

# RUSSIAN PETROLEUM INVESTOR™

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## *Common Sense Persuades the Russian Government to Exempt the Komi Venture*

# How Gulf Canada and British Gas Received Tariff Exemptions

One of the two joint ventures receiving an exemption from export tariffs during the past two months is KomiArcticOil, a project involving Komineft, Gulf Canada Resources, and British Gas. The joint venture was formed in November 1991 in order to develop the Vozeisky and Verkhne-Vozeisky oilfields in the Komi republic, and was operating successfully until the passage of the decree imposing stiff tariffs on exports in January of 1992. These tariffs, together with a recent increase in profit tax from 25% to 32%, made operations unprofitable and put the viability of KomiArcticOil in question.

### Project Background

Initial discussions concerning the KomiArcticOil joint venture began in early 1990, and culminated with the signing of the agreement in May 1991. On November 2, 1991, the Russian Federation Council of Ministers issued a resolution officially recognizing the legal existence of the venture and authorizing its operations.

50% of the joint venture is owned by the foreign partners and 50% by the Russian partner. The statutory fund of the joint venture is \$155 million, and the expected amount of recovered oil over the 25-year life of the project is 65 million tons.

According to the joint-venture agreement, the foreign parties will con-

tribute technology which permits the partners to increase the rate of recovery from the current 20%-25% to 60% of the proven oil reserves. Total capital investment over the life of the project is estimated at \$930 million. The partners of the joint venture have agreed that the total revenues of the project over the first four years of operations will be reinvested in the venture.

According to the terms of the foundation agreement and the feasibility study, the joint venture is to pay a 10% royalty, a 25% profit tax, and a 15% withholding tax on the part of the profit repatriated by the foreign partners.

The net profits of the joint venture over the life of the project were projected

at nearly \$700 million, and the rate of return on the project was estimated at 20%. According to the original estimates, the breakeven period was projected at six years and eight months.

The total revenues of the Russian side are estimated at \$2.42 billion, an equivalent of 23% of total revenues from oil sales.

According to *RPI* sources, the first shipment of oil produced by the joint venture was exported in January 1992. From the commencement of operations until April 1992, the total volume of oil sold amounted to 43,000 tons.

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### Decree of the Russian Government No. 957

To exempt the Russian-Canadian joint venture KomiArcticOil from payment of export tariffs on the oil produced by the above joint venture over a period from January 1, 1992 to the date of full recoupment of expenditures related to the incremental oil production compared to the estimated volume of oil recovery from the joint venture's well fund as of the time of its establishment.

Yegor Gaidar  
Prime Minister

May 27, 1992

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## From Optimism to Concern

Despite early successes, in the spring of 1992 the attitude of the Western partners toward the Komi project changed from enthusiasm and optimism to frustration and concern. The reason was the legislative changes introduced by the Russian government which imposed export tariffs of about \$5 per barrel and increased corporate income tax from 25% to 32%.

As a result of paying higher taxes and handing over to the government nearly 1/3 of its net revenues in the form of export tariffs, the financial performance of the joint venture drastically deteriorated (see accompanying tables). As opposed to making an after-tax profit of \$11.63 per ton, the venture suffered a loss of \$21.28 per ton over the period of January to April 1992.

It quickly became obvious to foreign partners that the performance of Komi-ArcticOil could not be turned around unless the venture was exempted from export tariffs. Thus, Gulf Canada Resources and British Gas had two options: either to stop producing or to lobby the government for an exemption from the tariffs. The partners wisely chose the latter and together with the support of local authorities in Komi, filed a petition with the Russian government.

Extensive calculations and analysis were prepared by Gulf Canada and British Gas in order to persuade the Ministry of Fuel and Energy and the Committee on Foreign Investment, which reviewed these calculations, to rule favorably. They did. After extensive review, both the ministry and committee accepted the arguments put forth by the Western partners regarding the devastating effect of the export tariffs on the joint venture, and granted the venture an exemption.

## Nothing But Praise

According to one joint venture official, "The petition was reviewed by competent specialists who could see the difference between long-term strategic objectives and short-term fiscal interests of the state. Those experts were also well aware of the internationally accepted principles governing the relations between a host country and foreign investors."

A representative of one of the partners added: "Fortunately, the Russian experts who did the examining were not the ones who had prepared the draft law on taxes and customs tariffs in 1992." Both executives spoke to RPI on condition of anonymity.

After a careful examination of the petition, the conclusion was reached that, in the case of KomiArcticOil, the legislative innovations would not serve even the short-term fiscal interests of the state. According to the findings of the Committee on Foreign Investment, which RPI managed to obtain, the imposition of export tariffs on the KomiArcticOil project would raise revenues of Russia as a whole by only about \$1.5 million per year — approximately 12% of overall projected revenues (which includes taxes, export revenues, and Komineft's profits).

However, if the foreign partners chose to walk away from the project as a result of new export tariffs—which was very probable given the economics of the venture—the loss to the Russian state would exceed \$2.7 billion. This figure does not even taken into calculation the funds that would have been invested in infrastructure development, social programs, and other projects not directly related to production.

### Impact of Export Tariffs on the Financial Performance of KomiArcticOil

December 1991 - April 1992

	1992 (with tariff)		1991 (without tariff)	
	\$/Ton	%	\$/Ton	%
Revenue	125.74	100.00	125.74	100.00
Production Costs	88.89	70.69	88.89	70.69
Transportation and Marketing Costs	8.78	6.98	8.78	6.98
Royalty	12.57	10.00	12.57	10.00
<u>Export tariff</u>	<u>36.78</u>	<u>29.25</u>	<u>0.00</u>	<u>0.00</u>
Total Costs	147.02	116.92	110.24	87.67
Profit/Loss Before Tax	(21.28)		15.50	12.33
Profit Tax*			3.87	3.08
Profit/Loss After Tax			11.63	9.25

\* Income Tax was 25% in 1991 and 32% (starting from January 1992).

Source: RPI Research

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## It's Better in Azerbaijan

The Ministry of Fuel and Energy and the Committee on Foreign Investment also concluded that the changes in the law were clearly in violation of internationally accepted principles protecting foreign investment from legislative changes in the host country. Incidentally, laws passed in Kazakhstan, Ukraine, and Azerbaijan—unlike those in Russia—specifically address this issue. In Azerbaijan, for instance, a resolution was passed which stipulated that, in case a new law worsening conditions for the investor is passed, the investor is entitled to continue operating under the terms of the original agreement over a period of 10 years.

In view of this and other considerations, the Ministry of Fuel and Energy and the Committee on Foreign Investments of the Ministry of Finance supported KomiArcticOil's petition for exemption from export tariffs until the original investment of the joint venture partners is recouped. In late May of 1992, Prime Minister Yegor Gaidar, acting on the recommendations of these ministries, issued a corresponding decree.

## Happy Partners?

Needless to say, the enthusiasm of Gulf Canada and British Gas is back at the previous level—although both companies regret the time and effort wasted on this exercise. Also, executives at these companies privately expressed concern about the instability of the legal environment in Russia, and apprehension about the possibility of adverse legislation being introduced in the future.

For now, however, KomiArcticOil is again preparing to commence its op-

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## Financial Projections of KomiArcticOil Without Export-Tariff Exemption

December 1991 - December 1992  
(Oil Recovery and Sales of Approximately 650,000 Tons)

	\$/Ton	%
Revenue	120.20	100.00
Cost,	51.10	42.51
including:		
Ruble Cost*	3.70	3.08
Dollar Cost*	47.40	39.43
Depreciation	20.00	16.64
Transportation and Marketing Expenses	14.00	11.65
Royalty (10%)	12.00	9.98
<u>Export Tariff</u>	<u>41.90</u>	<u>34.86</u>
Total Cost	139.00	115.64
Profit before Tax	(18.80)	

\* Exchange rate: \$1/R100

Source: RPI Research

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Depreciation	20.00	16.64
Transportation and Marketing Expenses	14.00	11.65
<u>Royalty (10%)</u>	<u>12.00</u>	<u>9.98</u>
Total Cost	97.10	80.78
Profit before Tax	23.10	19.22
Profit Tax (32%)	7.40	6.16
Profit after Tax	15.70	13.06

\* Exchange rate: \$1=R100

Source: RPI Research

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- To introduce special regulations which would guarantee proper control over investments in Russia;
- To synchronize resolution of the aforementioned problems with the gradual involvement of the CIS states;
- To develop informal contacts which are emerging between Russian and CIS experts.

**Questions Still Remain**

Despite the obvious interest of many Russians in seeing the agreement signed, some Russian parliamentarians and entrepreneurs will undoubtedly be divided over Russia's participation in the Basic Agreement. Questions about the future of national resources, the "sacrifice" of Russian interests to those of foreign investors, and similar issues are already being hotly debated.

In addition, certain state and quasi-market structures in the highly monopolized Russian energy industry will be reluctant to accept the main premise of the Basic Agreement—foreign access to state resources—perceiving it as a threat to their monopoly on the energy market. Ultimately, the outcome of the Basic Agreement will depend on whether Russia is planning to join the world economic community, accepting its general principles, or whether it will seek ways of improving its economic position by other means.

**One More for Total**

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**Project Economics**

According to sources familiar with the contract, Total expects to earn a rate of return of 17.9% on its Komi project. RPI also obtained the following financial projections which are based on assump-

tions that world oil prices will average \$150 a ton (\$20 a barrel) and inflation will run at 4.5% per year during the 30-year life of the project.

- 1) Engineering and production costs will amount to \$5.304 million (in current prices).
- 2) Capital expenditures will be

\$118 million;

3) Operating expenditures will amount to \$31.120 billion;

4) Transportation expenditures (oil pipeline) will be \$999 million.

The Russian side will be responsible for paying \$2.716 billion of these expenditures. **RPA**

**Negotiating Production Deals**

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<sup>2</sup> Increasingly, national ministries and committees have administrative units that operate at the local level (e.g., the Anti-Monopoly Commission, the Ministry of Fuel and Power, etc.). These offices must also be "lobbied" as part of the approval process.

<sup>3</sup> Before the new venture is formerly registered, local government (region) officials can only grant preliminary approval of land allocations. The actual

allocation cannot take place until after registration.

<sup>4</sup> For example, a May 1992 decree exempts the KomiArcticOil joint venture from paying the export tariff until such time as the original investment is paid off. (Ruling No. 957-r of May 27, 1992). The Novokuibyskerskii petrochemical combinat has been freed from paying export tariffs through 1994 to enable it to purchase equipment for capital development (Ruling No. 934-rof of May 25, 1992).

**Gulf Canada and British Gas**

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erations. According to RPI sources at Komineft, over the recent months the joint venture produced over 300,000 tons of oil which it did not ship because of the legal uncertainties. These sources indicate that now—after the export-tariff situation has been resolved in favor of the venture—this entire volume will be exported for hard currency to the West.

**RPA**