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INVESTMENT IN WEST SIBERIAN OIL: A KEY TO SUCCESS

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IT IS STRANGE to hear that with tremendous oil reserves in Russia oil extraction is becoming unprofitable. It seems that the potential reserves of this vital raw material of Russia, accounting for more than a third of the world reserves, could be a source of the republic's economic prosperity and cover a substantial part of the world requirements for oil and gas. However, we have to speak about a tangible drop in oil extraction. To illustrate, between 1988 and 1991 oil extraction decreased by more than 20 percent with an expected further drop in 1992. If this trend persists and in view of the existing internal need for oil and oil products the country may have to face the necessity of importing oil and oil products already in the next few years.

In a nutshell, the main reasons for the crisis phenomena in oil extraction and processing are the following:

— major high debit oil fields of the exploited fund making up the bedrock of the resource base are substantially depleted;

— the properties of new reserves have sharply deteriorated. Not a single large high-yield oil field has been discovered lately;

— financing of geological prospecting has been curtailed. Thus, in West Siberia where the degree of the development of forecasted resources amounts to 35 percent the financing of geological prospecting has declined by 30 percent since 1989. A corresponding drop was recorded in the volume of prospective drilling;

— there is an acute need for highly productive extracting and drilling machinery and equipment. The major part of technical facilities has wear and tear of more than 50 percent. Only 14 percent of machinery and equipment conform to world standards, while 70 percent of all drilling machines became obsolete and require replacement. The breakup of the Soviet Union has exacerbated the situation with the supply of oil extraction equipment from CIS countries: prices are being raised while deliveries of equipment to Russia are on the decline;

— low internal prices for oil fail to ensure the self-financing of oil-extracting enterprises (this situation remains the same today, too, after several increases in oil prices). It resulted in a sharp deterioration of the material, technical, financial and foreign currency provision of the industry;

— the lack of efficient and ecologically safe equipment poses a particularly acute problem of environmental pollution in the industry. The solution of this problem diverts substantial material and financial resources which do not participate directly in expanding oil extraction.

Here it is possible to cite an equal number of main reasons entailing the decline of the oil extracting and processing industries. However, even those mentioned above are a constant headache for all workers of this sector.

Against the background of a marked decline in production, a substantial shortage of material, technical and financial resources of enterprises,

an insufficiently high technological level of production in the oil industry of the Russian Federation, one of the most efficient options for stabilising the work not only of this sector but of the economy of the republic as a whole could be the attraction of foreign investments.

An increased oil production in Russia could mitigate the strain in relations with the republics of the former Union, which was caused by short deliveries of oil in return for failure to deliver equipment and materials, and would contribute to the establishment of a genuine Commonwealth which is of major significance for improving the international political climate. It could also contribute to mitigating control over world prices exercised by the OPEC which would contribute to stabilising the situation on the world oil market. Moreover, direct foreign investments can have some other similarly positive effects not only for the host country but also for potential investors and the world community at large. For instance, against the background of the reduced extraction and lower volume of drilling operations in North America and the release, i. e. mothballing, of a substantial part of oil-extracting equipment, capacities for its production and financial resources (which is already leading to the bankruptcy of a number of companies engaged in oil business), the investment of capital into the Russian oil industry offers great opportunities for strengthening the financial positions of American oil companies.

There is no doubt that in order to attract foreign investments it is necessary to create certain favourable conditions such as the ensuring of an acceptable level of profitability of capital investments of foreign participants with a stable financial regime of the running of enterprises. The latter is also determined by providing guarantees for the protection of investments, including from changes in the legislation in force in the host country. In world practice such guarantees are usually reflected in legislature and therefore easily put into practice. In Russia, however, until recently that issue has not been mentioned, to say nothing of being regulated, in legislative acts. This, among other factors, not only discourages new investments but has already begun to provoke the outflow of some previously made investments.

Various unofficial experts estimate that foreign firms are ready to invest in the Russian oil-extracting industry about \$60-70 billion. Taking this into account it is necessary to offer the investors an explicit long-range strategy in order to convince them that the further evolution of the until recently unstable and, consequently, rather risky economic situation in Russia will reduce these risks.

SHORT-TERM PRIORITIES

IN THE SHORT TERM the most urgent is the problem of preventing the declining oil production at the existing oil fields. The quickest return on capital can be obtained if investments are made in the rehabilitation of idle oil wells.

Due to the systematic undersupply of material and technical resources to oil-producing enterprises the exploitation of oil-producing wells has sharply deteriorated in recent years. As of March 1, 1992 the total number of idle wells exceeded 25,000 (17.3 percent of the total number of wells) which is 12,400 more than the technologically justified norm. The number of idle wells was most rapidly growing in the last three years: in 1989 their number increased by 2,100; in 1990, by 6,700; in 1991, by 5,900; and during the first two months of 1992, by 1,600.

The greater part of idle wells is located in West Siberia. As of March 1, 1992 their number was 17,900 or 25.8 percent of the total number of wells in operation, which is 10,700 more than the technologically justified norm (see table below). According to the estimates of oil-producing enterprises, the average debit of an idle well is about eight tonnes per day.

Due to this the average annual losses of oil extraction in Russia

amount to roughly $12,400 \times 8 = 99,000$ tonnes daily or about 30 million tonnes annually. This entails a loss of export revenues in the amount of approximately \$3.6 billion. And, on the contrary, the total inputs required for rehabilitation of 12,400 wells are estimated at \$1.4 billion.

This means that we are offering foreign investors a sound economic project with a guaranteed pay-back period of three to four months. One of the major positive features of this project is that it is mainly oriented towards medium and small, i. e. more mobile, companies rather than major, i. e. less nimble, firms.

Table
The number of idle wells at oil-producing enterprises in West Siberia (as a percentage of completed oil wells as of March 1, 1992)

Total for West Siberia including	25.38
Nizhnevartovskneftegaz	21.7
Yuganskneftegaz	23.6
Noyabrskneftegaz	36.8
Varienganneftegaz	35.5
Kogalymneftegaz	42.7
Tomskneft	29.3

Western firms can make direct investments, for example on the basis of service contracts as is usually the practice in the West. However, taking into account the high skills of Russian production personnel, the most appropriate form of rehabilitation of idle wells with foreign participation will be to receive western credits for the purchasing of necessary equipment which will be used by Russian oilmen themselves; the credits will be paid off by supplies of some part of the oil extracted from the rehabilitated wells.

These potential credit lines have already been rather well prepared by the Russian side: a great number of contracts have already been discussed and many of them signed. But as a result of the USSR Vnesheconombank's bankruptcy in December 1991 all the hard currency accounts of oil-producing enterprises were frozen and presently they cannot pay for their contracts. In this situation it is necessary to understand that these credit lines could be used as a kind of bridge for financing highly reliable and technically developed projects suitable for both small and medium firms.

This type of projects was supported by the World Bank and the European Bank for Reconstruction and Development. The World Bank is preparing a special "petroleum" credit line for Russia so far to the sum of \$870 million and is expected to increase this sum by several dozen million dollars through the energy part of the urgent "rehabilitation" credit. The EBRD intends to provide the Russian oil sector with some \$500 million in addition to the World Bank's petroleum loans. Sixty percent of this sum will be offered to 5 or 6 oil-extracting enterprises for the rehabilitation of idle oil wells and financing of some vital import purchases of oil-extracting equipment.

MEDIUM-TERM PRIORITIES

IN THE MEDIUM TERM (3 to 5 years) it is possible to prevent a drop in oil production through massive development of the already proven but not yet exploited oil fields due to the lack of funds for their development. It is planned to draw foreign companies into these activities on the tender basis as is provided for by the law On Mineral Resources. The return on their investments will take the form of a guarantee to export a portion of the oil produced. Companies will be offered an opportunity to reinvest their profits into the stocks of the joint ventures established or to be set up and/or the stocks of oil-producing enterprises privatised.

An essentially new approach to the selection of the already proven oil fields handed over to foreign companies on the tender basis for further development has been developed. Now foreign firms will get an access not only

to the worst oil fields as was the case in the past but also to the fields with rather favourable geological parameters.

The terms for tender procedures will be extended not only to foreign but also to domestic companies including private ones. It is necessary to envisage an optimum form of the participation of Russian oil-extracting enterprises on whose territory these new oil fields put out to tender are located.

For tackling all these complex procedural problems a special Investment Tender Commission was set up under the auspices of the Committee for Foreign Investments at the Ministry of Finance. The Commission is headed by Leonid Grigoriev who is also head of the Committee for Foreign Investments. It is planned that this Commission will be an interdepartmental coordinating body called upon to ensure a methodological uniformity of approaches of various departments to the solution of complex problems involved in organising tenders in various sectors of the Russian economy. The Commission has already approved the proposal submitted by the Ministry of Fuel and Energy in cooperation with geologists and regional authorities on putting out to tenders the first three West Siberian oil fields. These are the Priobskoye (northern part), Salymskoye and Novoportovskoye oil fields. Indeed, what are the first three oil fields put out for the competition?

THE *PRIOBSKOYE* oil field is located in the Khanty-Mansi autonomous district of the Tyumen Region, 65 kilometres away from the city of Khanty-Mansiisk and 100 kilometres to the west of Nefteyugansk. The nearest railway station, Salym, is 125 kilometres away, while the nearest oil pipeline linking Kholmogory with Klin is 80 kilometres away.

Oil reserves of this field were confirmed by the State Committee for the Reserves of Natural Resources in 1988. As of January 1, 1992 the so-called balance reserves of the C1 category totalled 1.7 billion tonnes in the northern part of the field. Since its exploration is not finished yet one can expect a further increase of reserves particularly if the exploration is carried out in the direction of the Studyonoye field.

THE *SALYMSKOYE* field is also situated in the Khanty-Mansi autonomous district of the Tyumen Region which is the most industrially developed oil-extracting market in West Siberia. About 70 percent of the area of the field is concentrated in the Nefteyugansk district, and the other 30 percent—in the Surgut and Khanty-Mansi districts. The field is 95 kilometres to the south-west of Surgut, 90 kilometres to the east of Khanty-Mansiisk and 68 kilometres from Nefteyugansk. The Urengoi-Novopolotsk and Ust-Balyk-Omsk oil pipelines are running to the south of the oil field. The construction of a main line from the oil field to the Ust-Balyk-Omsk oil pipeline is under way.

Oil reserves were confirmed by the State Committee for the Reserves of Natural Resources in 1985. As of January 1, 1992 balance reserves of the C1+C2 categories totalled 1.9 billion tonnes, including 1 billion tonnes of the C1 category.

Pilot and industrial oil extraction at the field started back in 1974. There were drilled 40 exploitation wells with the accumulated extraction amounting to 2.8 million tonnes.

By using appropriate seismic methods it is quite possible to discover oil-saturated cavities in the clays of the Bazhenovskaya suite. In that case horizontal drilling may increase debits dozens of times and even more. All this will substantially enhance the economic attractiveness of the project.

THE *NOVOPORTOVSKOYE* field is located in the Yamal-Nenetsk autonomous district of the Tyumen Region, in the south-western part of the Yamal Peninsula, on the left bank of the Ob Bay (40 kilometres off the coast), 15 kilometres to the north-east of Salekhard. Further 300 kilometres to the north-east there is a giant Bovanenkovskoye gas field. The Yamburg gas field and the railway are 120 kilometres to the east of the Novoportovskoye field. They are separated by the Ob Bay.

Oil reserves were confirmed by the State Committee for the Reserves of Natural Resources in 1970. Balance reserves of oil of the C1+C2 categories are put at 760 million tonnes, including 690 million tonnes of oil of the C1 category, 210 billion cubic metres of gas of the C1 category and 16 million tonnes of condensate.

The winner of the tender for the Novoportovskoye field can gain an opportunity not only to participate in its development but also to carry out prospecting work on some adjacent territories in these fabulously rich in oil and gas districts of the Yamal Peninsula and the Kara Sea.

LEGAL AND TAX ASPECTS

IN RECENT YEARS the world capital markets were an arena of an acute competition for foreign investments. That is why the creation of a favourable domestic climate for investors, domestic and foreign alike, is becoming an urgent task for all host countries. The mildness of this climate will determine future investment activities in these countries.

The Russian government intends to develop relations with all countries that are based on the principles proclaimed in the European Energy Charter and its legally binding documents (Basic Agreement and the related Protocols). Thanks to these documents there will be established a common energy, legal and economic environment throughout the entire industrialised zone of the modern world where there will operate various non-discriminatory rules equally applicable to all the participants. These rules include the access to energy resources and markets for exports of energy carriers, rules on transportation of energy carriers, including the order of transit, access to energy technologies and capital markets, etc. This will help establish the balance of interests of host countries and prospective investors both in the sphere of investment protection and in commercial and political issues.

Being an instrument of worldwide significance, the European Energy Charter will provide an internationally approved non-discriminative legal status for foreign investors in the member states of the Charter. About fifty countries of Europe, North America and Asia have signed the political declaration and are conducting talks in Brussels on the Basic Agreement and the Protocols. However, along with the work in Brussels it is necessary to continue drafting a relevant national legislation on principles that do not contradict those contained in the Charter.

From this viewpoint it is necessary to introduce major improvements in the Russian tax legislation with regard to oil. The existing taxation system is essentially restrictive and is indifferent to market fluctuations. This is because the current system heavily relies on the taxation of gross incomes or the ceiling rates, rather than on profit-based taxation.

The existing taxation system is also rather intricate: according to different domestic calculations the total number of taxes, tariffs, duties, etc., at the federal, regional and municipal (local) levels in Russia is about 40. Each of them may not be individually over-rated. However, producers believe that their cumulative effect is unprecedentedly excessive compared to the world oil taxation practice.

High rates of taxation of revenues from the sale of oil penalise oil

extraction operations with higher production costs, increase producers' risks and thus imperil the development of new fields.

Though elsewhere in the world, according to the World Bank, total governmental "deductions" from profit range from 40 to 80 percent depending on the profitability of a project, the taxes and tariff in Russia at present infrequently skyrocket to 100 and more percent of the producers' profit.

EXPORT TARIFFS

IN RECENT MONTHS the major negative impact on profits of foreign investors was made by the so-called export tariffs effective from January 1, 1992 with the flat rate in the amount of 26 ECUs per tonne of crude oil. More than a dozen joint ventures engaged in oil production have already applied to the Ministry of Fuel and Energy with a request to repeal that tariff in order to continue an economically expedient oil extraction.

The amount of this tariff (\$35 per tonne or \$5 per barrel) is about 30 percent of the world price for oil. In introducing that export tariff its aim was to offset the difference between the international and national oil prices for enterprises operating on the Russian market and exporting some part of their oil extracted as well as for intermediary and broker firms which bought oil at domestic prices with the aim of reselling it on the world market.

However, since joint ventures made their decisions on investments on the basis of the world market prices (all of them need to be partly export-orientated) the introduction of the export tariff dealt a heavy blow at their economies.

There were rather sharp discussions in the government between the proponents of the idea of the tariff and the opponents of its application to all and sundry enterprises operating both in the oil industry and other extracting sectors. The proponents of the idea of a tariff with its indiscriminate application to all exporting enterprises including joint ventures set up prior to January 1, 1992 include "fiscal" ministries which were the initiators of introducing that tariff: the Ministry of Finance, the Ministry of Foreign Economic Relations, the Customs Committee. Among those who spared no effort to repeal that tariff for joint ventures registered prior to January 1, 1992 and proved their point by referring to the then yet non-existent in the Russian legislation on foreign investments but a rather typical for the international legal practice legislative rule protecting the investors (after their adoption of the decision to invest or after the carrying out of investments) against changes in tax legislation of the home country there were ministries responsible for long-range economic development determined by the level of investment activity in the country, i. e. the Ministry of Fuel and Energy, the Committee for Foreign Investments, the Ministry of Economics.

As a result of all those discussions two joint ventures which were the first to apply to the Ministry of Fuel and Energy and the Committee for Foreign Investments in connection with their problems caused by the "export tariff" were relieved in May and June from paying that tariff for their pay-back period. Presently acting and then yet Prime Minister Yegor Gaidar signed relevant decrees for joint venture KomiArcticOil set up by Gulf Canada, British Gas and the Russian production association Komineft as well as Northern Lights established by Conoco (USA) and the Russian production association Arkhangelskgeologiya.

The end of June saw the signing of a more general Instruction of the Government of the Russian Federation, under which all enterprises with foreign investments (the latter exceeding 30 percent) registered prior to January 1, 1992 will be exempt from paying the "export tariff" for the period of recoupment of the investments in those joint ventures. The initiators of that Instruction were the same three ministries mentioned above and engaged in tackling the tasks of the country's long-term economic development and the related problems of investment.

The above-said, coupled with the difficult economic situation, continues to discourage potential investors from making major investments into the Russian power industry. Today, the average relative sum of investments into the Russian oil industry does not exceed \$10 million. However, this fact should be viewed as a result of the lack of necessary practice (for we did not have the market and were not concerned with attracting investments including foreign ones), as a result of inadequate laws or their total absence, rather than the result of implementing some clearly realised "economic policy" aimed at banning foreign investments from the country.

The present-day practice and experience of drawing foreign investments into the oil and gas industries of Russia are mostly associated with the establishment of joint ventures (JVs). Therefore, the evolution in tackling tax problems in connection with attracting foreign investments to Russia can be clearly demonstrated on the example of the establishment and activities of JVs, the Russian-Canadian-British KomiArcticOil enterprise for one.

KOMIARCTICOIL: A HERO-PIONEER?

AN AGREEMENT on setting up a joint Russian-Canadian-British enterprise was signed in May 1991 and approved by the decree of the Government of Russia of November 5, 1991. It was preceded by the elaboration and examination of the feasibility study (about twelve months), the receipt of a permission and the approval of constituent documents in Russian ministries (about two months), etc.

The founders of the JV are Gulf Canada Resources, British Gas and Kominеft (Russia). Foreign participants are leading companies in the elaboration and application of Arctic technologies for both land drilling and work on the continental shelf. They were among the first to use horizontal drilling. The equity participation of foreign and Russian partners in the JV KomiArcticOil is 50:50. The initial authorised capital of the joint venture is over \$155 million. The aim of the JV activities is to develop the Vozeiskoye and Verkhne-Vozeiskoye oil fields with a total area of more than 70 square kilometres. The project is planned for twenty-five years during which it is expected to extract 65 million tonnes of oil. These fields are characterised by a high hydrogen sulphide content and a difficult extraction of crude oil requiring the application of an advanced extraction technology. The project employs a technology allowing to bring the extraction coefficient to 60 percent of the field potential (at national enterprises this coefficient does not exceed 20 or 25 percent), as well as a technology of pumping hydrogen sulphide into the stratum and its purification. This allows to substantially reduce the negative effect of the development of oil fields on the environment and increase oil output. Use is made of progressive methods of carrying out oil-extraction operations.

Total capital investments to be made under the project are put at \$930 million with the correlation of dollar and ruble investments being fifty-fifty and the dollar exchange rate to the ruble being 1:1.8. With this exchange rate the correlation of dollar and ruble operating costs is 45:55. The JV net profit will be about \$700 million. Total proceeds received by the Russian side without taking into account the profit of the Russian JV participant over the entire period of the implementation of the project subject to the terms contained in the JV constituent documents and the feasibility study (royalty—10 percent, export tax—10 percent, profit tax—25 percent), were to amount to \$2.42 billion (taking into account a 25-percent deduction of expenditures) or 23 percent of the gross receipts from oil sales. Taking into account the profit of the Russian JV participant, the share of the Russian side in the profits would amount to over 70 percent (\$892 million), taking into consideration a 15-percent tax on the repatriated profit of the foreign JV participant. The coefficient of the internal profitability under the project equals 20 percent on the whole.

The introduction of a new tax legislation effective from January 1992 and, in particular, the increase of the profit tax to 32 percent as well as the introduction of the export duty has sharply worsened the financial indicators of the JV work. The first batch of oil of the JV was shipped in January 1992. Since the beginning of the operations till April the volume of oil sales has reached 43,000 tonnes. The new conditions of work led to a situation when the joint venture had to pay more than a third of its gross receipts only as export duty, while cash after covering all expenditures and the payment of taxes was in the red.

According to the terms adopted at the moment of setting up the joint venture, the period for the recoupment of capital expenditures was estimated at 6-8 years. However, in the new conditions that arose this period would be much longer. The changed terms of taxation resulted in the fact that economic inexpediency of the joint venture became apparent to the foreign partner and he would have to discontinue production.

In absolute terms the additional profits of the Russian side in the form of the payment of export duties would amount, over the entire period of the implementation of the project, to \$300 million. In a real situation when the foreign partner would rather not accept such conditions (when the closing down of the enterprise seemed inevitable) the losses of the Russian side would amount to \$2.7 billion not counting the lost expenditures that always accompany projects for the development and exploitation of oil and gas fields (the development of infrastructure, social programmes, etc.).

In this connection the Ministry of Fuel and Energy and the Committee for Foreign Investments at the Ministry of Finance of the Russian Federation advanced a proposal to relieve joint ventures KomiArcticOil and Northern Lights from paying the export tariff during the pay-back period for the additional oil they produce. As was already said relevant decrees of the Russian government concerning the above joint ventures, as well as other JVs registered prior to January 1, 1992 have already been passed.

Taking into account the present economic situation in the republic, the requirements of the national economy for substantial financial, material and technological resources, its integration into the market and the world economy, the Ministry of Fuel and Energy of the Russian Federation spares no effort to create a favourable investment climate on the understanding that it will contribute to the solution of the current economic problems, the attraction of the most up-to-date machinery, equipment and technologies to the country, the accumulation of new experience and knowledge for the implementation of larger-scale projects, which will be helpful in stabilising the national economy and consolidating democratic processes. The very fact that Russia is at the initial stage in tackling a new range of investment problems causes certain difficulties and probably evokes excessive caution in making necessary decisions sometimes proceeding not only from economic expediency but also from the need for overcoming such problems. The latter circumstance is evidently a matter of only time and experience.
