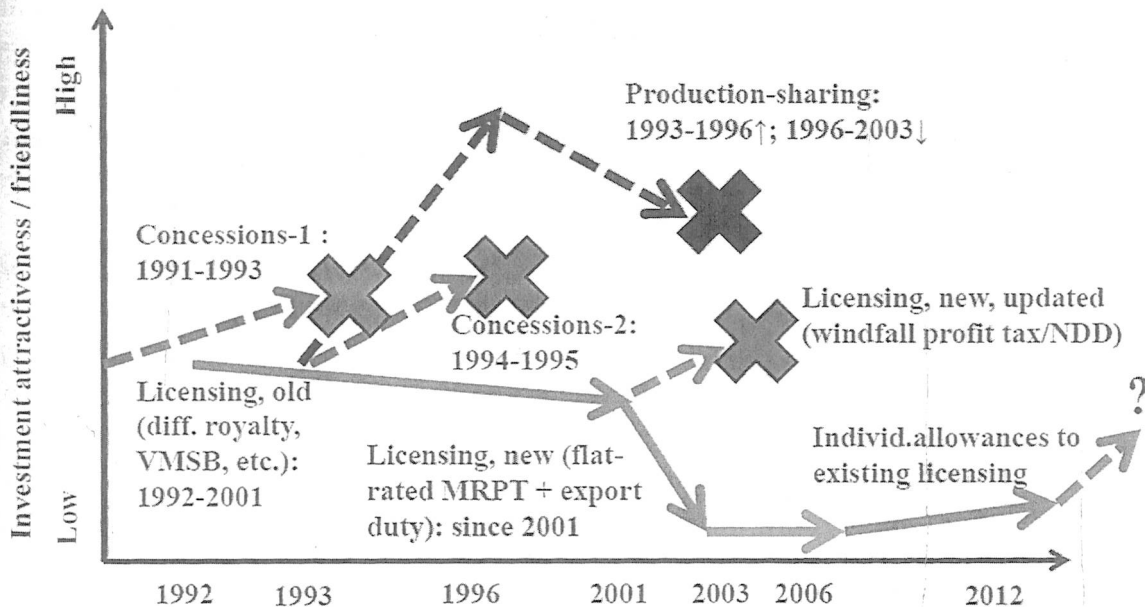


FIGURE 2.2 Development of Russian subsoil legislation: State's preferred alternative always worsened oil and gas investment climate

Russian economic climate, more investor-friendly civil law compared to the less investor-friendly contemporary Russia administrative (public) law.

Regular changes and adaptations of the licensing system have led to the incremental increase in tax pressure within the public law environment with negative consequences for Russian subsoil investment.

The major change in this negative trend, which has led to a (temporary) breakthrough in the Russian investment climate for subsoil use, was the development of the PSA legislation. It provided a much more effective mechanism of subsoil use aimed at financial ability and fair and predictable resource rent-sharing. The State Duma adopted its first version in autumn 1995. Then this law was watered down firstly, as a result of a conciliatory procedure between lower and upper chambers of Russian Parliament (October–December 1995), and then, secondly, as a result of strong opposition from the major private Russian oil companies, owned and headed by newly-established Russian oligarchs (in early 2000s). When oil prices began to recover from their collapse in 1998, the oil barons were prepared to sell major stakes in their VICs, which they had received at big discounts in the course of “loans for shares” auctions, to major Western oil companies. However, the PSA legislation created opportunities for Russian and, more importantly, foreign companies to invest directly in the upstream projects without buying shares of Russian VICs. On the contrary, Russian oligarchs would have liked to create for Western companies only one legitimate way to invest in Russian subsoil – by buying a package of minority shares of the new Russian VICs. By creating an alternative way for investing into Russian subsoil, PSA became a competitor for such plans of major Russian VICs, downgrading their selling price. This is why the efforts of fiscal agencies (Ministry of Finance, Tax and Customs Services) and major private Russian oil VICs (headed by Yukos and Sibneft companies) have collaborated in fighting against the PSA regime. Their successful joint efforts have, in fact, stopped practical implementation of PSA in Russia.¹¹

The two options for the differentiation of the licensing regime were: 1) individual allowances to some areas (*e.g.* East Siberia) and for specific types of projects (*e.g.* fading fields) or 2) establishing a more systemic mechanism (*e.g.* windfall profit tax). The first avenue was chosen, which is less attractive for any investor who would prefer not to rely on individual exemptions from basically unfriendly investment regimes, especially if they are granted in a “handy” manner, but to rely, instead, on systemic mechanisms of tax differentiation introduced by law.

¹¹ The detailed Russian PSA story is presented in my publications available at www.konoplyanik.ru.

Whereas today's regulation governing Russian subsoil investment was created mostly by oil taxation reform in the early 2000s, there is now a demand for rather radical improvement.

4 Oil Tax Reform of Early 2000s: Administrative Simplicity vs. Economic Efficiency

This reform has presented a turning point in movement from a differentiated to a single tax regime disregarding the particularities of specific upstream projects. The driver of this reform was an intended/expected maximization of tax receipts from oil fields development starting with the very first barrel of oil produced and simplification of tax administration. So the fiscal interests of the state and administrative interests of tax authorities were placed at the top of the agenda, rather than more general and more complex micro- and macroeconomic benefits of the host state, which should be interested in maximization of its resource rent generation and extraction through most effective development of its non-renewable energy resources. Thus, the host state should be interested, in my view, in maximization of not only direct tax revenues from the oil flow, but also in the sum-total of direct and indirect benefits and the multiplier effect of upstream project development.¹²

A good illustration of pure fiscal orientation of MRPT (a key innovation of the oil tax reform of early 2000s) is that it is a flat-rated tax, linked solely

¹² The issue of the multiplier effect of oil fields development was examined in the works of late Prof. Alexander Arbatov, including his famous joint study with the Petroleum Advisory Forum in mid-1990s on the multiplier effect of six PSA projects (Russian Social and Economic Impact Evaluation for Large-Scale Oil and Gas Investments under Six Production-Sharing Agreements, ed. Alexander Arbatov (Moscow: KEPS-PAF, 1996)). I have evaluated the correlation between direct tax and indirect and multiplier effects in, for instance: А. Конопляник, Реформы в нефтяной отрасли России (налоги, СПИ, концессии) и их последствия для инвесторов (Москва: «Олита», 2002) (A. Konoplyanik. Reforms in the oil industry of Russia (taxes, PSA, concessions) and its consequences for the investors. Moscow: Olita, 2002); А. Конопляник, «Анализ эффекта от реализации нефтегазовых проектов СПИ в России для бюджетов разных уровней (к вопросу об оценке воздействия на социально-экономическое положение страны крупномасштабных инвестиций в реализуемые на условиях СПИ нефтегазовые проекты)» (A. Konoplyanik. "Effect analysis of oil and gas PSA projects for the budgets of different levels (to the issue of evaluation of impact on socio-economic situation in the state of large-scale investments made into PSA-based oil and gas projects)", *Нефтяное хозяйство (Oil Economy)*, 10 (2000) 24.

to fluctuations in international oil prices and without considering whether a taxpaying domestic oil producer (subject to MRPT) supplied oil only to the domestic market or had obtained an export quota and exported its oil. So, the higher the international price, the higher the flat rate of this domestic tax, even if the company only supplied the domestic market (as small and medium non-integrated oil companies did).

According to my view, the philosophy of this reform aimed against multiplicity of investment regimes and in favour of the simple and single flat-rated oil taxation is still dominant among decision-making bodies. But why, in my view, is MRPT not good for the host state from the long-term economic perspective (though it is a simple, straightforward and effective pure fiscal instrument)? What are the negative consequences (major deficiencies) of this flat rate system? What does the state lose in this case? And who wins instead?

Let's distribute all the fields in the country through the X-axis from left to right by diminishing percentage of the mineral (resource) rent in the oil price. The biggest, the youngest (at the earlier stages of production) fields will be located to the left, the oldest, at the late and fading production stages, the most expensive fields will be located to the right. Flat-rated MRPT will cut off the fixed absolute value of rent from every field (see Figure 2.3-1). The crossover of two lines and perpendicular from this crossover point down to the X-axis will show the cut-off volume of reserves (to the right from this perpendicular) for which development will provide zero or negative value of resource rent – zero/negative rate of return (ROR). But since no company will develop any project without some reasonable positive ROR (potential to break even is not sufficient incentive), the number of the fields to be developed will be less (the cut-off vertical line will go further to the left). This tax model does, firstly, significantly diminish the number of fields to be developed (only the most profitable fields will be exploited). Secondly, the flat rate leaves the "lucky" companies that have received subsoil use rights for the most efficient fields with extra super-high ROR (with the highest portion of resource rent in the price and the abnormally higher portion of economic rent) which can be considered windfall profit and further taxed with reasonable ROR and not with extra super-high ROR (Figure 2.3-1).

Introduction of the MRPT flat rate (effective January 1, 2002) has put an end to the initial period of at least limited oil tax differentiation in Russia (1992–2001), which existed by virtue of a corridor of subsoil royalty payments (6–16%) and the PSA regime, though the latter at a very limited scale. Only three PSA projects were developed before the PSA law came into force and thus grandfathered them. PSA projects were strongly suppressed from the very beginning based on a number of perceptions, such as the claim that PSA is:

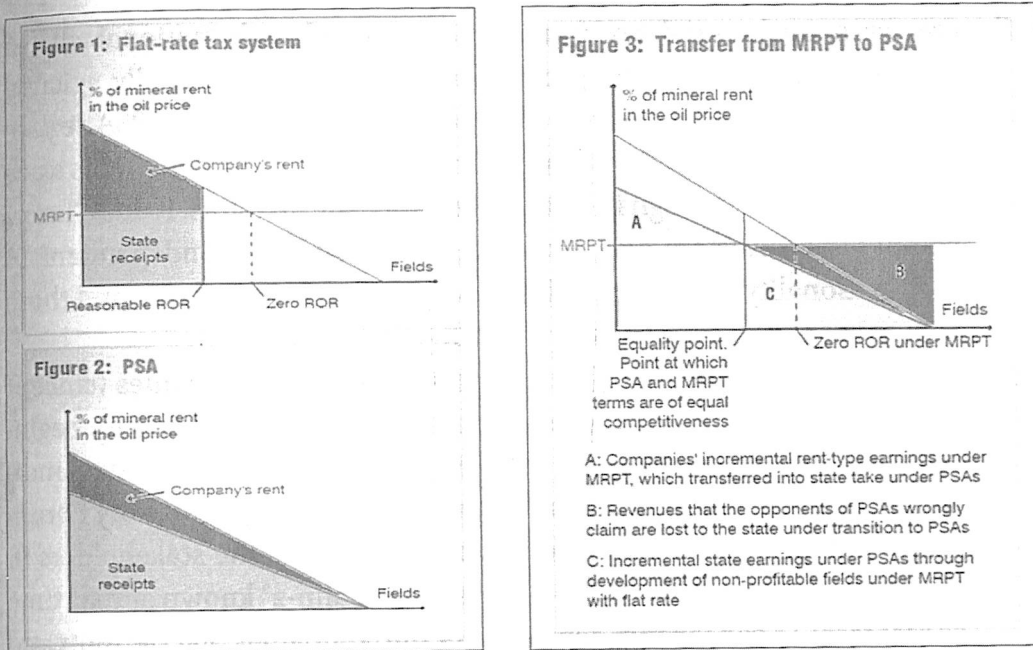


FIGURE 2.3 Comparison of flat-rate MRPT with PSA system: Why host state is the loser under MRPT

SOURCE: ANDREY KONOPLYANIK, 'A STRUGGLE FOR MINERAL RENT', "PETROLEUM ECONOMIST", AUGUST 2003, PP.23-24; АНДРЕЙ КОНОПЛЯНИК, 'УХУДШЕНИЕ ЭКОНОМИЧЕСКИХ УСЛОВИЙ ВОЗВРАЩАЕТ НА ПОВЕСТКУ ДНЯ ЗАКОНОДАТЕЛЕЙ ВОПРОС РЕАБИЛИТАЦИИ СРП', «НЕФТЬ И КАПИТАЛ», 2009, №3, С.18-23.

- (i) is an attribute of colonialism and less (even the least) developed countries and we, the Russians, would not wish to be identified with such countries by using an instrument associated with them, and since PSAs are usually used in monarchies and autocracies, implementation in Russia might spoil the image of Russia as a democratic state;¹³

13 This issue was specifically addressed by my analysis of worldwide distribution of PSA and licensing/concessionary schemes ('tax + royalty' regimes in oil taxation) compared to state of economic development of the host states (measured in per capita GDP), which shows that: (i) distribution curves for both regimes have a bell-type character with upper peaks, (ii) the PSA peak refers to the states with lower per capita GDP level than "tax + royalty" schemes, and (iii) Russia has been slowly moving through the 2000s from the per capita GDP area well correlated with the peak of PSA in the early 2000s to the zone between two peaks nowadays. (А. Конопляник, «Средство от «правового вакуума». Уровень экономического и правового развития государства определяет выбор инвестиционных режимов в недропользовании» (А. Конопляник. "The mean against the legal vacuum. The level of economic and legal development of the state predetermines selection of investment regimes in the subsoil"), *Нефть России (Oil of Russia)*, 8 (2012) 20, 9 (2012) 26, 10 (2012) 16).

- (ii) creates a preferential tax treatment compared with 'national oil tax regime'. That was how the proponents of MRPT have proudly agitated against the PSA regime – as if it had a “foreign” nature. The PSA regime indeed does not have a “foreign” nature as claimed by its opponents since it does not favour foreign investors over domestic investors; it does “favor” competitive investors over non-competitive investors independent of their nationality since it provides a level-playing field for both, and those who are non-competitive thus will fail;
- (iii) constitutes a preferential tax treatment for foreign companies (since it was first and foremost the foreign companies, who from the very beginning have been supporting the creation of a PSA regime in Russia – individually and on a collective basis through the Petroleum Advisory Forum (PAF). On top of this, only foreign companies were the stakeholders in the first successful PSA project in Russia “Sakhalin-2” known at that time as MMMMS (a consortium consisting of the companies MacDermott and Marathon (USA), Mitsui and Mitsubishi (Japan), and Royal-Dutch/Shell (UK/Netherlands)).

The PSA does not constitute a preferential tax regime for companies. Taxation is rent-based. PSAs will, overall, always yield greater revenue to the state than the licensing system. In projects that provide subsoil users with higher-than-average rents, PSAs can maximize state revenues by allowing case-by-case adjustments to taxation levels. In small projects, the burden of the flat tax rate will prevent companies from achieving an adequate rate of return (ROR) and fields will not be developed. State revenues in these cases will be zero. A PSA would enable the same project to go ahead, as it allows the state and the investor to compromise on economic terms of the project development scheme. The result is a reasonable ROR for companies and additional tax revenues for the state from the projects that alternatively would not be developed (Figure 2.3-2).

Figure 2.3-3 indicates the consequences for the state budget of transferring from the MRPT to the PSA system. The state would have received additional revenues, denoted by zones A and C. Under MRPT, it would not have received this revenue, as Zone A rents would have been retained by the companies (with the flat rate of tax capping state revenues). And Zone C rents would not have been generated in the MRPT case because, under this system, no company would have developed the fields, given the prospect of negative profitability.

The opponents of PSAs view the picture differently. They argue that if PSAs are used to develop fields to the right of the equality point, the state would face “lost revenues” (Zone B at Figure 2.3-3). This conclusion is based on a mathematical calculation of the virtual tax that would have been generated by the

MRPT's flat tax rate. Although this is higher than tax revenues under PSAs, the argument is invalid because no investor would develop a field with an unreasonably low or negative ROR. Therefore, PSA revenues in this Zone must be compared with zero revenues under the MRPT regime.

Secondly, they have kept quiet about the possibility of PSAs being employed in another part of the resource spectrum where the share of rent in the price exceeds the tax level (effective tax rate) under the MRPT by more than reasonable ROR (Zone A at Figure 2.3-3). In that zone, PSA arrangements would considerably increase the tax burden on companies. They would result in a larger state take at every budgetary level (federal, regional, local), while preserving investors' RORs at an acceptable level, in turn stimulating investment in exploration and production. This was precisely what Russian oil companies opposing PSAs have feared most: they would have to share revenues more fairly with the state (as well as facing more competition).

Nevertheless, the existence of such misconceptions does not mean that the licensing system should be dispensed with and PSAs introduced for all subsoil developments (even though Western companies lobbied for such proposals in the mid-1990s both individually and through PAF). The different categories of risks arising under PSAs and the licensing system make peaceful coexistence of both regimes possible. All other conditions being equal, PSAs are more effective from the standpoint of fair rent allocation. But negotiations on PSA terms are more time-consuming and delay field development, and, therefore, cash-flow.

5 Multiple Investment Regimes for Russian Subsoil (Author's Historical Proposal)

The core element of my historical proposal is to present investors with a legally adopted "menu" of subsoil investment regimes and thus create competition among different investment regimes for investors. This investment menu is project-based, not company-based. If investors have an opportunity to choose among investment regimes for subsoil development, they will vote with their money in favor of this or that regime. That will enable the host state to monitor at the everyday level the comparative attractiveness of the available investment regimes and, over time, improve the less attractive regimes so as to stimulate the inflow of resource investment capital. Meanwhile, as a result of comparative monitoring and analysis, the host state will manage to evaluate whether the comparative advantages of the most attractive regime are excessive within the given state of the market. This might help the host state support the optimal level of attractiveness and efficiency of its subsoil investment.

The evolving structure of investment regimes should correspond to the current state of economic development of this or that country as well as the market for a particular resource.

To make it simple, I have proposed to organize the system of investment regimes for Russian subsoil as a matrix consisting of four such regimes. Each regime presents a combination of two major parameters – the legal system and the tax system. The legal parameter consists of either (administrative) public law or civil law, while the tax system can be based on either a unified, general taxation or a differentiated (individualized) taxation. In case of disputes, as a general rule, the individual investor has no right to international arbitration. Within the civil law, according to my vision/proposal, the investor shall have such rights which are provided in international law, inter alia, by Article 26 of the Energy Charter Treaty (ECT).¹⁴

Based on my approach each investment regime differs from one another (see Figure 2.4).¹⁵

Key idea: to create competition between investment regimes for investor

		Legal system	
		Administrative (public)	Civil
Tax treatment	General (common)	Licenses Ⓐ	Concessions Ⓒ
	Special (incl. individualized)	Licenses with allowances (differentiated licensing regime) Ⓑ	PSAs Ⓓ

FIGURE 2.4 Author's historical proposal: Possible composition of investment regimes for Russian subsoil use (investment menu/matrix within legal vs. taxation axes)

¹⁴ The fact that Russia withdrew from the provisional application of the ECT in 2009 and has stated then that it does not intend to ratify the ECT, does not mean that this decision – which, from my view, has no visible justification behind it – should be considered as a final one, once and for all. ECT has brought into international law by its Art. 26 an innovation – direct application of the private/foreign investor to one of the international arbitration tribunals (ICSID, UNCITRAL, SCC) – which can be used in Russia as well, when Russian authorities reverse their decision regarding ratification.

¹⁵ First presented in this configuration in: А. Коноплиник. «Договор концессии: возможное место и роль в инвестиционном законодательстве России» – в кн. *Нефтегаз, энергетика и законодательство, 2001–2002. Информационно-правовое*

- (A) Licensing regime is based on administrative (public) law and treatment of upstream investment projects. According to administrative law the investor and the state are not equal partners in their agreement regarding subsoil development – an investor is always subordinate to the host state. All changes, even with best intentions, in the domestic law are usually applicable in full to the projects in question which creates legal and tax instability for project development. This is a major negative characteristic of the existing Russian subsoil investment regime;
- (B) Licensing regime with allowances (differentiated licensing regime) is based on administrative (public) law and special (differentiated) tax treatment which is mostly being developed in the form of individual fixed exemptions for a limited period of time and for a particular project or group of projects or for an area;
- (C) Concessionary regime is to be based on civil law and general (common) taxation. In this case, the tax burden can be fixed through stabilization clauses for the whole project life, thereby boosting the predictability of project economics. The investor would be further protected by an opportunity to use international arbitration in case the host state violates its contractual obligations, thereby creating stability of investment contracts terms and conditions;
- (D) Regime of production-sharing agreements is based on civil law and individualized tax treatment. This is the most transparent and predictable and also the most economically attractive regime for the investor–subsoil user since it provides a flexible and adaptable mechanism of rent sharing over the life of the project.

Legal attractiveness of investment regimes for subsoil users differs for regimes based on administrative (public) law and on civil law in petroleum arrangements. The former does not provide adequate legal stability for an investor while the latter can provide incremental legal stability and adequate legal protection through the possibility to apply for international arbitration in case of dispute settlements between the host state and an investor–subsoil user.

Tax burden within the proposed “investment menu” of four regimes also differs. From my point of view, PSA provides optimal proportions of rent-

издание ТЭК России (ежегодник), (Москва: Нестор Экономик Паблшерз, 2001) 77.
(A. Konoplyanik. “Concessionary agreement: possible place and role in the investment legislation of Russia”. – in: *Oil & Gas, Energy, Legislation: 2001–2002*. Informative and legal publication of Russian fuel & energy complex (annual), (Moscow: Nestor Economic Publishers, 2001) 77).

sharing between the state and an investor for individual projects, given skilled and knowledgeable negotiators on both sides. All other regimes do not provide optimal tax allocation by definition since they provide proportions of rent-sharing that are determined in a centralised manner (unilaterally established by the host state) rather than a project-based mechanism. Within all regimes there is a trade-off between its simplicity/complexity, on the one hand, and its optimal/non-optimal economic character, on the other hand. So it is for the investor, in my view, to choose whether he would like to receive optimal proportions of rent-sharing through a rather lengthy and more costly negotiating process, or whether he will be ready to relinquish to the state part of his ROR in exchange for speeding up the administrative procedures regarding access to subsoil exploration and thus saving some costs upfront.

Current generalised and fiscal-oriented, flat-rated licensing regime in such a large and diverse country as Russia cannot provide anything else except non-optimal oil taxation. Such approach cannot – by definition – optimize resource rent sharing between the state and an investor. Partial differentiation of taxation within the licensing regime through the mechanism of individual exemptions softens its suboptimal character but does not provide stability, while the concessionary regime provides stability by fixing non-optimal tax parameters for the whole project life thus also diminishing the non-optimal character of general taxation (Figure 2.5).

Investment regime	Investment regime's characteristics during project life-time	
	Tax pressure	Legal stability
Licensing (A)	Non-optimal (high), established unilaterally	No
Licensing with allowances (special / differentiated tax regimes) (B)	Non-optimal (high / diminished), established unilaterally	No
Concessions (C)	Non-optimal (high), established unilaterally	Yes
PSA (D)	Optimal, negotiated	Yes

FIGURE 2.5 *Different investment regimes in subsoil use: Comparative legal and tax advantages/disadvantages*

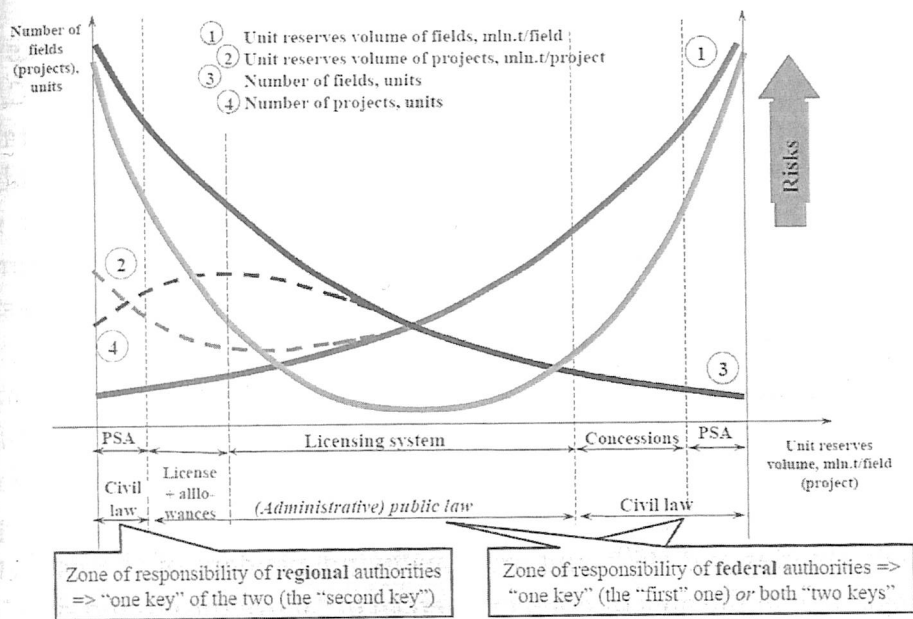


FIGURE 2.6 Application zones proposed for different Russian subsoil investment regimes

6 Proposed Application Zones for Different Investment Regimes in Subsoil Use in Russia

From my perspective, it is possible to justify preferential zoning with implementation of the proposed menu of investment regimes dependent on the scale of projects and economic attractiveness of their development measured by the portion of resource rent in the oil price (Figure 2.6). This can be argued based on the different type/origin and value of investment risks which are faced by the investor-subsoil users while developing different categories of fields/upstream projects.

Due to geologically-proven asymmetry of natural (including energy) resource concentration in the subsoil worldwide, there is a well-known correlation between the size of the discovered fields and their quantity: the larger the size (reserves/resources volume) of the individual field, the smaller their quantity (see Figure 2.6). Due to different geological characteristics of the fields and the natural conditions of the geographical areas of subsoil deposits, there is no direct correlation between the size of the field and the value of resource rent in the price (equal to the difference between the price and the cost) since the size of the field is an important but not the only factor influencing the level of the production costs. In principle this deviation does not change the inverse correlation between field size and quantity, which is mostly the result of economies of scale.

This is why I identify development of mega-fields and small-fields as most economically risky (in terms of the risk of possible no-return of CAPEX invested) and thus most dependent on stability, transparency and predictability of the regulatory environment in the host country.¹⁶ In case of mega-fields this is explained by the highest capital value of the single upstream project, so by the absolute value of CAPEX at risk. In the case of small fields, the investor subsoil-user does not benefit from economies of scale; on contrary, the investor is under pressure of the opposite to economies of scale effect.

So the risk-curve of energy resources development has a U-curve character with lower extreme point and peaking in the area of small- and mega-fields (Figure 2.6). And if the investors-subsoil users can deal with commercial risks, including "below the ground" risks (geological, technological, which depend on their abilities and skills and are usually independent of the host state's actions), then in the area of non-commercial or "above the ground risks" they are fully dependent on the legal environment within the host state to determine profitability.

As we know, there is an economic limit for profitable development of any small field. This means that below some quantitative level of geologically known and technically recoverable reserves, development of a field becomes unprofitable since the value of oil/gas extracted and marketed would in no case justify the discounted amount of CAPEX and OPEX through the project life. Below this level, such reserves would not be considered as proven recoverable reserves. Bearing this in mind, it makes economic sense, in my opinion, to allow investors-subsoil users to unite a group of small fields located near each other into one single project to attain this profitability benchmark. Our calculations, based on the real group of small fields in Russia's Udmurtia Republic (when we have developed for the local authorities a justification of the different development options for the so-called "Udmurtia project" on its pre-licensing stage: based on the individual development of the fields to be licensed, and on the same fields to be unified in the single project, arguing in favour of a corresponding amendment to Russia's subsoil legislation)¹⁷ show that if the

16 А. Конопляник, Реформы в нефтяной отрасли России (налоги, СПИ, концессии) и их последствия для инвесторов (Москва: Олита, 2002) (A. Konoplyanik. Reforms in the oil industry of Russia (taxes, PSA, concessions) and its consequences for the investors. Moscow: Olita, 2002).

17 Е. Дьячкова, А. Конопляник. «Соглашения о разделе продукции: удмуртский вариант» (E. Diachkova and A. Konoplyanik. "Production-sharing agreements: Udmurtia case"), *Нефть и капитал (Oil & Capital)*, 12 (1995) 14; В. Грушин, А. Конопляник. «О подготовке и заключении СПИ по мелким месторождениям» (V. Grushin and A. Konoplyanik. "On preparation and making PSA on small fields"). *Минеральные ресурсы России. Экономика и управление (Mineral resources of Russia. Economics and*

group of small fields would have been unified into one single upstream project, the value of peak CAPEX would have been diminished by 20%, zero DCF would have been reached in 8.5 and not in 12 years, and at the end of licensing period (after 20 years) cumulated positive DCF could have been almost three times higher than in the case of individual development of each individual field as a single project (Figure 2.7).

Moreover, in the case of small fields, even when they are united in a bigger, single upstream project, the duration of the period for passing through regulatory procedures does matter much more than in the case of mega-fields, consider the value of discounted cash-flows (where time does cost money). So from my perspective, it would be practical in my country to distinguish between regulatory authorities who review small projects and the ones that review all other projects. I consider it reasonable to transfer all authority for decision-taking regarding small fields/projects from the federal (as existing since 2004 and until today) to regional authorities, who are much better



FIGURE 2.7 Cumulated DCF/NPV of individual and combined field development (Udmurtia Project)

SOURCE: В. ГРУШИН, А. КОНОПЛЯНИК, Н. ОКСЕНГОРН. О ПОРЯДКЕ ПЕРЕВОДА МЕЛКИХ МЕСТОРОЖДЕНИЙ УГЛЕВОДОРОДОВ НА РЕЖИМ СПП (В ПОРЯДКЕ ОБСУЖДЕНИЯ). – «НЕФТЯНОЕ ХОЗЯЙСТВО», ИЮНЬ 2002, №6, с.83–89.

Management), 1–2 (2002) 68; В. Грушин, А. Конопляник, Н. Оксенгорн. «О порядке перевода мелких месторождений углеводородов на режим СПП (в порядке обсуждения)» (V. Grushin, A. Konoplyanik and N. Oxengorn. "On the rules for transferring small fields to the PSA regime (in the order of discussion)"). *Нефтяное хозяйство (Oil Economy)*, 6 (2002) 83.

placed to make decisions regarding a big number of small projects within their territories than civil servants in Moscow. The development of large numbers of small fields within many different Russian regions will have much more local (region-wide) indirect and multiplier effects compared to country-wide indirect and multiplier effects of the mega-fields. This is why I consider it to be quite natural that they can stay within the sphere of the regional authorities contrary to the current practice (Figure 2.6).

This will also enable regional authorities to be less dependent on transfers from the federal center and more economically independent in their judgments. From my view, this is to the benefit of the whole federal state. For me, a strong country means, primarily, strong territories and provinces, even though it is easier to control the territories with top-down power if they are dependent on donations/transfers from the central government.

The ability to join/unite few small fields in a single project, if allowed by the state within its licensing policy, would change the risk curve. (This approach is not the case yet in Russia despite a strong campaign in favor of permitting such unification in the late 1990s).¹⁸ The number of such unified projects would be much lower than the number of corresponding small fields involved in unification, and the unit reserves value of unified projects will be much higher than the value of reserves of the individual fields involved (effect of artificially created economies of scale). This would also downgrade the left wing of the risk-curve in the area of the small fields after transition to unified projects in this area.

This type of risk-curve explains my vision of the distribution of the proposed investment regimes in the Russian subsoil based on an investor's preference. At the margins of the field's reserves (their resource rent) (Figure 2.6, at the left and right margins of the X-axis) an investor would most probably prefer the PSA regime which through its sliding scale of rent-sharing mechanism provides effective opportunity for both parties to reach optimal proportions of rent sharing.¹⁹ PSA will be especially attractive for the mega-fields since this

18 Ibid.

19 I do not mean precisely the currently existing PSA regime in Russian legislation, radically being worsened since its adoption by the State Duma in December 1995 and finally almost killed by the Law on amendments to Chapter 26 of the Tax Code of 2003. This current version of PSA law and implementation procedure needs to be radically improved. Argumentation for this and other benefits of the PSA regime in general and in Russia in particular can be found at my numerous PSA-related publications and presentations at www.konoplyanik.ru, especially through the period since early 1990s till, mostly, through 2003. Also for PSA-related discussion in Russia see websites www.concessions.ru and www.yabloko.ru.

is a project-oriented, individualised regime which provides thorough (though lengthy) negotiations for balanced distribution of resource rent between host state and investor. So the time factor matters less in this case than the value at risk due to usually enormous CAPEX per project. The development of such fields will have a much greater country-wide indirect and multiplier effect, so it is natural that it can stay within the full authority of the federal government and its regulatory bodies.

The central zone at Figure 2.6 will possibly remain the dominant zone of the pure licensing regime. It is, generally speaking, the zone of medium to big fields. For such fields, especially if located within the area with well-developed infrastructure, the trade-off will be as follows: the investor might prefer to go through a standardized licensing process and procedures (permissions, etc.) which will enable time-saving in DCF terms by shortening the period between investment of capital and production/return on investment. On the other side of the equation will be some additional costs (hopefully, not to exceed the above-mentioned cost savings) due to unbalanced taxation within the current licensing system. Russian subsoil tax regime with flat-rated MRPT can in some cases lead to a higher or a lower portion of the government take in the price (see Figure 2.3).

The zone to the right from the central one, from the area of dominance of pure licensing regime (see Figure 2.6) is, generally, the zone from medium and big to very big and mega-fields. It will be, most probably, the zone of primary preference for concessionary regime.²⁰ This is explained, in my view, by the fact, that in this zone the fields/projects are generally larger than in the left part of the diapason, project life-cycles are longer, so investor's demand for transparency, stability, predictability of investment regime is stronger, the urge for opportunities for more effective dispute settlement procedures is higher. And the latter are better provided for by the instruments of civil law, like international arbitration. Bigger reserves per single project plus legal stability provide more opportunities to survive within non-optimal taxation.

²⁰ In 1995 we presented a package to the State Duma, consisting of two proposed laws for subsoil investment regimes: 1) PSA and 2) concessions. This was based on Art. 12 of the law 'On the subsoil' (1992) which allowed multiple uses of different types of petroleum arrangements in Russia. The PSA law has passed the Duma and came into force (though much spoiled by the Upper chamber of Russian Parliament in the conciliatory procedure); the law on concessions was vetoed by the Duma (see: www.konoplyanik.ru). Since then the new law "On concessions" was adopted by the State Duma and came into force, implementation of this mechanism for Russian subsoil investment was rejected.

The zone to the left from the central one at Figure 2.6 is the zone from medium and big to small fields' diapason. For the investors in this zone time does matter much more. So, most probably, they would prefer to use the licensing regime with exemptions as a dominant route for developing their projects: rather than long negotiations for optimal rent-sharing they would prefer to take the non-optimal but shorter route to start production. A shorter time-period within administrative law procedures is preferable for this type of project than fine-tuning within a longer time frame under civil law.

This means that in the center of the diapason is the zone where administrative or public law would be located and at its margins would be the two zones of civil law.

7 Vicious Circle

If we create the development curve of Russian oil tax regimes, presented in paragraph 3, inside the matrix of investment regimes in the subsoil, presented at Figure 2.4, we'll come to the illustration presented at Figure 2.8. It shows that after 20 years of search for optimal investment regime in the Russian subsoil, the state has come to the starting point: attempts to introduce differentiation within the dominant (de facto solely existing) licensing regime by some

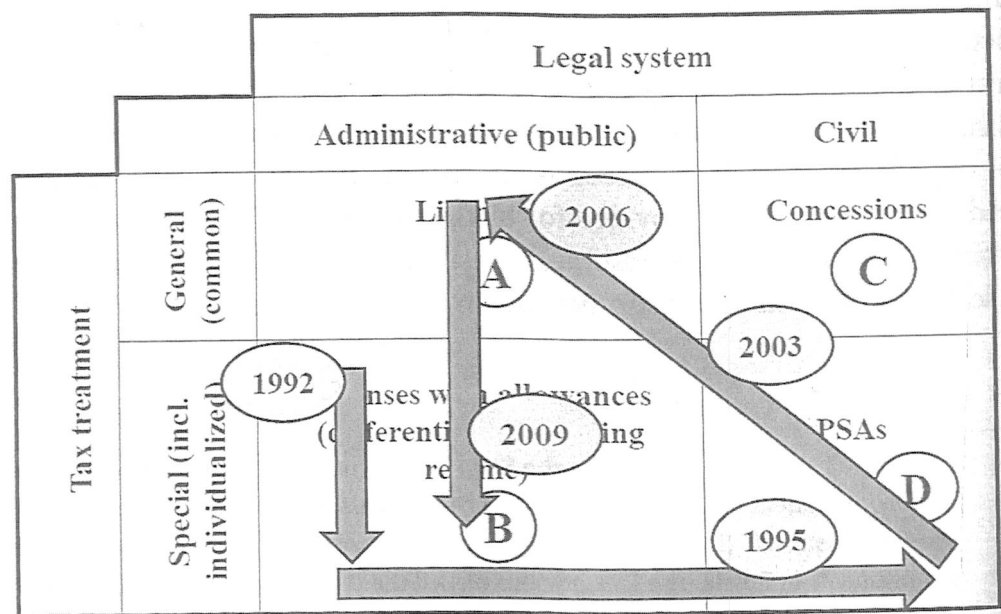


FIGURE 2.8 Evolution of tax regimes in Russian subsoil: From systemic though limited differentiation (1990's) through withdrawal of differentiation (2000's), to chaotic and "handy" differentiation (2010's)

groups of tax allowances within purely fiscal oriented oil taxation. Figure 2.8 shows that evolution of tax regimes in Russian subsoil has made sort of a circle: starting from systemic though limited differentiation in the 1990s, it has passed through resignation of differentiation in the 2000s and the search for differentiation in oil taxation in the 2010s has been taking place in a chaotic and handy, *e.g.* non-systemic manner. However, the lack of systematic mechanism can be considered as a system in action.

Dominant methods of providing differentiation in oil taxation differ between the early 1990s period and the present time. When subsoil legislation was in the early stage of development, limited differentiation was introduced through the royalty values established by law, while presently, such allowances have been presented through downgrades of MRPT and deductions from, up to full cancellation of, export duties, sometimes together with allowances in other taxes. Such deviation from a basically unfriendly investment climate creates a situation where the only way forward for a capital-intensive upstream project is the avenue of individual tax allowances. Thus, deviations or exemptions from subsoil licensing rules established in the early 2000s under the new oil tax system, became the dominant way forward with such projects, *i.e.* exceptions to the rules became the rule.²¹ But any exception from the general

²¹ I would like to underline that this is not only a phenomenon for Russia, where deviation from the rule becomes the rule. In the EU, both its Second and Third energy packages establish the market rules which, while considered to be favourable for trade, have definitely discouraged investments, inclusive of such rules as unbundling of vertically integrated companies (VIC), mandatory third party access (MTPA), etc. The clever EU legislators envisaged this problem (lack of investment stimuli for long-term capital-intensive investment projects, especially in infrastructure developments such as pipelines, LNG import terminals, etc.) and established special clauses in the legislation providing for derogations from general EU rules for individual projects on a case by case basis. Thus legal procedures for such individual derogations were established by law (for instance in gas, it is Art. 21–22 of the Second and Art. 35–36 of the Third EU Gas Directives). Thus the way for obtaining derogations in the EU is established by law which is a better option compared to lack of legal procedure for obtaining derogations that we face today in Russia where it still need to be done in a handy manner. Though the best option is to improve investment climate (nondependent, whether in Russia or in the EU) in such a way, so there will be no more need in derogations from the legally established flexible and adaptable procedures. For more details on EU, see, for instance: A. Konoplyanik, Russia and the Third EU Energy Package: Regulatory Changes for Internal EU Energy Markets in Gas and Possible Consequences for Suppliers (Including Non-EU Suppliers) and Consumers, *International Energy Law Review*, 8 (2011) 24; А. Конопляник, «Уменьшить риски и неопределенности Третьего Энергопакета ЕС» (А. Конопляник. To reduce risks and uncertainties of the Third EU Energy Package), *Нефтегазовая Вертикаль* (Oil

rules, if not established by law, means a manipulative way of achieving an extra-legal advantage. This is a most risky and potentially corrupt way of doing business and it is not welcomed by reputable companies.

I think it is possible to mention at least some of the key names – proponents of this or that type of petroleum arrangement, that have influenced the ‘see-saw’ process of development of subsoil investment regimes in Russia depicted in Figure 2.8. This list reflects purely and solely my vision of the particular names and their roles. I will try to link them to the corresponding matrix of investment regimes.

Key proponents of the upper left quadrant in the matrix (licensing regime) have been: the Ministry of Finance (drafters headed by Deputy Minister S. Shatalov), former Yukos oil company and its former CEO M. Khodorkovsky (sponsor and promoter in the State Duma in late 1990s–early 2000s), President V. Putin (post-2000), and Minister of Economy G. Gref (post-2000).

Key proponents of the lower-left quadrant (licensing regime with differentiation) have been M. Gazeev and N. Volynskaya from the Fuel and Energy Independent Institute (TENI) in Moscow – key drafters of different concepts of differentiation through the whole period, and at the very initial stage the World Bank and its winner-consultant Houston University with the team headed by J. Hardi III, Ministry of Energy, Ministry of Natural Resources. This is currently a preferential government’s approach to improve the Russian subsoil investment climate.

Key proponents of the upper-right quadrant (concessions in the subsoil) have been myself (as a leader) and my other colleague-drafters of the second version of concessions law, the “Yabloko” political party which initiated the idea of redrafting of the first concessions law in 1994, Ministry of Energy, and Ministry of Economy (in the 1990s, during pre-Gref times).

Key proponents of the lower-right quadrant (PSA regime) have been myself (as a leader) and my other colleague drafters of the PSA law,²² Yukos (in pre-Khodorkovsky time) and other Russian oil companies in the mid/late-1990s, Petroleum Advisory Forum (PAF), Yabloko political party,²³ E. Gaidar

& *Gas Vertical*), 7 (2012) 79; A. Konoplyanik, ‘Reducing risks and uncertainty of EU Third Energy Package’, *Energy Dialogue. Review of International Energy Policy and Security*, 3 (2012) 12.

22 Both groups of my colleague – drafters include the same key people (M. Subbotin, I. Amirov, A. Averkin, E. Diachkova, V. Grushin L. Linnik, and S. Sosna) since we prepared the two laws – on concessions and on PSA – in a package within (and then developed in practice) the concept of multiple investment regimes in Russian subsoil.

23 And especially two of its major deputies in the State Duma – A. Melnikov and A. Mikhailov.

(especially in the 1990s, first in his government capacity and afterwards in the State Duma), President V. Putin (at least just immediately after his inauguration in 2000),²⁴ Ministry of Energy, Ministry of Natural Resources, and Ministry of Economy (in the 1990s, during pre-Gref times).

The composition of these groups of opponents and proponents of various models of oil taxation, and their comparative administrative powers explains the configuration of the current investment regime.

8 Which Way Forward

There are two possible ways of further development.

First – the Government will continue to stay within the so called “national investment regime” and so called “national tax system” – the terms proposed and promoted by former Yukos CEO M. Khodorkovsky (licensing regime based on public law, MRPT with flat rate and customs export duty). Necessity to advance oil and gas exploration and production to the remote areas such as Arctic offshore, Eastern Siberia, etc. will stimulate the government to provide in a “handy” manner individual exemptions from existing unified restrictive rules in order to make corresponding projects profitable and attract foreign investors – mostly major oil companies possessing advanced technologies and managerial skills (see Figure 2.9, Option 1). Second – to implement the concept of “multiple investment regimes” advocated in this paper (which is my preferred and long-argued option) (see Figure 2.9, Option 2).

The most recent statements of high-ranking Russian government officials have demonstrated their understanding that changes are inevitable. However, there is no consolidated view in the Russian government on this issue. On the one hand, the Ministry of Energy has recently proposed again (this time by the new Minister A. Novak, whose immediate previous position was deputy Minister of Finance) an introduction in the oil industry of the “windfall profit tax” or the “tax on financial results.” According to the Minister, the fiscal pressure on the oil industry in Russia is one of the highest compared to other oil producing states. It is not the financial result, which is taxed and levied, but the absolute value of the gross revenue of the company. This helps to ease tax administration and tax collection, but this does not consider project

²⁴ See, for instance, his presentation at the First International PSA-2000 conference in Yuzhno-Sakhalinsk at 1–2 September 2000 (see: *Нефтегазовая Вертикаль*, специальный выпуск «СПИ-2000», 10 (2000) (*Oil & Gas Vertical*, Special Issue “PSA-2000”, 10 (2000))).

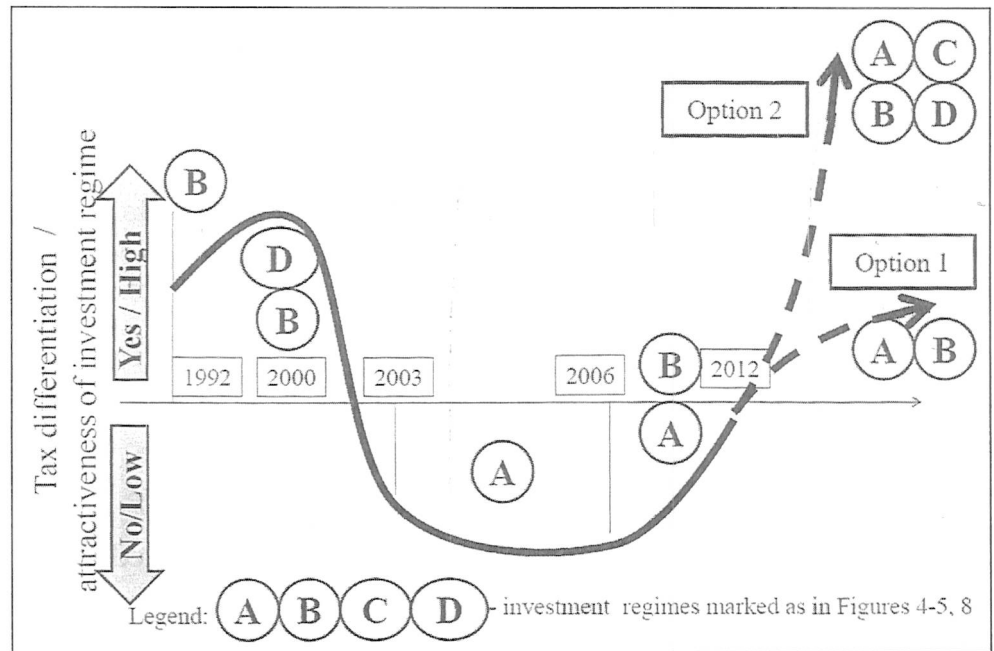


FIGURE 2.9 Evolution of differentiation in tax treatment in Russian investment regimes for subsoil use: At the cross road

economics and hinders inflow of investment in Russian oil. This also makes non-profitable both new oil production and continuation of development of existing fields. If nothing is changed this would lead to a decline in oil production in Russia.

But Deputy Prime Minister A. Dvorkovich considers that the new approach should be first tested on a few fields since he is not confident in the advantages of windfall profit taxation compared to the active oil tax regime with different concessions (temporary deviations) from its common rules. Among those, the following can be mentioned: individual concessions in flat-rated MRPT for some limited period of time at the project start-up to zero downgraded MRPT value, temporary downgrading of customs export duty up to full cancellation, nullified rates of some other taxes – such as property tax and VAT.

But recently long-standing Deputy Minister of Finance S. Shatalov (responsible for oil taxation all throughout his period in office for almost two decades) has stated that the idea of windfall profit tax (WPT) has lost its momentum.

In the recent years during the debate on differentiation of oil taxation, several alternatives were examined:

- Stay with MRPT, diminish export customs duty and introduce WPT,
- Cancel export customs duty and stay with MRPT and introduce WPT;
- Introduce WPT only for early stages of offshore fields development; and
- Other configurations of oil taxation system based on MRPT.

This discussion of alternatives makes it clear to me that there is a demand for differentiation of oil taxation and for diversity of choices for the investors so the rules are best adapted to particular project conditions. But there is no consensus in the decision-making circles on this.

In my view, the optimal way to radically improve the Russian subsoil investment climate would be to implement the concept of "multiple investment regimes" advocated in this paper (see Figure 2.9, "option 2").

How can these regimes be simultaneously implemented in Russia? My vision is presented in Figure 2.10 and outlined below.

First, the law "On PSA" should be revitalized (at least returned to its initial version).

Secondly, either the law "On concessions in the subsoil" should be specifically developed as separate from the existing law "On concessions" (which aims mostly for infrastructure concessions) or the existing law should be expanded to include subsoil use. Before making a choice, we need to determine whether the rules in the current concessions law are applicable and effective for the purpose of creating multiple subsoil investment regimes.

Thirdly, there is a regular bidding procedure for access to subsoil rights introduced by the law "On the Subsoil." This existing mechanism should be slightly adapted by giving investors the opportunity to choose between all available regimes in the bidding procedure. The state should prepare model

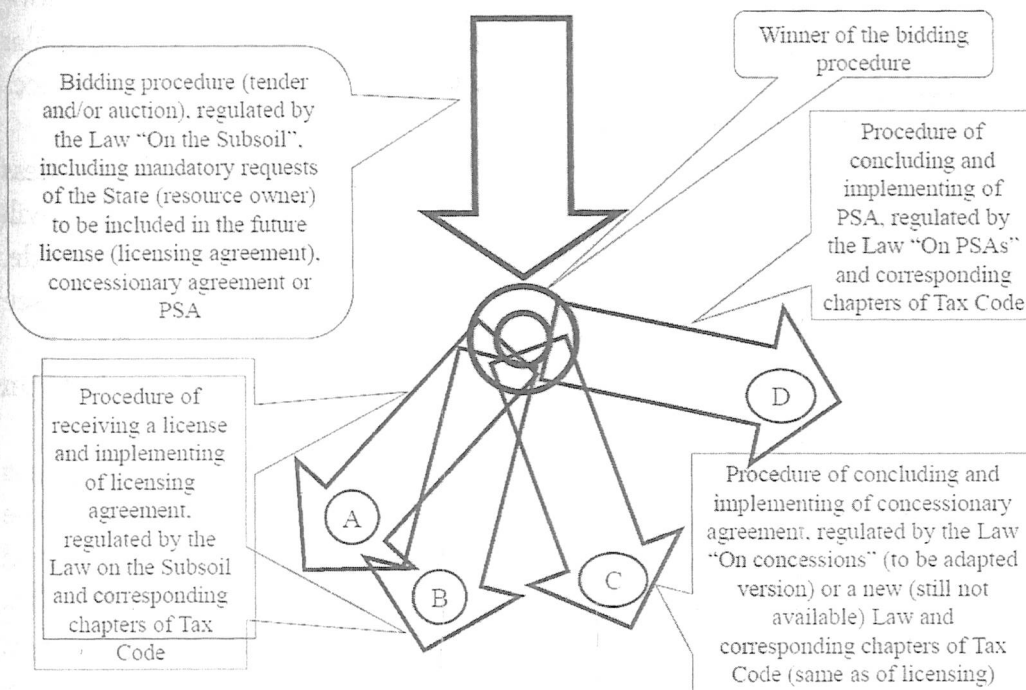


FIGURE 2.10 Equal and competitive investment regimes in Russian subsoil use (historical proposal of author)

licensing, PSA, and concession agreements and make these available to the potential bidders in advance. The open element in them (bidding criteria) should be the discounted value of rent collection by the state throughout the project life (contrary to today's practice with auctions where just initial financial payment matters). Today only the *de facto* financial capabilities of the bidders matter, not their technical capacities and skills which, in my view, is best demonstrated not by the sum of initial payment, but by an accumulated value of reserves extraction through the project life and corresponding mineral rent collection. Initial financial payment thus has nothing to do with the accumulated DCF for the state throughout the project life.

Rights for subsoil use are granted in Russia for 20 years (production) and a further 5 years (exploration). An investor applying for subsoil use should indicate in his bidding proposal not only this value of accumulated DCF for the host state through project life (the bigger will win) but also the type of investment regime of subsoil use under which he would like to develop this project. The rule should be that after the investor is granted rights for exploration and exploitation, he cannot change his choice of regime under which he has won the bid.

A winner indicating in his bidding proposal his willingness to operate under licensing system, will receive his license and licensing agreement and his future operations will be governed by the law "On the subsoil" including the tax system attributable to the licensing regime and governed by corresponding Chapters of the Tax Code. If his fields are located in the area where allowances to licensing regimes are applicable, investors working at these particular projects under the licensing regime may receive such specific area allowances (see Figure 2.10).

By the same token, a winning investor indicating in his bid his willingness to operate under a PSA regime will receive his PSA and future operations will be governed by the law "On PSA" and corresponding chapters of the Tax Code, including a system of rent collection characteristic of the PSA regime (see Figure 2.10).

The same procedure would be operative under the potential new law "On concessions in the subsoil."

Most probably, development of resources in complicated and remote areas (such as the Arctic offshore, for which Figure 2.11 is an illustration) will be organized in the form of consortia formed between Russian companies and major Western oil companies with available technologies, managerial skills, access to financial resource with lower cost of raising capital due to the high credit ratings these companies can provide compared to Russian companies

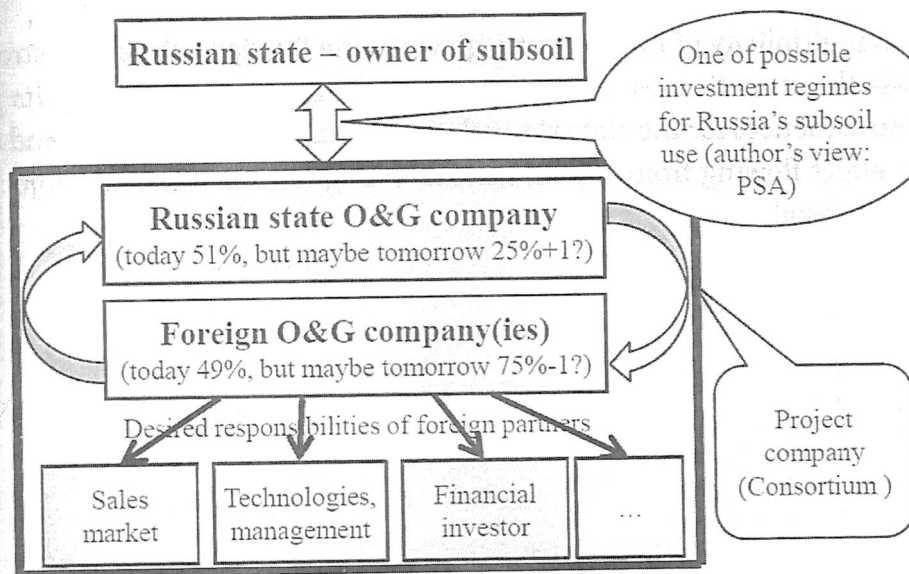


FIGURE 2.11 Possible organizational structure of consortia for Russian Arctic offshore oil and gas development (within author's concept of multiple investment regimes for subsoil use)

can provide, and other factors. In the case of Russian offshore development, Russian state companies, Rosneft and Gazprom, are by law the only companies which can be granted a license for subsoil use in offshore areas. Recent agreements on strategic alliances for development of Russian offshore resources, including the Arctic, between Rosneft and ExxonMobil, ENI, Statoil, and BP supports this expectation.

Agreements on subsoil use between the host state–resource owner (Russia) and consortia should be one of the arrangements offered in the “investment menu” and the competitive process should be organized based on the procedure presented in Figure 2.10. Consortia would be structured according to the specific competencies of its members and relative importance of various competencies for this or that particular project.

In my view, the current Russian legislation which demands majority control of Russian state companies–license holders in the consortia (no less than 50% plus one stock) leaving to foreign or non-Russian companies only minority participation, can be updated in the future by leaving with the state-controlled companies an ownership interest (25% plus one stock) which will be sufficient to block any decisions that the host state will consider as incompatible with the state's interests in regard to a particular project development. Besides, this will diminish the “financial burden” on the state-controlled companies in any such project by two-fold.

Such multiplicity of investment regimes in the Russian subsoil will strongly increase the attractiveness of the Russian investment climate with all its positive consequences for the state through the increased direct, indirect and multiplier effect flowing from capital-intensive long-term investment projects in Russian subsoil.