



FSU ENERGY

# Decision Brief

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## PRODUCTION SHARING AGREEMENTS LAW WHAT REALLY HAPPENED IN THE FEDERATION COUNCIL ON OCTOBER 3—AND WHAT'S NEXT?

by Dr. Andrey Konoplyanik

### Summary

On October 3, 1995 the Federation Council (The Russian Parliament's Upper House) rejected the PSA Law because of disagreements with certain provisions, returned it to the State Duma, and set up a conciliation commission which is supposed to fine-tune the law. Given impending elections and the present composition of Parliament, the chances of a successful re-vote by the Duma are very slim. That being so, the trail-blazing law is unlikely to be passed this year, nor if the parliament should swing to the left following the December elections, is it likely to be passed in the coming years. At the same time, the high priority assigned to the PSA Law by Russia's top leadership and the procedural transgressions at the time of the vote on October 3 put the Federation Council in a position to see through the never-completed procedure of in-absentia voting by written ballot slips, which will effectively ensure approval of the law by Parliament's Upper House. Thereafter the Russian President is most likely to sign the law without further delay.

The ongoing battle for investor-friendly legislation in the Russian Federation underwent another round at the beginning of October, with the defeat of the Production-Sharing Agreement (PSA) law in the Federation Council. While many potential investors recognize that the current law was far from perfect\*, a delay in its passage is seen as a major setback for foreign investment in the Russian oil sector.

Andrei Konoplyanik, a driving force behind the struggle for PSA legislation in Russia, has provided some key insights into the October 3 vote. These observations from an insider who was instrumental in the drafting of the law as it currently stands, illustrate how PSA legislation has been caught up in the struggles in Russian politics as the election season arrives.

CERA has reproduced Dr. Konoplyanik's thoughts on the subject of the PSA Law in conjunction with Akin, Gump, Strauss, Hauer & Feld, with whom Dr. Konoplyanik has been cooperating for a number of years.

\*See the CERA Private Report, *Dream Law or Deal Killer? Russian PSA Legislation*.

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**Cambridge Energy Research Associates**

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The domestic and foreign investors, as well as most of Russia's regions, had been looking forward to the autumn session of the Federation Council: one of its first meetings was to announce the count of the summer vacation's ballot by mail on the PSA. The Law, which was approved by the Duma in June, establishes legal stability and a favorable tax climate for long-term capital-intensive investment projects, which understandably, are in no position to attract ready and willing investors today. The Law places the State (government) and the investor on an equal footing in terms of their respective rights, and contains what today may be referred to as "revolutionary" provisions, that could open the floodgate for domestic and foreign investments into the Russian economy.

### The Voting Procedure

The PSA Law elicited a heated discussion in both Houses of Parliament, the Duma and the Federation Council. Therefore, mindful of the vital importance of the Law for attracting foreign investment and revitalizing the Russian economy, on July 27 the Federation Council ruled to conduct a summer vote by canvassing (by mail) in order to enable *all members* of the Federation Council to express their volition.

However, the Counting Commission, established for this purpose had not had a session in two months, and so had not approved the format of the ballot slip, which it ought to have done according to the House Rules. Nor had the Commission mailed or subsequently collected or processed the voting slips. It was only on September 26 that the administrative Secretariat of the Federation Council dispatched the voting slips to the deputies (or senators) and insisted that they be back by October 3, which under the circumstances was technically impossible. However, under the pretext that only 40 or 50 voting slips had allegedly come back to the Federation Council by the time of its first session, and that "the Counting Commission need not ever bother to count," the Speaker of the Upper House, Vladimir Shumeiko, in his formal announcement described the ballot by mail as "not having taken place."\*

Finally, without allowing time for all the voting slips to reach the Counting Commission, on the same evening the members of the Council decided to call what can safely be described as an emergency vote (in the Speaker's words: "while they are making copies of the Committee's opinion and of the crime controlling ruling..."), which in fact amounted to restricting the vote to just the available members of the Federation Council (71 members were unable to participate in the ballot).

The "mail-in" vote was never contested, the voting slips actually received were never claimed to be null and void. Therefore, today two "legal" vote counting procedures are in effect, of which one—the "mail-in" questionnaire—was never completed.

### The Result of the Two Ballots

On October 3, the law's proponents were only 27 votes away from carrying the law (with 64 ayes, 41 nays, and 4 abstentions). Therefore, 59 percent of the 109 voting deputies who voted that day were in favor of the law. Of equal importance, the voting procedure itself was preceded by Shumeiko's unambiguous and pointed remark about "being in two minds" with respect to the law. "On the one hand, Russia's immediate interests call for approval of the law, since it would facilitate foreign investment and consequently replenish the federal budget. However, from the perspective of Russia's long-term interests

\*Here and elsewhere quotes are from the session's transcript.

**A. KONOPLYANIK**, Ph.D., Economics is the head of the drafting group for the PSA Law, Advisor to the Ministry of Fuel and Power, Advisor to the Ministry of Finance, and to the State Duma's Committee for Economic Policies (Subcommittee for foreign activities and foreign investment).

I wouldn't risk approving it," said Speaker Shumeiko, who had voted "in favor" in his voting slip, but showed an abstention on October 3. Following this admonition, some of the senators automatically voted against the law, 7 of whom (4 against and 3 abstentions) had voted in favor in their voting slips.

If voting slips had been used properly and consistently, the action by the Speaker would not have been possible, and the results of such a roll-call vote, had it been seen through to completion, would undoubtedly have been totally different. To illustrate:

- of the 61 slips which had arrived by October 3 but were never claimed or processed, 53 were in favor (or 87 percent), only 5 against and 3 abstentions
- 14 persons who had earlier voted in favor in their voting slips did not participate in the October 3 vote, with the result that their votes, already cast in favor of the law, were not counted.

Therefore, an unjaundiced analysis of the two "incomplete" votes by the senators suggests that the law's proponents almost had the 91 votes required to pass the law (let me emphasize again that the vote by questionnaire had effectively commenced but was never legally completed: the votes of only one third of the senators were counted by mail, and only 60 percent of the senators participated in the October 3 vote).

Here is a tally of the favorable votes:

- the 64 votes in favor of the law from the October 3 vote,
- the 14 votes which did not participate in the October 3 vote but voted in favor of the law in their slips,
- the 7 slips originally in favor of the law but subsequently "lured to the other side of the counter" by the Speaker on October 3.

To summarize: of the 126 persons who participated in the two votes, 85 or 67 percent voted in favor of the law. If it had not been for the Speaker's inopportune preamble, the number of favorable votes cast by the participants in the two voting procedures would have been still greater (by at least about 10 persons).

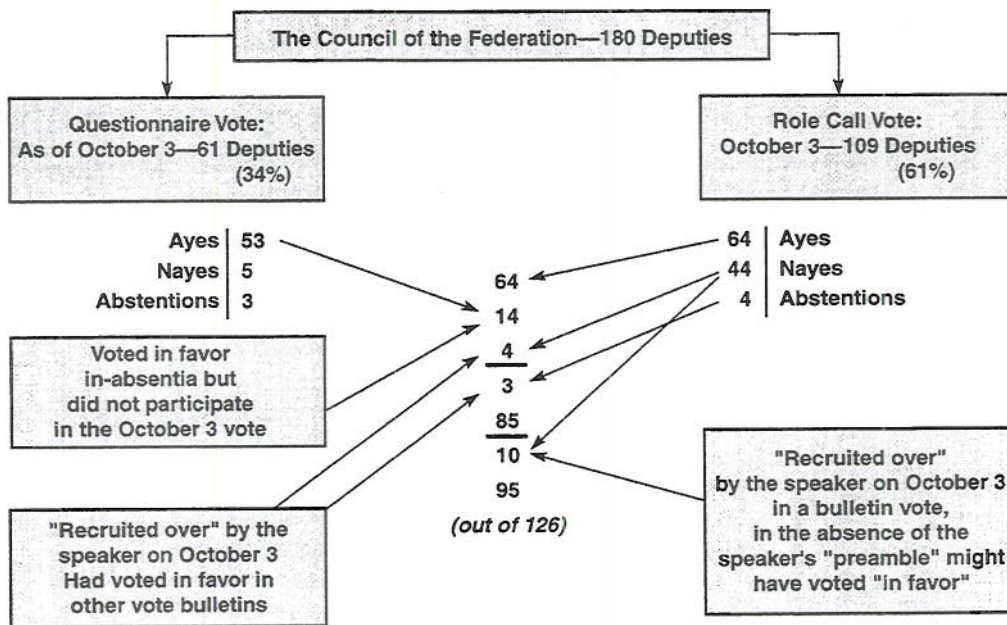
It would appear that the above statistics in themselves provide unprejudiced evidence of a realistic acceptance of the PSA Law by the Russian Parliament's Upper House. Most of the senators had succeeded in understanding the law's worth. Therefore, if the ballot by questionnaire had been completed, the law would have been carried with a sizable margin of "in favor" votes (see Figure 1).

### **The Role of Mr. Shumeiko, the Upper House Speaker**

In these circumstances, having been forewarned just before the fall session by the preliminary results of voting by questionnaire, the law's opponents had only one last hope, and that was to steamroller the ballot by questionnaire, and to have the law voted on by the available senators with a precarious quorum margin. If the quorum maneuver were to succeed, even the vast majority of supporting senators would have fallen short of the crucial 91 votes. That was exactly what happened on October 3.



**Figure 1**  
**The Council of the Federation:**  
**The Results of the Two Votes on the PSA Law**



Source: Cambridge Energy Research Associates.  
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In the early afternoon of October 3, senator Yuri Shafranik, Minister of Fuel and Power, who was to be flown to Chechnya that same evening, had received every assurance that the results of the ballot by mail on the PSA Law were not on the agenda of the October 3 session. However, actual events proved different.

Why, then, did Shumeiko present to the Upper House so distorted a view of the subject? Why did the opinions and arguments offered by the law's many advocates remain unheeded by the Speaker as he was fine-tuning his position on the PSA Law, a view which he chose to share with the senators just a few moments before the vote on October 3?

Claims of Shumeiko's unswerving conviction that the PSA Law runs counter to Russia's long-term interests do not hold water.

First, the law's approval was preceded by thorough and open discussion of possible implications of the law's approval for Russia's economy. The discussion demonstrated irrefutable *long-term* benefits of the PSA Law for Russia.

Second, the Speaker's split-second transformation occurred only hours before the fall session, and after he had handed over his mail-in voting slip (which he had not received until after September 26). Shumeiko's voting slip indicated he was "in favor" of the PSA Law.

### Version One—The PSA Law Runs Counter to Russia's Long-Term Interests

Even under cursory examination this version appears trivial.

The PSA Law had taken 18 months to draft. During that time it had been passed through a grueling screening procedure involving examination by Russian and foreign experts, and by many of the world's leading legal and consulting firms. Over two hundred comments and proposals had been received, most of which were supportive and came from the executive and legislative bodies of practically all of the Russian Federation's 89 constituent entities. Those proposals not at variance with the law's philosophy were incorporated into the draft law. The broad discussion of the law demonstrated that its opponents' counter arguments could easily be dismissed and in fact were refuted by our drafting Group's open discussions in the press and at numerous conferences and workshops. And even the law's principal opponents in the State Duma (Mr. Surenkov and Mr. Podmazko of the Natural Resources Committee) and in the Federation Council (Mr. Boldyrev and Mr. Titkin of the Budget Committee) while disagreeing with certain basic provisions of the PSA Law, recognize that it needs to be enacted as soon as possible.

The deputies who really tried to understand the law's underlying concept realize that the very economic philosophy of the PSA defeats the claim that the law will only promote Russia's short-term interests, since under PSA most of the money will come to the government budget after the investors have paid the lump-sum bonuses—initially from placement of orders with Russian industries and taxes from the Russian manufacturers of oil field equipment, and later, with production of mineral resources underway—from royalties, profit tax, and the government's split of produced mineral resources.

The deputies, particularly those representing the oil and gas regions, realize that delayed approval of the PSA Law is costing the Russian economy many billions. The investment into the few initial Russian/foreign oil and gas production sharing projects currently under review (Priobskoye Prirazlomnoye, several on Sakhalin, Timan-Pechora, Kharyaga, and others) is estimated at 7 to 8 billion US dollars annually, with about 70 percent of the investment expected to be injected into the Russian manufacturing industries as orders.

The vigorous educational campaign mounted by our Group at the time of the drafting of the law and its approval by the Federal Assembly was designed to demonstrate to the deputies that the PSA Law will benefit not only the "raw material," but also the "machine-building" regions, because the earliest investment furnished pursuant to the PS agreements will be in support of manufacturing of equipment to produce and process mineral resources. Moreover, the government's aggregate income from the "machine-building" regions may be equal to, or greater than (sometimes by a factor of 1.5 or 2) its income from "oil" regions.

It had been repeatedly explained to the deputies, both in the press and via personal contacts, that several early PSA projects alone (which will use dedicated financing not requiring government guarantees) may bring in the kind of investment already in excess of the country's IMF loans, which the Government spent so much time and effort "fighting for."

Therefore, Shumeiko's admonition does not *reflect* the opinion of most of the deputies. Many of the deputies cannot but be well aware of the *long-term* economic benefits Russia can derive from enactment of the PSA Law.



## Version Two—Confrontation Between Major Financial Groups

This version links the events of October 3 to the “confrontation between major financial groups seeking to receive as security the government’s packages of stock issued by Russia’s major companies.” It is being claimed that “certain potential ‘security holders’...believe that the failure of the PSA Law is nothing but yet another round of high-yield speculation involving government assets.”\*

This version does not appear based on fact either.

I suspect this version was “free-kicked” to the media by some in the oil circles, the kind that are close to the oil companies that not only found their names on the “securities” lists, but whose government packets of stock are slated to serve as the government’s participating interest in certain commercial financial structures. If such financial groups were to acquire the reputation of being instigators and perpetrators responsible for running the PSA Law into the ground, the Government, which today apparently supports approval of the PSA Law, would refrain from offering its stock in oil companies as its participating interest in such financial groups’ equity.

The following counter argument can be offered:

First, the PSA Law directly helps the banking community by creating the legal foundation for dedicating financing of investment projects in the mineral resource sector.

Second, it should be remembered that Russia’s largest banks (which are capable of impacting the decision-making process in the corridors of power) seek to be as diversified as possible. They want to be part of dedicated project financing and to be present on the stock market of the privatized enterprises. It means that by seeking an immediate coup-de-grace on the stock market by helping torpedo the PSA Law, such financial groups are killing their long-term business opportunities on the market of dedicated financing.

Third, the claim that the failure of the PSA Law was engineered to stir up the oil stock market and to make a bundle appears somewhat far-fetched. The stock of the companies engaged in PSA will only begin to climb when the projects to be mounted by such companies are supported by the required financing. And that would take the passage of the PSA Law.

Finally, one of the responses to the PSA Law discussion came from the Association of Russian Banks, which emphasized the banking community’s natural interest in the early passage of the PSA Law. Therefore, the short-term make-a-quick-buck interests of certain banks (if such banks do exist, that is) come into obvious conflict with the corporate interests of the entire banking community. And failure to observe corporate interests may cost violators more than just a few pennies.

Some other so-called “objective versions, for example, linking the events of October 3 to the alleged attempts to bring pressure to bear on the IMF for credits to compensate for the lack of investments that became unavailable when the PSA Law was rejected, are so obviously built on sand that there is no need to either describe them in detail or to try to analyze them.

Therefore, none of the “objective” versions for explaining away the results of the senator’s vote can hold water. And the Federation Council’s rejection of the law can only be rooted in personal agendas.

\*R. Narzikulov. Production sharing caught in the forging press of stock sharing—in “Segodnya,” October 10, 1995, p. 1.



### The Position of the Speaker: Two Possible Versions of His Change of Heart

There are at least two versions explaining why the Speaker “dexterously maneuvered the voting procedure towards assured steam-rolling of the law, which is known to have more supporters than opponents in the Upper House.”\*

#### *Version 1: Pressure from Highly Placed Officials*

The Speaker modified his position because he had sided with a group of highly placed officials from the President’s Administration and the Government headed by Anatoli Chubais, a group which since August had brought a lot of fiscal and institutional pressure to bear on oil and gas companies (by maintaining high oil export tariffs, accusing Gazprom of making super profits, trying to set up a Federal power company, etc.)\*

This version cannot be accepted for the following reasons:

- **First**, higher fiscal pressure on the oil and gas complex is designed to re-distribute in favor of the government budget and the already existing income of the oil and gas industry. The PSA Law, if approved, will create an additional avenue for increased cash flow to the government budget through a broader tax taxable base (a larger number of money-making projects). In that sense the law meets, rather than runs counter to, the interests of replenishing the credit part of the government budget.
- **Second**, Chubais, who is alleged to be the ideologue of such pressure on oil and gas men, repeatedly and unequivocally demonstrated a very good understanding of the PSA Law’s significance for Russia’s economy and expressed his “official support.” More particularly, on July 3, just before the law was put up for discussion by the Federation Council’s Sectoral Committees, he signed the Government’s positive opinion of the law, thus putting an end to idle conjecture and allegations that the Russian Government is undecided about the law and is about to support the “alternative” version of the PSA Law submitted to the State Duma in early January 1995 on behalf of the Russian President and rejected by the State Duma on February 21.
- **Third**, the claim that rejection of the PSA Law by the Federation Council involved top officials from the President’s Administration and the Government may be based on the fact that representatives of the two above agencies were involved in drafting the “alternative” version of the PSA Law that was rejected by the Duma upon the first reading on February 21. However, the pretext of “getting even” does not appear feasible, particularly in light of the fact that the Russian Government and the Russian Federation’s President are on record as unconditionally supporting the PSA Law as it is. This support has been reinforced with numerous public statements by
  - a) A. Lifshits, economic advisor the Russian Federation’s President;
  - b) V. Kossov, deputy Minister of Economics, official representative of the Government for the PSA Law;
  - c) Yu. Shafranik, Minister of Fuel and Power, and official presenter of the Law to the Federation Council on behalf of its sectoral Committee (on economic reform, of which Shafranik is a member as a senator), and by
  - d) the above letter on behalf of the Government and signed by A. Chubais.

\*R. Narzikulov. Some Speakers prefer deferred demand—in “Segodnya,” October 6, 1995, p. 1.



### *Version Two—The Most Likely One—“Personal Career Motivation”*

It is entirely possible that Mr. Shumeiko will only retain the position of the Speaker of the Federation Council until the December elections, and so his only bet is to use the remaining two months to demonstrate to all interested persons and organizations his ability to swing the Federation Council's decisions his way.\* In other words, the Speaker's behavior is being attributed to his pre-election drive for “the image of a public figure influential enough to impact major political issues;”\*\* and, therefore, for a strong “negotiating position.” Shumeiko “knows only too well that...early legalization of production sharing will be on the agenda of the forthcoming Russian-American summit scheduled for this month ...naturally a lot will depend on the Speaker's position, which is subject to evolution.”\*\*\* In that situation the PSA Law would be the most convenient bargaining chip to negotiate a comfortable post-deputy life.”

In analyzing the available versions “by elimination” or “by assuming the opposite,” I have to recognize that the last version is the most likely one. But if it is, the Speaker is very likely to turn around and rejoin the PSA Law's supporters, of whom he was one up until the very last days of September.

The arguments below suggest that it is not impossible that the Speaker may in fact modify his “dualism” with respect to the PSA Law.

### **Negative Implications of Failure to Pass the Law**

The investment community's negative response to the long delay in passing the PSA Law is becoming increasingly vocal. The International community's hopes for a better investment climate in Russia could be significantly raised by the PSA Law (whose basic principles could be explicated by a system of by-laws; a first version was drafted by our drafting Group and submitted to the Government). A number of executed agreements for major investment projects, pursuant to their own terms, will not become effective until after the passage of the PSA Law. The decision by the Federation Council to return the law to the Duma for improvement may mean that for all practical purposes passage of the law is being delayed by at least a year. Not only does this devalue assertions by Russia's top leaders to the effect that “a favorable investment climate” is emerging in Russia (the latest assertion came from the Russian Premier as he was trying to talk his Canadian counterpart into agreeing, just as the Federation Council and its resolution went out of their way to prove the opposite), but it also frustrates the international community's hopes to see Russia evolve as a country whose aspirations for “an investment future” are more than just lip service.

The political implications of the Federation Council's decision are equally damaging to Russia's investment reputation. The PSA problem is certain to be on the agenda of the next Russian-American summit. What could the Russian President say in support of the Federation Council's decision, which shuts the door in the face of domestic and foreign investors?

Unless the Federation Council reconsiders its decision, an exodus of investors from the Russian market can be expected, for a few years, until the country finally establishes a stable legal support for long-term and large-scale investments. Publication of the October 3 voting results has already led to some foreign companies that depend on the PSA Law for continued involvement in Russia shutting down their regional offices, and to shrinking foreign investment in Russia.

\*R. Narzikulov. Some Speakers prefer deferred demand—in “Segodnya,” October 6, 1995, p. 1.

\*\*A. Kachalov. Production Sharing. Who is behind the struggle around legislation?—in “Interfax—AiF,” No 15.9, October 15, 1995, p. 3.

\*\*\*V. Bardin. Russia scares off foreign investors—in “Commerzant Daily,” October 5, 1995, p. 1-2.



### A Conciliation Commission: A Dead End Option

The press has carried statements from a number of deputies and from sources in the Secretariat of the Federation Council, claiming that the conciliation commission would wrap up its work within a short time, and that it would not create any major delay in enacting the PSA Law. Such statements are false and are indicative of their authors' ulterior motives or a certain measure of ignorance.

The Federation Council is represented in the conciliation commission by Deputies Boldyrev, Sablin, Spiridonov, Tsvetkov, and Shafranik, of whom Deputies Boldyrev and Sablin are opponents of the law *on matters of principle*.

Yu. Boldyrev, for one, wants to see the following provisions included in the Law:

- each draft PSA Law, upon signing, shall go to Parliament for ratification;
- all projects under the PSA principle shall quantify a minimum Russian content;
- no direct negotiations shall be allowed; and
- no assignment of rights and duties under the agreement shall be allowed.

The State Duma is represented in the conciliation commission by Deputies Glazyev, Melnikov, Mikhailov, Podmasko, Puzanovsky, Surenkov, and Tretyak, of whom Deputies Surenkov and Podmasko are also opponents of the law *on matters of principle*.

Both insist that:

- the PSA Law be subordinated to the Law on Underground Resources,
- the license be primary and the PSA secondary,
- the license be an instrument of approval rather than of registration.

If that were to happen, the PSA Law would cease to exist as an instrument under civil law. Therefore, any work in the conciliation commission would be paralyzed early on, because opponents would insist on concessions that are likely to be matters of principle rather than of language.

In dealing with the opponents, two options are available:

1. Meet them halfway and give them the concessions they want; or
2. Persuade them to change their minds.

The law's drafters and their supporters view the second option as the only option. A. Melnikov, a member of the conciliation commission, Deputy to the State Duma from the Yabloko faction, and the person who submitted the law to the Duma said in no uncertain terms that the law's proponents in the commission "would not allow any provisions into the law which may worsen the investment climate." In that event it would be futile to expect passage of a viable law any time soon. Another option would be to accept the idea that the conciliation commission would produce "a legal freak, which would satisfy all law-makers, but which would do nothing to attract investment in the Russian economy."\* But that other option is *unacceptable* to PSA supporters.

\*S. Loyayeva. "Yabloko is resolved to fight for the PSA Law like the Spartans at Phermonilas"—in "Segodnya," October 10, 1995, p. 2.



**Federation Council May Resolve the Issue By End of October**

The law's proponents must work to have the Federation Council complete the ballot by questionnaire, which effectively assures passage of the PSA Law. The number of influential people who support the PSA Law as it is and want to see its early passage is fairly large. They include highly placed deputies to the Federation Council and the State Duma, the President's Administration, the Government, Russia's regions, and oil companies, both Russian and foreign.

Many of them have already expressed to the Speaker their concern over the Federation Council's resolution of October 3. This concern, as well as the appeal to see through the delay's on the ballot by questionnaire, can be found in a number of messages to the Speaker of the Upper House. Some of the messages carry additional clout by being jointly signed by both top officials of a regional administration, and by Russian and foreign companies involved in the respective PSA projects (to my knowledge, the first instance ever of this kind of joint action.)

Due to its vital importance, the situation is being monitored by the Russian President's inner circle.

The Federation Council's next session has been scheduled for October 23-24. A US-Russian summit is scheduled for around the same time. In view of the above, there is every reason to believe that within the specified time-frame the problem may be resolved in the Federation Council.



Table 1

**Russian Legal Framework for PSA in Chronological Order**

2.21.92	Passage of the Law on the Underground Resources. First mention of PSA in the text of an effective law
12.24.93	Decree No. 2285 by the Russian President "Questions of Production Sharing Agreements Associated With the Use of the Subsurface" initiated by Ye. Gaidar, the then First Deputy Prime Minister
11.24.94	The State Duma conducts the first reading of the Draft PSA Law drafted by our group under the auspices of the State Duma's Committee for Economic Policies (the so-called Konoplyanik version)
1.3.95	The Russian President submits to the State Duma a draft law "PSA Associated with the Use of the Subsurface" drafted under the auspices of the Russian Federation's Ministry of Fuel and Power and the Administration of the Russian President (the so-called Pashkov-Dvurechensky version)
2.24.95	The State Duma approved the first reading of the PSA Law (the so-called Konoplyanik version) submitted as an alternative
6.14.95	The State Duma approved the second and third readings of the PSA Law
7.3.95	The Sectoral Committees under the Federation Council issued their respective opinions on the PSA Law as follows: the Committee for Economic Reform and the Committee for International Affairs approved, the Budget Committee rejected the Law for reasons of disagreement with certain provisions of the Law
7.27.95	The Federation Council resolved to conduct a ballot by questionnaires (by mail) on the PSA Law
10.3.95	The Federation Council rejected the PSA Law by roll-call vote, without completing the ballot by questionnaire

Source: Cambridge Energy Research Associates.