

RUSSIAN PETROLEUM INVESTOR[®]

A Monthly Intelligence Report

October 1994

Proposed PSA Regulations May Not Be Enough To Unlock the Door to Foreign Investment

In Search of Compromise

By *Andrei Konoplianiuk*

An interministerial working group established by the government and operating under the aegis of the Russian Federation Ministry of Fuel and Energy has developed a package of normative documents regulating production-sharing agreements that would eliminate many of the obstacles currently hampering projects with foreign involvement. However, the proposed documents alone provide only a partial solution to the problems posed by the many contradictions inherent in Russia's legal system. Before foreign investment can begin to flow into the Russian energy complex on a major scale, the government must pass framework legislation giving production-sharing agreements appropriate legal status.

Despite approval by the Ministry of Fuel and Energy of a package of normative documents on production-sharing agreements, there is little hope that major PSA projects will be launched until the Russian parliament adopts appropriate legislation. Such is the conclusion reached by Russian production-sharing experts and foreign executives who have reviewed the documents, including a model agreement, that were released in early September by a group working under the aegis of the Ministry of Fuel and Energy. (See "Model Builders," page

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19.) The need for such umbrella legislation is especially acute in light of the often contradictory, if not mutually exclusive, legislative acts currently regulating various aspects of the PSA.

What Should Have Been

After President Boris Yeltsin signed Decree No. 2285, On Some Matters Pertaining to Production Sharing in the Use of Subsoil, on December 24, 1993, experts involved in drafting legislative acts seemed almost jubilant: They assumed that the flow of foreign investment into the Russian energy complex could be given a powerful impetus by relatively simple methods. The government established an interministerial working group to draft normative acts intended to provide a mechanism for enforcing the presidential decree. Special tax treatment and other incentives were to be offered to companies implementing PSAs by amending legislation that already had been adopted.

By making no effort to strike down Decree No. 2285, the Duma extended its tacit approval, suggesting that the hopes were not unfounded and that foreign companies could launch work on their projects even before parliament finished considering and adopting concession legislation. However, it became apparent by early summer, as practical legislative work proceeded, that the legal changes that had to be made before PSAs could be legalized were of a far greater scope than anyone had realized. To open the door to PSAs, parliamentarians first had to incorporate pro-

found changes to numerous laws. Almost 50 legal acts, including drafts, had to be taken into account. The revisions presumably would encompass tax laws, including the Fundamentals of Taxation Legislation, the Law on the Tax on Profit, and the Law on Value-Added Tax, as well as the Law on Underground Resources, the Law on Foreign Investment, and other laws regulating foreign investors' operations in the energy sector.

The magnitude of the changes needed and the relatively dim prospect that they would ever actually be made meant that the proposed package of documents, even if adopted by the government, fell short of guaranteeing a level of protection that financial institutions considering participation in PSAs would deem adequate. Even passage of Presidential Decree No. 2285 by the Duma would not be enough to dispel investors' doubts. Under the Russian constitution, laws carry more authority than decrees—and far more than normative documents developed and passed as follow-ups to decrees. Consequently, in implementing PSAs, investors would run the risk of confronting some previously uncharted legal approach to investments in the energy complex. Incongruities in tax principles could prove particularly disastrous.

There are two possible solutions to this problem. The first is formal approval by the Duma of the presidential decree. This might satisfy investors, but could create a bad precedent for the Duma, since several dozen presidential decrees

Legal Highlights

Below is a list of the basic legislation related to production-sharing agreements.

- The Russian Federation Law on Foreign Investment (the government has been preparing and will submit a new version of the law to the State Duma later this year): In Article 40, it introduces the concepts of concessions and PSAs.
- The Russian Federation Law on Underground Resources (amendments were submitted to the Duma and adopted on first reading): It includes a taxation system for PSAs in Article 12.
- The Russian Federation Law on the Fundamentals of the Taxation System in the Russian Federation (the government prepared amendments that are to be submitted to the Duma this fall): This law defines the general taxation regime and provides a list of compulsory taxes not liable for exemption.
- Decree of the Russian Federation President No. 2285, On Matters Pertaining to Production Sharing in the Use of Subsoil, dated December 24, 1993: It outlines the general procedure for PSAs and related taxes.

The following draft laws and international legal acts, which may be adopted in the near future, also deal with production-sharing agreements.

- The draft Russian Federation Law on Oil and Gas (passed by the State Duma on first reading, but then encountered opposition from President Boris Yeltsin and Prime Minister Viktor Chernomyrdin): The law lays down production-sharing principles for oil and gas projects.
- The draft Russian Federation Law on Concession Agreements, Agreements for Provision of Services, and Production-Sharing Agreements Made with Foreign Investors (may be considered by the State Duma this fall): It introduces the detailed regulations for PSA applications and defines the procedures for PSA taxation.
- The draft Russian Federation Law on Production-Sharing Agreements in the Use of Subsoil (may be considered by the State Duma this fall): It comprises the fullest regulations for PSAs, their signing and their execution.
- A package of legally binding documents for the European Energy Charter, including a Treaty for the European Energy Charter (may be signed later this year): They legalize for Russia the international principles of PSAs.

were signed between September 21 and December 25, 1993, and it would be logical to expect that some additional decrees would acquire approval. Second is a presentation to the Duma of a particular draft law on PSAs based on the principles of Decree No. 2285. This document would supplement other, more general framework laws.

What's Yet to Come

Over the past several months, the work-

ing group charged with preparing a package of normative PSA documents concluded that in order to overcome this huge obstacle to attracting foreign investment, the State Duma must adopt a special law defining and regulating all the basic conditions of investors' activities and operations in carrying out production-sharing agreements. Independently of the interministerial commission, another group of experts, which included some specialists who had

worked under Deputy Minister of Fuel and Energy Vadim Dvurechensky on the Sakhalin-2 contract, came to the same conclusion. Work on the draft law began under the auspices of the State Legal Department.

The two teams of experts independently proposed the same process for legalizing production-sharing agreements in Russia: a presidential decree, followed by the enactment of framework legislation and, followed finally, by a package of normative acts. Since both the PSA law and the normative documents are to be based on the principles of the presidential decree, they will totally correlate with each other, creating a stable legal structure for the legalization and implementation of PSAs.

Both teams are nearly finished with work on their respective drafts. Before a round-table discussion to develop a cohesive approach to the PSA is held this month (see "Before the Main Event"), they will meet to remove any lingering contradictions between the draft law and the proposed package of normative documents.

Regional representatives already have discussed the package and, following a proposal from the Khanty-Mansiysk Autonomous District, added another normative document to the package, regulating the distribution between federal and local governments of the Russian portion of oil and revenues generated by the PSA.

In principle, the round table offers an opportunity to find a compromise that will become the fundamental prerequisite for concession legislation and for paving the way for foreign investment in the Russian energy complex. And if, in fact, a body of coherent, consistent, and cohesive legislation can be developed, its existence would open the energy sector's door to foreign investment.

Two Groups, One Version

The question arises: What will be the

Before the Main Event

Anticipating the heated debate among different social groups that the adoption of production-sharing legislation is certain to trigger, the interministerial working group and the Russian Union of Oil Entrepreneurs decided to provide an outlet for some of the emotion before the main battles over concession legislation take place in the Russian parliament. From October 17 to 19, the Union will hold a roundtable discussion in Moscow on production sharing, and has invited all the concerned parties: representatives of industries, regions, government, and the State Duma, as well as foreign investors. Several Duma committees and factions agreed to take part in the round table, which looks likely to become the forum for an unofficial parliamentary debate on the drafts before they reach the Duma.

The discussion, viewed as an essential precursor to formal consideration by the Duma, will focus on the draft law on PSAs and on the package of normative documents on production sharing prepared by the government working group. The package includes:

- Regulations on Procedures for the Signing and Execution of PSAs for the Use of Subsoil (with supplementary legislation: Duties and Authority of the Federal Executive Body as Related to the Organization of PSA Signing and Execution, and Procedures for the Functioning of an Association of Legal Entities without Establishing a New Legal Entity)
- Model PSA for Subsoil Use for Oil and Gas Prospecting, Exploration, and Production under Production-Sharing Terms

- Regulations on the Taxation Regime for the Execution of PSAs (with supplementary legislation: Obligations of PSA Operators, and Procedures for Issue and Customs Acceptance of Documents for Customs Duty Exemptions at PSA Execution)
- Instructions on Procedures for Reimbursement of Capital and Exploitation Expenditures at PSA Execution for the Use of Subsoil in the Russian Federation

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correlation between the draft law on PSAs and the package of normative documents, on the one hand, and the draft concessions legislation that is slated to be presented to the State Duma later this year, on the other?

Two drafts of a concessions law already have been prepared. Both are based on the draft Law on Concessions and Other Agreements with Foreign Investors passed by the old Supreme Soviet in July 1993 but rejected by the president. One of the versions was prepared by the Russian Agency for International Cooperation and Development (RAMSIR) prior to its dissolution and applies only to foreign investors. The other draft was prepared by the working group of the Duma Committee for Economic Policy and applies to both foreign and Russian investors.

The RAMSIR version was presented to the government on April 30. In early

September it was sent to the Ministry of Economy to be redrafted within one month.

At a meeting at Deputy Minister of Economy Vladimir Kossov's office on September 14, representatives of the related ministries and the Duma working group reached an agreement to prepare a joint framework version of the paper. It will be based in principle on the Duma working group's draft that applies to both Russian and foreign investors.

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