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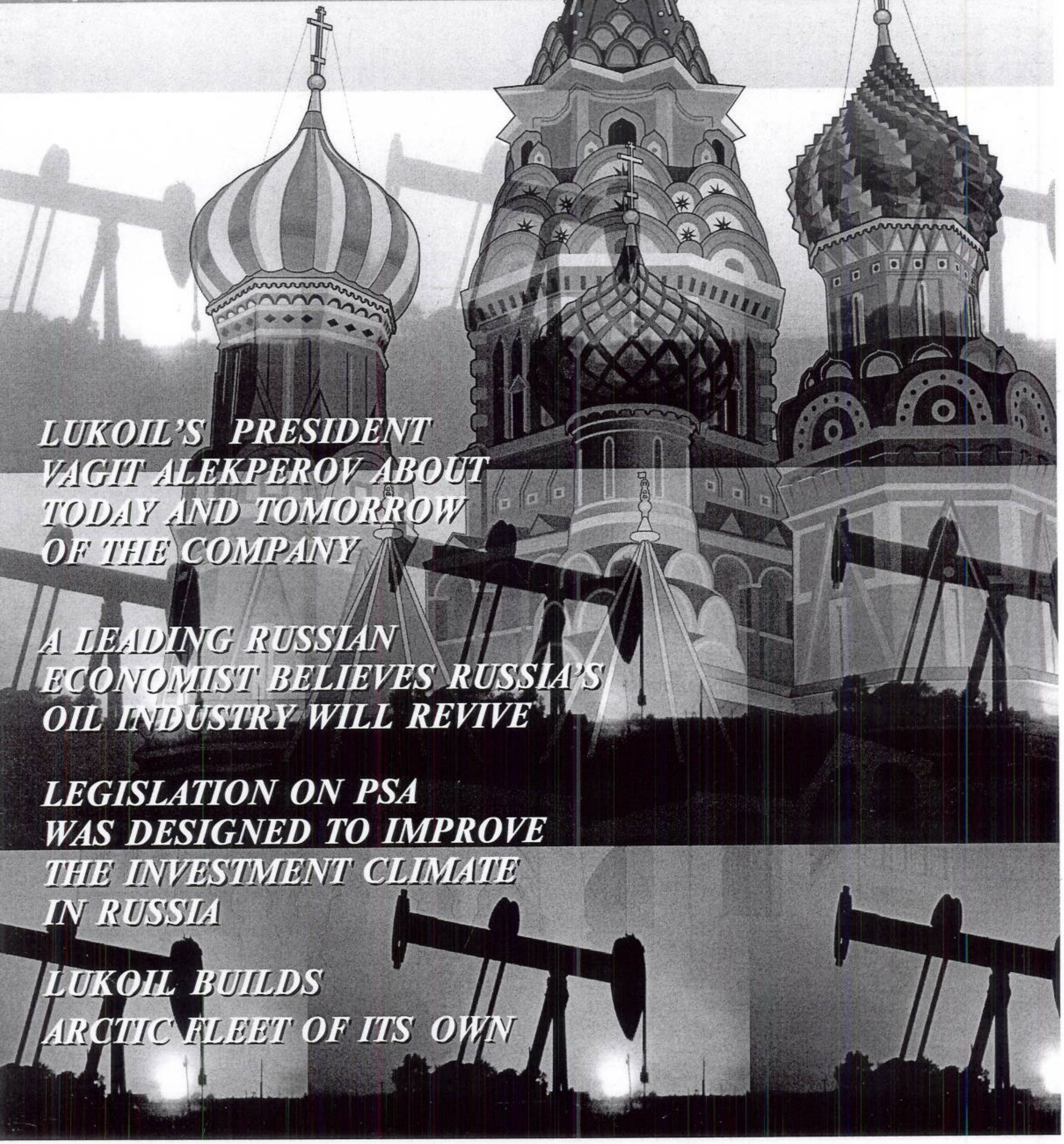

LUKOIL'S PRESIDENT VAGIT ALEKPEROV ABOUT TODAY AND TOMORROW OF THE COMPANY

A LEADING RUSSIAN ECONOMIST BELIEVES RUSSIA'S OIL INDUSTRY WILL REVIVE

LEGISLATION ON PSA WAS DESIGNED TO IMPROVE THE INVESTMENT CLIMATE IN RUSSIA

LUKOIL BUILDS ARCTIC FLEET OF ITS OWN

LEGISLATION ON PSA TO OVERCOME THE

The current social and economic situation in Russia requires measures aimed at invigorating the investment activity. Few today are inclined to invest their money into real production. Banks provide credits for such purposes at a maximum three to six months, the money is circulated in commerce and mostly goes into transactions with securities. Private capital continues to leave the coun-

WILL HELP RUSSIA INVESTMENT CRISIS

try, whereas the influx of foreign capital into Russia is done with utmost caution. In the six years of reform the volume of direct foreign investment into the Russian economy has not exceeded $1-1.5 billion per annum. Decline in transactions profitability with short-term state liabilities and other similar financial bills has not provided for an automatic transfer of capital into the market of

production investment. There is no direct competition between those markets and they are under pressure of different types of investor. As before, the capital is predominantly invested either into short-term transactions or is exported from the country.

Long-Term Projects Are Insecure

Long-term and capital-intensive projects have found themselves in a most precarious financing position, in particular, those related to the oil and gas industries. Meanwhile, it is mainly they that generate the primary sources of budget and foreign trade earnings. In 1996, one third of the federal budget arrivals and 45 percent of export arrivals were obtained through the Fuel and Energy Complex (FEC).

The basic worldwide method of financing projects of this kind is project financing. This is a loan provided to a separate economic unit, i.e. individual project, not a corporation implementing a series of projects. The creditor in this case treats project revenues as a single source of debt servicing and payment of its main part. Project financing, undertaken by non-governmental investors, has a vital peculiarity: it does not increase the expenses but increases the revenue of the state budget. Hence, no further growth of the state debt.

Striving to minimize risks, investors usually finance the exploration stage of the project from their own assets, though not more than 10-15 percent of the required investment. The remainder is provided on loan. Banks and other financial institutions provide loans in exchange for stable guarantees on the part of the project, judging their risks are too high as compared to the risks of investors who use their own risk capital. When analyzing the credit risks, the banks are forced to pay special attention to the negative factors which may result in the failure of project. According to international and national banking law in the majority of states, there is a marginal risk level, established for the creditor agencies when funds are allocated.

The international banking community regards the financial risks in to-day's Russia as too high to be accepted by all. Hence scarce project financing of Russia's raw material and oil and gas industries.

Out of the entire poor choice of possibilities the government has today only one powerful lever - Legislation on Production Sharing Agreements, able to trigger off major investment projects related to mineral resources and raw material industries.

One of the few currently accepted credit forms based on project financing are loans provided by major finance institutions, IBRD, EBRD, IFC, and export creditors of the industrial countries, ExImBanks, USA, Japan. Apart from traditional forms of crediting (mortgage provisions, project guarantees, etc.), they provide guarantees of the participant states. But even granted a relative political stability on the Russian side, commercial crediting of huge Russian projects is too exposed to fluctuations of the Russian investment climate. Project financing stands as unprofitable both for the giver and for the taker. Rejection by several Russian oil companies of the unwarranted quota of the World Bank First Oil Rehabilitation Loan (FORL) or of the framework agreement with ExImBank, USA, are examples of that. And this at a time when the World Bank Loan is considered the cheapest on the world oil market.

Back in 1994, the target of Russia's state policy was defined as "construction of a bridge from the inflationary past towards the investment future". The latter implied overcoming the investment crisis and enhancing economy by means of curbing inflation. We almost managed in 1995, but with no improvement as for investments. The budget crisis has leveled out the state investments. The expectation that a curb on inflation would cut on revenues from the financial markets, diverting part of the capital into economy's real sector, was not realized. The policy of the stick and carrot has brought no fruitful results. New financial levers of gaining high profit never stopped to appear, and the investor could not thus be "forced" to put the money into Russian economy.

Whence Shall Emerge the Billions of Dollars?

A major factor to provide for the investment growth is legislation, which protects the investor. Assurances by a lot Russian leaders of the oncoming "investment paradise" has left open the key issue: whence shall emerge the billions of dollars, when there is no well-adjusted mechanism of attracting them? Out of the entire poor choice of possibilities the government has today only one powerful lever - Legislation on Production-Sharing Agreements (PSA), able to trigger off major investment projects related to mineral resources and raw material industries.

Great hopes were pinned on the PSA Law. The projects evaluation on PSA terms was no less than $7-8 billion a year, comprising a series of projects related to the Russian FEC with foreign investors' participation. The bet was placed on the national assets, inclusion of other raw material industries within the Law domain, and better allocation of assets in the adjacent industries through contract awards in various spheres, envisaging profits in billions of dollars.

The Law on PSA adopted at the end of 1995, still remains ineffective. A number of amendments introduced by the Russian State Duma Conciliatory Commission placed, according to their authors, the "effective filters" on the road of the investor. Two more legislative acts are required at present: on amends to PSA-related RF Legislation and on the List of Fields (LOF) subject to PSA-related development. The latter is opposed by the Law authors regarding it as harmful for the Russian economy. They think it will dub the government programs aimed at the social and economic development in the regions, comprised by the LOF. Inclusion of other fields into the LOF scope does not provide for the right to use the resources on PSA terms. The smaller the list, the smaller the choice of potential investors. The fewer competitors, the worse economic situation within the country.

Unfortunately, the majority in the State Duma have failed to perceive the above-mentioned arguments. Under pressure on the part of the Left, the still not adopted LOF, initially including 250 fields, is being gradually reduced. The main idea advanced by PSA Legislation opponents is dangerous "trading with our Motherland". Scenario will be always the same: a foreign investor on PSA acquires shares in the Russian resources, building "a state within another state's territory". He does not oblige by the Russian laws. He even can transfer part of his right to a newcomer from another country and in this way make part of Russia's national wealth become property of some foreign proprietor.

Things take a different turn when it comes down to practice. The Parliament first passes the Law on PSA, which introduces the general regulations needed to conclude the relevant agreements, second, the Government works out the standard procedure, specifying the regulations, and, third, the state and the investor (foreign or Russian-based) sign a detailed contract, specifying the details of the future agreement. A sort of governmental commission acts on parallel lines with all the existing state control agencies within the scope of PSA, responsible for negotiations in the course of one year. Each new agreement is thoroughly scrutinized and finally acquires the form of a bulky document. Supervision becomes ever more strict. But the investor, seeking to conclude an agreement, gets in return stable state guarantees, and can now properly assess the project awards.

Most vital in PSA are new lease terms coming forward to replace the old privatization. Unlike the previous routine when the state property was leased on conditions to be easily changed by the state control bodies, contracts on PSA are concluded directly between the state and the investor. The state provides guarantees that taxation and legal norms will remain as unchanged in the course of the contract. Any transfer of rights will be approved by the state. The investor, negligent to his duties in relation to leased fields development practice, will be judged as the side negligent to its obligations on contract, and in this way leads to termination of contract. He loses the money, while the state will preserve its right to announce a new tender. False concerns of the Left in the Russian Parliament in relation to PSA can in this way be termed as political slander.

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Benefit to the Country, Benefit to Investor

The basic aim of PSA-related legislation developers was to present an adequate instrument to implement long-term investment projects in mineral resources and raw material industries, to reduce combined risks to a level approaching the international banking standards. A legal base was thus to be formed to provide for project financing in the Russian mineral resources, raw material and oil and gas industries, for legislation and taxation stability in the country with a still not too friendly investment climate.

The adoption of Legislation on PSA will help realize a long-cherished dream for a more stable jurisdiction, providing not only for short-term privileges but for long-term guarantees that the investments going down into the Russian economy are returned with a profit. The government, on the other hand, will have an opportunity to choose the investor, possessing the required financial and technological assets and the required managerial expertise. The investor to

sign an agreement on hand will be able to specify the required conditions and see to it that the terms of agreement will be strictly observed throughout the whole period of duration of contract.

Legislation on PSA implies that the state has the chance to enter directly into agreement with the investor and to extend its economic manoeuvre. The property not subject to privatization will thus be more effectively distributed, forming the legal bases for large-scale project financing of the Russian economy.

Legislation on PSA is intended primarily for the purposes of the Russian investor, though the role of the world market of capital is not to be overlooked. Foreign investment and the world market are a sort of a "litmus test" for the Russian economy.

The inflow of foreign capital into the Russian projects is predicted to cut on the national capital outflow. In 1996 alone, the bulk of the outflow, according to some estimates, approached $10 billion against $3.5 billion of foreign investment, with $2 billion spreading in the securities market.

The areas of investment activity in mineral resources and raw material industries, stimulated by PSA, are predicted in turn to spur business activity in the adjacent industries, in other regions of Russia, and along the entire investment chain. Oil and gas industries will be the most active. Here the GDP growth/investment growth value, based on six projects demand in the oil and gas industry, will be 1.9.

In other words, every 100 rubles invested into PSA projects, apart from direct GDP increment of 100 rubles, brings an additional 90 rubles revenue coming from the adjacent industries. The similar value for other industrial countries will be:

Norway - 1.7
Australia - 1.8 - 2.4
Gulf of Mexico, USA - 2.1

The Russian value of ratio is less than that for the USA, due to a higher taxation level and a lower income level. Still it is high if compared to other countries. Domestic component in the cost of the first Russian projects is relatively high though the role of foreign capital is quite sufficient. The value of the Russian component in the combined six projects demand thus will be:

in capital construction - 56 percent
in operational costs - 80 percent
in transportation services - 100 percent
on average - 72 percent

In other words, out of each 100 rubles of costs 72 will be spent on Russian territory. Distribution of complete revenue to come from the projects implementation shall be the following:

revenue of the Russian state as proprietor of resources - 43 percent
of Russia's non-government sector, including:
Russian investor-participants in the projects - 44 percent
foreign investors - 7 percent
other foreign participants - 6 percent

Time is Ripe for the New Legislation

The growth of GDP from the implementation of projects shall total around $450 billion, that is on average over $10 billion a year during the major production period (in 2000-2040), which shall undoubtedly become a powerful factor in the economic development of the country. The budget will get $257 billion. Every overdue year will decrease the real economic effect of the projects (gross discount revenue). For instance, a 5 year delay in the oil fields development will diminish the net growth of GDP from $83 to $52 billion, a 10 year delay - to $ 32 billion.

Russia's oil industry reached its peak in 1988. The following years saw a 1.9-fold drop: from 569 in 1988 to 301 million tons in 1996. The reserves base has worsened. Reserves recovery at developed oil fields was 60 percent and at major oil fields in Samotlor, Fedorovskoye, Romashkinskoye, Alanskoye - 70, 60, 87 and 80 percent, respectively. The bulk of the exploration drilling for oil and gas in the past five years decreased three times.

To maintain the level of oil production at 305 - 310 million tons (out of which 93 million are intended for exports) by the year 2005, the PSA-legislation mechanism should be introduced before now. Only in this case the operation of companies and requirements of the state will be equally balanced. Quite a number of projects, related to low-producing fields would require either the introduction of a whole package of tax privileges, or the new mechanism, laid down in the Law "On PSA". Further delay is extremely dangerous: urban settlements springing up around declining fields are populated with millions of people.

Over the last three years, due to uncontrolled shut-down of running wells, loss of 1.2 billion tons of resereves was registered in the country: irreversible geological processes like watering were observed. The loss is counted at approximately $120 billion. A whole package of investment and taxation laws is urgently needed to repair the situation. These should be professional laws capable of spurring the investment activity and to secure stable guarantees of control on the part of the state. Amendments to Laws "On Mineral Wealth", "On Continental Shelf", "On PSA", "On Foreign Investments" and "On Investment Activity" should be written. Urgently required are Laws "On Agreements Concluded by the Government with a Non-Governmental Investor", "On Concessions", "On Service Contract", "On Public Service Concessions", "On Leasing". We need a modern tax legislation. Much of the above is already prepared, some requires an improved law-making process and urgent preparation of the relevant draft laws.

The Left majority in the Russian Parliament still persists in obstructing the new laws. And this at a time when the industrial countries are engaged in severe battle for foreign investments. The adoption of draft laws on LOF to be developed on terms of production sharing, on the amendments to legislation, and the adoption of PSA Law will drastically improve the Russian investment climate. There is no chance to retreat now even for the short-sighted State Duma leaders.

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