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Former Deputy Minister of Energy on the President's Production-Sharing Decree

Unwrapping Yeltsin's Gift

By *Andrei Konoplyanik*

On December 24, 1993, President Boris Yeltsin gave foreign investors a Christmas present: He signed Decree No. 2285, On Issues Pertaining to Production Sharing in Subsoil Utilization. The decree heralded a new economic and legal relationship between Russia and potential investors, giving legal effect to a number of crucial provisions that will enable the signing and implementation of production-sharing agreements. The following article examines several key provisions of Decree No. 2285 and assesses the additional opportunities it offers foreign investors.

The need for adequate legislation governing the development of Russia's natural resources has long been obvious. Current Russian laws—including those on foreign investment, underground resources, and concessions—not only dif-

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fer in their treatment of certain key aspects of this subject, but also do not contain detailed regulations dealing with the signing and approval of production-sharing agreements (PSAs), clearly the most sensible form of cooperation between Russia and prospective investors, including foreign oil companies.

President Boris Yeltsin's December decree on production-sharing agreements represents a first attempt to create a legal framework for attracting Russian and foreign investment in the energy industry using PSAs.

The decree contains many benefits for Western investors. Among the most important are a provision reducing the number of taxes that must be paid by both foreign and domestic companies and a clause stipulating that consortia of legal entities, rather than having to create a new legal entity, may sign such agreements themselves.

Equally important are the provisions that contain guarantees against adverse legal changes in Russia, echoing principles introduced last year, including those contained in Yeltsin's "grandfather clause" decree, No. 1466, On Improving Work with Foreign Investment, signed on September 27, 1993.

Licensing Practices

In addition to sanctioning the traditional practice of establishing one of the consortium members as the operator, the decree also provides a legal basis for

a consortium to set up a special non-commercial operator company. In both cases, the license issued to the operator specifies that it is acting on behalf of all of the consortium members listed on the title sheet of the license.

This provision proposes a solution to a problem that arose with regard to MMMMS, when each consortium member sought its own license even though, according to the Law on Underground Resources, only one legal entity may receive a license.

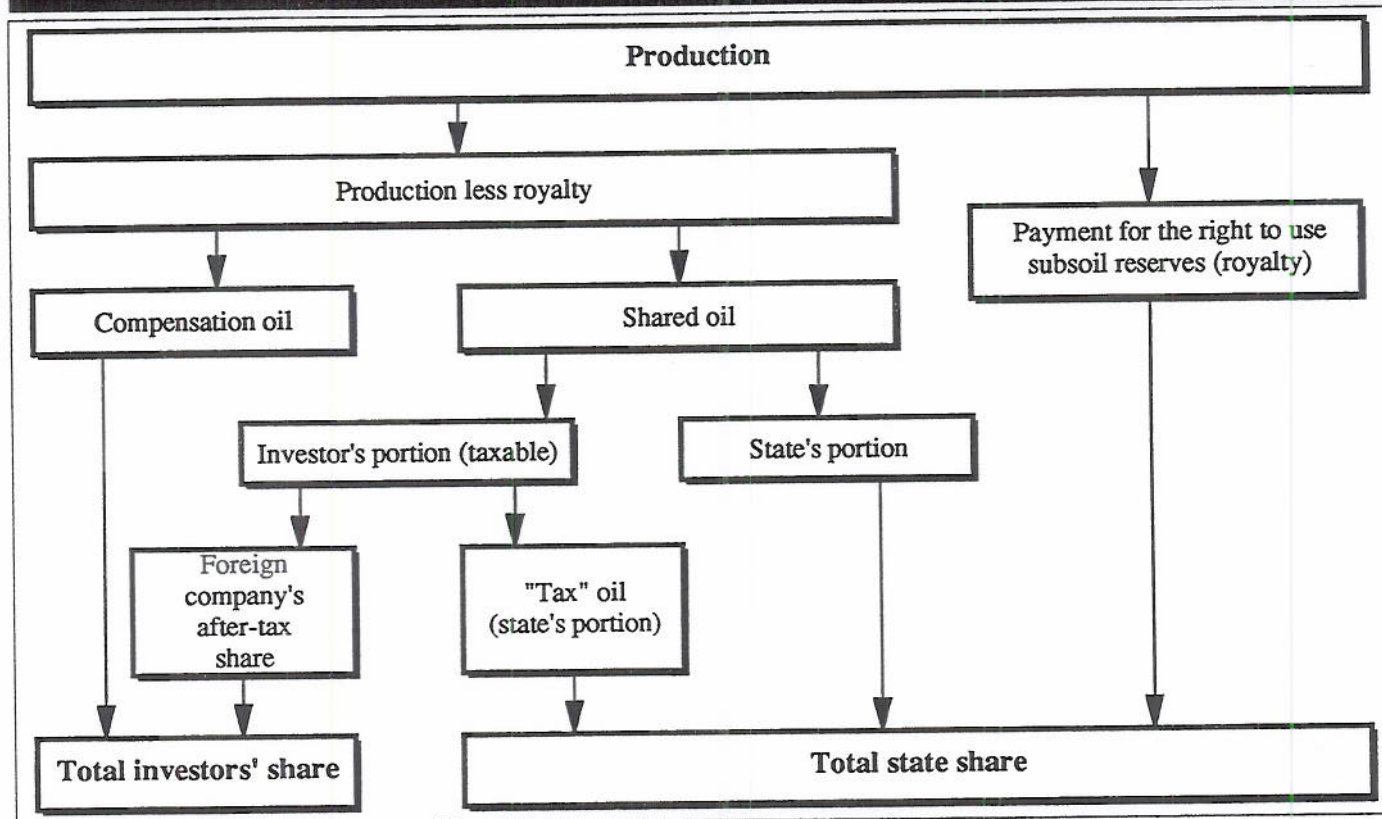
The decree also established a mechanism for the distribution of mineral resources (or their value equivalent) between the federal and regional governments. It calls for this distribution of resources to be agreed upon on a contractual basis between these governments, and stipulates that this agreement is not to be included in the PSA signed with the investor.

Thus, the decree eliminates situations such as the one that occurred during the preparation of a production-sharing agreement with Texaco. In that case, the distribution of after-tax "profit oil" between the Russian Federation, as owner of the Timan-Pechora subsoil, and Arkhangelskgeologiya, the subcontractor, was part and parcel of the production-sharing agreement itself, rather than the subject of a separate contract between the two parties. The decree also establishes procedures for exporting production belonging to the investor (Section 7), eliminating any confusion that currently exists.

POSSIBLE OPPONENTS OF DECREE No. 2285 AND THEIR LIKELY ARGUMENTS

Possible opponents	Likely arguments	Counter-arguments
In Government: <ul style="list-style-type: none"> Fiscal Ministries 	Leads to a reduction of budgetary revenues	Theoretically, yes. In practice, however it will enhance revenues, strengthening projects' viability.
In Parliament: <ul style="list-style-type: none"> Nationalists 	Constitutes sell out of the country	The decree creates equal opportunities for domestic and foreign investors under government supervision.
<ul style="list-style-type: none"> Industrial Lobbies 	Does not properly safeguard the interests of Russian subsoil users and domestic industries	The decree ensures equal rights of Russian subsoil users with foreign companies in the spheres where such rights were infringed. By creating the same "rules of the game" for all, the decree encourages domestic subsoil users and industries to raise efficiency and competitiveness.
<ul style="list-style-type: none"> Regions 	The decree was not agreed upon by the regions	The president acted within his powers. The decree defines the mechanism enabling regions and the center to exercise their equal rights. It does not seek to reallocate these rights or contract the center and regions.

DISTRIBUTION OF OIL PRODUCED UNDER MODEL PRODUCTION-SHARING AGREEMENT



Accelerated Depreciation

Another important element of the decree is the treatment of fixed assets created in the course of operations under a PSA (Section 9). After much debate among the drafters of the decree, it was decided that such assets will remain the property of the investor. Despite numerous arguments that these assets should be transferred to the state, the position that doing so ultimately would hurt Russia's revenues prevailed.

The logic behind the decision was as follows: If the investor knew that fixed assets would eventually be transferred to the state, there would be strong pressure to write off capital expenditures as quickly as possible. Accelerated depreciation would cause operating costs to grow at early stages of the project, which consequently would delay the state's receipt of its share of production as more crude would have to be given to the foreign side in order to reimburse it for its costs.

The authors of the decree also concluded that the state is unlikely to need all of the fixed assets that would be created in the course of implementing production-sharing agreements. It would, therefore, be more prudent to use the revenues that would otherwise be turned over to the investor to purchase whatever equipment and technology were required.

Tax Breaks

One of the decree's major advantages for foreign oil companies operating in Russia is the simplified tax structure it establishes. The tax regime currently in force in Russia is a cumbersome system consisting of 47 different federal, regional, and local levies, although oil-producing enterprises must pay only about half of them.

Under these circumstances, the investor has only one, very unreliable way of implementing projects: to "battle" for individual tax exemptions. That often creates a vicious circle, with the investor trying in vain to find a way out.

Documents to Be Drafted by the Ministry of Fuel and Energy

Document	Deadline
Model Production-Sharing Agreement	April 1, 1994
Regulations on Federal Agencies Representing Functioning of Associations of Legal Entities without the Establishment of a New Legal Entity (Consortia and Others)	May 1, 1994
Regulations on Federal Agencies Representing Executing Production-Sharing Agreements	May 1, 1994
Regulations on Federal Agencies Representing the Interests of the State in Production-Sharing Agreements	June 1, 1994
Instruction on Accounting for Capital Investment and Current Expenditures in the Course of Implementing Production-Sharing Agreements	June 1, 1994
Methodological Recommendations Concerning Formulation of Terms and Conditions of the Production-Sharing Agreement	July 1, 1994

Fortunately, Yeltsin's decree contains a mechanism that can sever this loop by replacing all of the mandatory payments with only three: tax on profit, payments for the right to use underground resources, and the allocation of a portion of produced crude to the Russian side.

What Next?

To become fully legitimate, the presidential decree must be approved by the Russian parliament. Although many observers and quite a few parliamentarians doubt that the parliament will get around to approving it anytime soon, the situation is not as desperate as it may seem. By virtue of its recognized nonpolitical nature, Decree No. 2285 may well receive the blessing of both the Duma and the Council of the Federation (parliament's upper chamber) before too long.

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