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$3 Billion Timano-Pechora Joint Venture Gets Export Tariff Exemptions

Polar Lights Look Brighter for Conoco

On June 18, 1992, Conoco (US) announced that it was set to proceed with operations on its Polar Lights (*Polyarnoye Siyaniye*) joint venture in the north of the Timano-Pechora Basin. This decision followed the June 12 signing of the Russian government's Decree No. 1059-p which exempted Conoco from tariffs on oil exports and lowered the royalty paid to the government from the standard 10% to 5%.

Conoco is the first foreign company which has received both of these concessions from the Russian government. The other major joint venture which has been exempted from export tariffs, KomiArcticOil (owned 50% by British Gas and Gulf Canada Resources) has not received any concessions on royalties.

Both government officials and Conoco executives indicate that the main reason for the concessions is the fact that Polar Lights entails the development of a completely new field in a hostile environment with no infrastructure. *RPI* sources indicate that another reason for Conoco's success was its coherent approach toward negotiations with the Russian goverment. Special feasibility studies had been prepared by Conoco which clearly demonstrated to the Russian government that the venture was not viable under the new tariff and tax regimes.

Project Background

The joint venture Polar Lights (*Polyarnoye Siyaniye*) was set up by Conoco and the Arkhangelskgeologia Enterprise for the development of three oilfields in the Timano-Pechora Basin, known as the Ardalinsk, Vostochno-Kolvinsky, and Dyusushevsky Ardalinsk complex. The recoverable reserves of the Ardalinsk oil field are estimated at over 12.2 million tons of oil, those of the Dyusushevsky field at 2.5 million tons, and those of Vostochno-Kolvinsky of nearly 1.3 million tons.

The agreement to form the 50/50 joint venture was signed in the end of 1991, and the venture was registered in January 1992.

In addition to the above three fields, sources at Conoco indicate that the Polar Lights project may also include the pros-

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Tariff-Exempt Scenario

Financial Projections of the
Polar Lights Joint Venture Over the Life of the Project

Based on Russian legislation in effect at the time of the feasibility study's preparation in 1991.
All figures are per ton.

	$	%
Gross Revenues	184.4	100.0
Cost of Production	93.3	50.6
Cost of Transportation	26.7	14.5
Export Tariff	—	—
Royalty	18.4	10.0
Total Costs	138.4	75.0
Profit Before Taxes	46.0	24.9
Profit Tax (25%)	11.5	6.2
Profit After Taxes	34.5	18.7
Conoco's Share (50%)	17.2	9.4
Withholding Tax (15%)	2.6	1.4
Conoco's Net Profits	14.6	7.9

Note: Assumes production levels of approximately 122 barrels for the duration of the project.

Source: RPI Research

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pecting and development of the Oshkotinsk oilfield. According to preliminary estimates, the reserves of Oshkotinsk amount to 12.4 million tons (about 91 million barrels).

Production Plans

In its June 18 announcement, Conoco indicated that the joint venture will begin production in late 1994. This differs from the plans outlined in the original feasibility study which called for production to begin in 1993 (estimates for production during the initial year are about 3.6 million barrels or 480,000 tons of oil).

Production will begin with the development of the Ardalinsk field, with output expected to reach the equivalent of 9-10 million barrels of oil (about 1.3 million tons) during the period 1996-1999.

Total capital investment in the development of the Ardalinsk complex is projected at $661 million—$313 million of this amount is intended for purchasing oil-producing equipment and services abroad. A major part of the investment will be allocated to the development of wells (about 58%) and pipelines (about 12%). 75% of capital investment and production costs are to be paid for in hard currency. The exchange rate used to account for capital expenditures is $1:R1.8 — the rate that was agreed upon by the partners at the time of signing. Also, it was assumed by the partners that the price of oil will climb by 4% per year during the life of the project.

Sources at Conoco estimate the payback period at 6.8 years. A set of detailed financial projections for the Polar Lights project is displayed on p. 42.

Conoco Demands

As clearly evident from these financial tables, changes introduced in Russia's tariff laws earlier this year rendered the project unprofitable. Anatoly Kazakov, chief engineer of Arkhangelskgeologia told *RPI* that after the joint venture partners revised the feasibility study based on new tariff data, they "immediately saw that whatever approach we accept, the venture could not be profitable." The partners decided to show the revised feasibility study to Rosgeolkom (Russian Committee for Geology), which, according to Kazakov, was sympathetic to the concerns of the JV.

Key among these demands was that Polar Lights be exempt from the export tariff until the partners recoup their investment. The tariff, which was initially set at $36 per ton of crude oil, was increased in June to about $52 per ton. Among Conoco's other requests were a two-year tax holiday, a reduction in royalties, and the right to open hard-currency accounts outside Russia.

Conoco Holds Firm

Negotiations between Polar Lights and the Russian government lasted several months. According to sources in the Russian government, Conoco's position was "extremely firm," which helped convince the government that it could lose a large Western investor from one of its key projects.

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Export-Tariffs Scenario

Financial Projections of the Polar Lights Joint Venture over the Life of the Project

Assuming Conoco is not exempt from export tariffs levied in 1992. All figures are per ton.

	$	%
Gross Revenues	184.4	100.0
Cost of Production*	105.3	57.1
Cost of Transportation	26.7	14.5
Export Tariff	53.5	29.0
Royalty	18.4	10.0
Total Cost	203.9	110.5
Profit/Loss before Taxes	(19.5)	

* The increase is accounted for by the introduction of the value-added tax in Russia.

Note: Assumes production levels of 122 million barrels for the duration of the project.

Source: RPI *Research*

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Withdrawing from the project, however, was the last thing Conoco wanted to do. According to officials at Conoco, over the course of the past 18 months, the US company spent "millions of dollars" on the Polar Lights project. Had the project been derailed, all of this money and time would have gone to waste, and Conoco would have to begin everything from scratch on some other project.

Local Support

According to *RPI* sources, the joint venture had received strong support from a number of Russian organizations during its negotiations with the government. Most active supporters were the Committee for Geology, the Arkhangelsk Regional Administration, the local government of the Nenetsk territorial district, and, especially, the Foreign Economic Department of the Ministry of Fuel and Energy.

Despite this support, the Russian government was not willing to make all of the concessions demanded by Conoco. While granting Conoco an exemption from export tariffs and lowering its royalty to 5%, the government rejected Conoco's other requests when it announced its decision in early June.

The most important elements of this decision were included in a decree signed by Prime Minister Yegor Gaidar on June 12, 1992. The text of the decree was prepared by the Committee on Foreign Investment of the Ministry of Finance and the Geology Committee. Several days after the decree was passed, Conoco announced that Polar Lights was set to commence operations under almost the same terms as those reflected in the original agreement.

Errors Have Been Corrected

Ironically, the extreme haste in which the decree was drafted led to several errors in its text. For instance, Conoco's name was misspelled—the decree refers to the company as Conaco. In addition, the area where the joint venture plans to operate was mistakenly limited to only the Ardalinsk oilfield instead of the whole of the Ardalinsk complex with its 64 million tons of oil reserves.

After approximately one month, the Russian government prepared another decree with all mistakes and inaccuracies corrected (see Decree No. 1252-p on p. 44). Unlike the first draft, the decree also mentions Conoco's Russian partner, Arkhangelskgeologia.

Ecological Problems

However, there is at least one more hurdle that needs to be passed by Conoco before operations may commence. According to the Interfax news agency, the project has not yet passed an ecological examination which is now required for all production ventures (see "Ecology Inspections a Must" on p. 61).

According to sources at the State Ecological Commission, the operations of Polar Lights may be delayed by as much as a year if the situation is not resolved in the near future. Joint-venture officials, however, do not appear concerned. "Having come as far as we have, I am sure Conoco will be able to overcome this final hurdle in no time," a Conoco spokesperson told *RPI*. RPA

Polar Lights

1993-1998 Financial Projections ($/Ton)

	1993	1994	1995	1996	1997	1998
Gross Revenues	138.7	144.3	150.1	156.1	162.3	168.8
Cost of Production	312.5	88.4	112.5	75.6	79.4	107.2
Cost of Transportation	27.0	29.5	21.4	22.5	23.0	24.2
Export Tariff	—	—	—	—	—	—
Royalty (5%)	7.0	7.2	7.5	7.8	8.1	8.5
Total Cost	346.5	125.7	141.4	105.9	110.5	139.9
Profit Before Tax	(207.8)	18.6	8.7	50.2	51.8	28.9
Profit Tax (32%)	—	6.0	2.8	16.0	16.6	9.2
Profit After Tax	—	12.6	5.9	34.2	35.2	19.7

Note: Gross Development Expenditures were $37 million for 1991 and $127 million for 1992.