

OIL

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AN INTERNATIONAL
MONTHLY REVIEW FOR
THE ENERGY SPECIALIST
COVERING LEGISLATION,
COURT DECISIONS AND
FISCAL DEVELOPMENTS.

Sweet & Maxwell

VOLUME 14 ISSUE 7 JULY 1996 ISSN 0263-5070

CONTENTS

ARTICLES

Natural Resource Damage Assessment under the Revised US
DOI Regulations

Louis L. Wilde

The Abandonment Controversy: From the Development of
International Law to the Brent Spar Incident – 'Economy'
Overshadowing Environmental Protection?

Mark Osa Igiehon

Proposed US Sanctions on Persons or Entities Participating in
the Development of the Petroleum Resources of Iran or Libya

Preston Brown

Legal Aspects of the Russian Federal Production Sharing
Agreements Law

Maya I. Makhlina

COMMENT SECTION

The Russian Production Sharing Agreement Law

Andrei Konoplyanik

Court Reluctant to Consider Contractual Negotiations to Find
'Common Aim' to Parties

Paul Todd

Electricity Privatisation in India

Geoffrey Picton-Turbervill

MARITIME COLUMN

Delivery of Cargo Without Bills of Lading

Mark Morrison

BOOK REVIEWS

Indonesia: The Political Economy of Energy

Competition for Capital in the International Oil & Gas Industry

NEWS SECTION

An international review of recent cases and legislation

COMMENT SECTION

Andrei Konoplyanik

The Russian Production Sharing Agreement Law

On 24 December 1993, Presidential Decree #2285 'On Production Sharing Agreements in the Use of the Subsurface' was signed in Russia, thus starting the legalisation of the PSAs in this country and initiating the drafting of the special PSA Law (for the philosophy of the drafter's version of the PSA Law see: OGLTR 13 [1995] 6 at 246). It took two years for the drafters to prepare this Law and the basic package of the normative documents for it, to pass the Law through the State Duma on a competitive basis, winning in the competition with the less friendly to the investors alternative version of the Law initiated by the Government, and to withstand the direct opposition to the very idea of the PSA Law from the Federation Council, overcoming the struggle for the Law in the Conciliatory Commission, etc. The author presents his general comments on the current value of the PSA Law for potential investors after all these battles are over.

On 30 December 1995 the President of Russia signed the Production Sharing Agreement ('PSA') Law; a law passed in a more heated debate than any other law.

As a result, the final wording of the document turned out to be more confusing than the version passed by the State Duma in the first and second reading on 14 July 1995 (see Figure 1). Two of the 'new' provisions that were brought into the law through the efforts of the Conciliatory Commission, set up after the Federation Council rejected the first version passed by the Duma, should be mentioned.

First, the legal procedure to prepare and conclude production sharing agreements has become more 'bureaucraticised' as a result of the amendments requiring that the lists of facilities entitled to PSA (Article 2, Item 3) as well as certain agreements in case of 'using plots on the continental shelf in the exclusive

economic zone of Russia or plots related to the state's special strategic interests, as well as in the case of agreements concluded without a tender or auction' (Article 6, Item 1, Paragraph 2), should be approved by federal laws. In fact, this definition covers all the existing and planned PSA in Russia without exception. A 'legal matryoshka' of three federal laws has been established, to be passed in consecutive order before the investor starts spending millions and billions of dollars from his own resources, or those attracted under his guarantees. This is going to restrict, not expand, the potential investment proposal.

Second, there is now a possibility of introducing changes into agreements 'on demand from one of the parties in case of an essential change in the circumstances in accordance with the Civil Code of the Russian Federation' (see Article 17, Item 1). This language presents the possibility of an arbitrary interpretation of the definition 'essential change in the circumstances'. Around the world, the risk of an 'essential change' in the prices situation to which the authors of the amendment refer every now and then, is reduced by introducing a sliding scale for progressive sharing of the profit product, and not by a revision of the terms of the agreement. That is, the amendment for Article 17 'Stability of the Terms of the Agreement' distinctly reduces this same stability.

This leads, first, to a reduction in the number of investors, and second, to investors presetting a higher rate of profitability to secure themselves against the increased investment risks. Consequently, the share of the profit product to be re-distributed in favour of the receiving country will be reduced as well, which means that the state will not be receiving part of the mining rent due to it.

The law's supporters have been trying hard not to let the law be ruined by the conciliatory commission which from the very beginning was inclined to destroy the law under the pretext of 'protecting the state's interests'. Unfortunately, not all attacks have been repelled. It has to be admitted that the version of the law signed by the president is not only worse than the

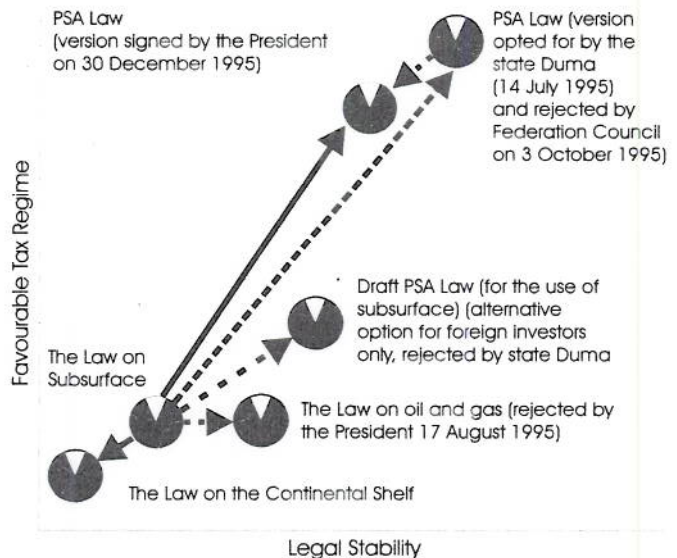


Figure 1: Comparative Attractiveness of investment climate according to the PSA Law

The author is head of the group which developed the PSA law and the package of normative documents for it.

one dated 14 July 1995, but contains a number of provisions that block up the effective practical application of the law.

To look at the law from the viewpoint of its location in the existing legislative environment regulating or purporting to regulate the investment relations in the use of subsurface. Among those laws, even on the current wording the PSA law holds the most progressive position, providing the best legal stability and most favourable tax conditions (see Figure 1), especially if a number of obstacles blocking the effective use of the law are removed.

For the first time in Russia, relations based on civil law have been extended to the area of mineral resources. For these industries, two parallel legal regimes have been introduced: civil law and public law. The monopoly of the existing permissive system of subsurface use has been put to an end. The provision of Article 124 of the Civil Code of the Russian Federation, declaring that the state may act on equal terms with the other participants of relations regulated by the civil legislation, has been interpreted by the law in terms of concrete types of agreements with their own specific mechanisms. There is a possibility of arbitration, including agreements between the state and a non-state investor. The legal stability of the concluded contracts has been confirmed, and not only for the initial starting period of the contract (as in case of stabilising or grandfathering clauses in public law deals), but throughout the term of the agreement.

The PSA law has brought up an alternative for the tax-based system of the investor's settlements with the state, based on rent relations and a system of rent payments taking into account individual features of particular oil and gas fields. And this does not mean individual benefits or certain exceptions from the general rule when privileges for some investors result in a heavier tax burden on the others. This is a universal mechanism that takes into consideration peculiar features of certain projects, a mechanism which is ultimately 'tax-abiding' and ensures 100 per cent 'tax collectibility' for all types of payments.

At last, on both economic and legal grounds, the investor has a choice as to which system to take as a basis for building up his business in Russia. Competition between the two different subsurface use systems will guarantee that the effectiveness of both will be increasing steadily, thus making use of the state's property, part of which is the subsurface, more efficient.

From this viewpoint, the passing of the PSA law is a principal breakthrough as compared with the investment regimes of subsurface use established by the laws 'On Subsurface' and 'On the Continental Shelf', the draft law 'On Oil and Gas' and so on.

Of course, it is unlikely that any serious investors have been planning to immediately begin the implementation of PSA projects before the presidential elections. However, all of them were eager to have the PSA law passed before the elections. The attitude of Boris Yeltsin towards the law is well-known. No one can tell what kind of an attitude towards the law the new president is going to have, if Yeltsin is not re-elected. However, for understandable reasons, not one company has opened this problem to discussion. Factors hampering the implementation of PSA projects were first said to be the absence of the law itself, and

afterwards the absence of the package of normative documents to accompany the law.

Therefore, worsening the law's quality gives potential investors an opportunity to justify their investment passivity in the first half of 1996. Afterwards, (if the consequences of the presidential election are not very obvious) they will be able to complain that the regular 'weather window' for the implementation of work in the fields has been missed. However, there is the other side of the coin. Delaying the 'investment pause' too much favours domestic companies that are ready to start working on this still imperfect law, as they are used to even less favourable conditions. They could start, if not squeezing the wary western investors out of the most promising PSA projects, then at least gradually expanding the participation of Russian companies in them.

At all events, 'investment lock-gates' for investments are not likely to open in the next half-year. This means that there is pause to allow for the elimination of the law's shortcomings as well as the completion of the accompanying package of normative documents.

The work should be concentrated in three directions:

- a) introduction of necessary amendments in the law itself to eliminate the insertions that had been brought into it later;
- b) introduction of the necessary amendments into the existing legislation in order to conform with PSA law;
- c) completion of the package of normative documents submitted to the Government in the fall of 1994, the updating of which had been postponed until the law was passed.

In accordance with Article 26 of the PSA law a three-month period is established to conform with other normative legal acts and to prepare proposals on the introduction of changes and amendments resulting from this law into the legal acts of the RF, as well as to prepare the law on the approval of the list of deposits for PSA.

Under those conditions, a close co-ordination of activities is necessary or, which is even better, joint efforts of government and parliament to prepare the necessary documents. All the pre-conditions for that are in place.

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