PETROLEUM REVIEW

IP THE INSTITUTE OF PETROLEUM

July 1994

AGM
David Varney becomes IP president

Gas
Will the Interconnector project get the green light?

Russia
Yuri Shafranik's views on his country's oil and energy sectors

Privatisation
Future privatisation plans may meet rough path

External financing priorities for the Russian oil industry

By Dr Andrei A Konoplyanik

The Russian oil industry has been passing through a difficult period of development. One of the most effective ways to achieve stabilisation could be to encourage foreign investment. What are the major forms of external financing?

Three major forms of external financing for the energy sector in Russia can be considered – technical assistance, hard currency loans and direct foreign investments.

Technical assistance

Technical assistance has been allocated usually by the governments of Western countries and by the international financial institutions. This explains why it is not aimed basically at purely commercial results but is oriented mainly towards the acquisition of system transformations in the economy of the recipient of such aid.

In my view, technical assistance should not be considered as an important source of finance for energy projects in the same way as loans or direct investments. But it can be directed at the realisation of the pre-investment phase of such projects and also at the spread of market-type ideology by the recipient country (for instance, through the organisation of conferences and seminars).

Hard currency loans

In credit policy the major emphasis should be paid to the transition from debt financing to project financing, where loan repayment will be guaranteed not by the recipient government but by the project itself and its economic attractiveness and creditworthiness.

Recently, the Ministry for Fuel and Energy of Russia has been developing 13 major foreign credit projects valued at over $10 billion of which eight credit projects valued at over $5.7 billion are to be channelled to the Russian oil sector (see Table 1). The opening of the financing for the majority should take place this year – financing for the World Bank/EBRD/Netherlands's Oil Rehabilitation Loan opened last November.

Because of the excessive risks in the Russian business climate and the fall in Russia's rating as a borrower on the international financial market, we might succeed in attracting foreign loans firstly from international financial institutions and the state financial bodies of industrially developed countries but less successfully from private commercial banks.

That is why the first major credit project that we were seeking to start during the 1993-94 'winter weather window' was the so-called 'Oil Rehabilitation Project' of the World Bank and other co-financiers. This aims to provide three Russian oil production associations (Kogalimneftegas, Variegannef-tegas and Purneftegas) with loans to finance the import of equipment for the revitalisation of the idle oil wells, the utilisation of associated gas and the reconstruction of oilfield gathering lines.

This loan is one of the first 'new-type' credit projects in Russia. It demands a sovereign guarantee from the government of Russia but in its internal organisation this loan has been structured using a project-financing approach. Thus, the World Bank's Oil Rehabilitation Project can be treated as an intermediary form of foreign loan and as a step towards a project-financing approach.

In my view, the Oil and Gas Framework Agreement, signed with the US Exim-Bank, is another strong step forward in the same direction. This agreement aims to provide $2 billion or more in the form of direct loans and/or loan guarantees to oil and gas production associations and refineries in Russia to help to finance the import of US goods and services. A general framework has been defined according to which individual projects should be incorporated into this agreement.

The selection of projects will be organised on a project-financing basis. Particular projects will be undertaken on the basis of the individual model agreements in the 'Oil and Gas Framework Agreement'. This agreement will represent an intermediate stage in the change-over from debt financing to project financing (see **Table 2**).

Direct foreign investments

Until now practically the only legal form for direct foreign investments in the USSR/Russia was a joint venture (JV) organised in a special Soviet/Russian style. The experience of the last five years proves that this form of relationship between a host country and potential investors is not the most effective model for mining industries including oil and gas extraction. That is why we are trying now to adopt the traditional form of international petroleum agreements that have proved their practicability over time.

Particular forms of oil and gas production agreements are defined by the priority and time-horizons of the tasks to be solved.

The top priority task from the short-term point of view is to halt the decline in oil production. This requires the revitalisation of idle oil wells. These totalled over 32,000 in the second

TABLE 1
LIST OF FOREIGN CREDIT LINES

Donor country/Head financial agency	*Credit value $ billion*	*Other donors participating in the credit line*
World Bank		
1. Oil Rehabilitation Project	866.3	EBRD, government of the Netherlands
2. Second oil project	1,000	...
3. For critical import for the coal-mining industry (within the framework of the 'Rehabilitation Loan' for the Russian Federation)	50	-
4. Project on associated gas utilisation	1,300	-
European Bank for Reconstruction and Development		
5. For rehabilitation of idle wells	300	
6. Project on gas-distribution network development and gas-saving	550	Ruhrgas, International Financial Corporation
USA (Export-Import Bank)		
7. Oil and Gas Framework Agreement	2,000	-
8. On equipment purchase for Russian oil industry with Lafkin company	100	-
Canada		
9. On equipment purchase for Russian oil industry	54.2	-
Japan (Export-Import Bank/Ministry for International Trade and Industry)		
10. On equipment purchase for Russian gas industry	700	-
11. On equipment purchase for Russian oil industry	700	-
12. On equipment supplies by Mitsui company to LUKOIL	700	-
Italy (SACA Export-Import Agency)		
13. On equipment supplies for the reconstruction of gas pipelines	1,700-2,000	-

quarter of 1993 – more than one-fifth of the total production wells. With an average daily oil yield of not less than 8 tonnes per well, the total annual volume of non-produced oil reaches about 40 million tonnes.

Because of the comparatively low cost of repair and revitalisation ($80-100,000 per well) the pay-back period is fairly short, making it more attractive for foreign capital despite the heavy taxation in Russia.

Western investors (and what is very important – small and medium-sized firms) can be involved here by means of pure service contracts. But generally it will be more attractive for this country and its production associations to obtain hard currency loans to finance purchases of necessary equipment to be maintained by the domestic producers themselves. The repayment of the loan in this case can be guaranteed by prospective export earnings of a portion of the incremental oil. This approach has been used in a series of loans being developed by the Ministry for Fuels and Energy (see **Table 1**).

In the medium term oil production can be stimulated through the large-scale development of already proven fields which have not been yet developed through lack of funds. There are about 450 such fields with a maximum potential producing capacity of about 90 million tonnes a year. Foreign companies have been and would be involved in their development on a competitive and risk basis. The guarantees for repayment of their investments would be provided by the right to export part of the oil produced.

TABLE 2
Evolution of organisational forms in providing Russian energy sector with external financing

Yesterday	Debt financing
Today	Technical assistance Hard currency loans - debt financing - framework agreements Project financing
Tomorrow	Project financing

The Presidential Decree N 1403 of November 1992 on the details of the privatisation of fuel and energy enterprises provided foreign investors with the legal opportunity to reinvest their profits into the stocks of newly created Russian joint-stock oil companies and privatised enterprises in the domestic oil business.

The licence for resource management can be provided to the foreign company that wins the tender. But in the case when the licence for a discovered field has been already given to the corresponding Russian company or production association, the foreign company might (should) create a JV with that Russian licence holder. Such an experience has been demonstrated recently during the first Khanti-Mansi tender.

The new, different approach provides foreign investors with the opportunity to participate in the development of not only marginal fields and areas but also in the development of high-productivity fields and prospective territories (such as Priobsky field in the Khanti-Mansi region). This will provide an opportunity to speed up development of and production from those fields and maximise economic rent collected for the Russian state.

In this area of cooperation the foreign partners are likely to be major vertically integrated oil companies. The major form of their participation in the field development should be joint operation agreements (JOAs) and different forms of risk contracts. In my view, the most attractive for Russia among the latter would be a production-sharing contract (PSC).

At the same time, in the majority of cases, it is not so much an equity-participating foreign investor for joint production that is needed. It will be preferable for the Russian licence holder to sign a loan agreement, structured on a project-financing basis, with a financial institution (see **Table 3**).

In the long term the downward trend in oil production can be halted only through exploration and development of prospective oil provinces. The dominant forms of contract for foreign investors should be mainly risk contracts. Again as in the earlier instance, the most attractive type of such contracts should be a production-sharing agreement which allows the allocation of all costs and risks to the foreign partner and provides repayment of these costs from the oil produced (see **Table 3**).

Until very recently there was no diversified legal basis for the implementation of production-sharing agreements in Russia. Their legality was only mentioned in the law 'On the Subsoil

TABLE 3
ENERGY POLICY CONCEPT FOR DIRECT FOREIGN INVESTMENTS INVOLVEMENT INTO THE RUSSIAN OIL INDUSTRY

Time-horizon	*Major activity for activity*	*Potential for cooperation*	*Potential foreign counterparts; prospective forms of external financing*	*First incremental oil expected*
Short-term	Revitalisation of idle oil wells	>32,000 idle wells Annual non-produced potential: - 90 mtoe (theory) - 40 mtoe (practical)	Small and medium oil-producing and service companies (pure service contracts); equipment producers and suppliers(purchase contracts); financial institutions (hard currency loans)	In some months
Medium-term	Development of already proven fields	450 fields Maximum production capacity 90 mtoe/year	Major oil firms and consortiums of large, medium and small firms (JOAs, risk contracts – mainlyproduction sharing); financial institutions (hard currency loans)	In 3-5 years
Long-term	Exploration and production in new prospective areas	19 tenders and auctions until now, incl.: - tenders: Sakhalin II & III, Khanti-Mansi, Tomsk; - auctions: Komi, Khanti-Mansi, Magadan	Major oil firms and consortiums of large, medium and small firms (JOAs, risk-contracts – mainly production-sharing)	In 8-10 years

Resources' but corresponding regulating procedures did not exist. On 24 December 1993 the Presidential Decree N 2285 'On Production-Sharing Agreements' was signed which clarified some basic principles of their implementation and gave an order to the government for preparation of the corresponding regulatory procedures. At present a package of such legal documents has been drafted including a model agreement, regulation of its preparation and implementation and some other documents legalising not yet clarified questions related to PSCs.

In accordance with the law 'On the Subsoil Resources', the issue of licences for the right of the utilisation of the subsoil resources, and thus the involvement of foreign investors in exploration and development of new fields, should be carried out on a competitive basis. Tender practice to date is limited but the tendering process has been developing. Six tenders and auctions both for the development of already proven fields and for exploration and development of new prospective territories have already taken place (see **Table 4**). Another 13 tenders and auctions have been started or are being developed, including such major ones as Sakhalin III, second Khanti-Mansi, Tomsk and Magadan. In this manner, through the system of tenders and auctions, foreign investors are gaining access to the exploration and development of Russian oil and gas resources.

Conclusion

The results of the December 1993 elections for the new Russian Parliament and the subsequent recent changes in the Russian government could significantly slow down the process of foreign investment involvement in the Russian economy and its oil industry. But nevertheless, if that slowdown or even an outflow of foreign capital from Russia takes place, some time will pass (two to three years presumably at the worst scenario) and Russia will then again open its energy economy to foreign investments. At that time the above mentioned priorities for its external financing will still be, in my view, basically the same.

TABLE 4
OIL AND GAS TENDERS AND AUCTIONS

Year	*Russian region/ FSU republic*	*Tender or auction**	*Field name*	*Foreign companies - the winners*
1991	Azerbaijan	Tender	Azeri	Amoco, etc.
1991	East Turkmenia	Auction	...	Bridas
1992	Kazakhstan	Tender	Karachaganak	Agip, British Gas, etc.
1992	Komi Republic	Auction	...	Occidental
1992	Sakhalin-II	Tender	Piltun-Astokhskoye, Lunskoye	Marathon, McDermott, Mitsui, Shell, Mitsubishi
1993	Hanti-Mansi Autonomous	Tender	11 fields	Amoco, Shell, Urals-ARA
	District	Auction	3 blocks	Surgutneftegas, 'Rosa Mira'

* Tender – for the right of development of already discovered fields; auction – for the right of exploration and development of prospective territories