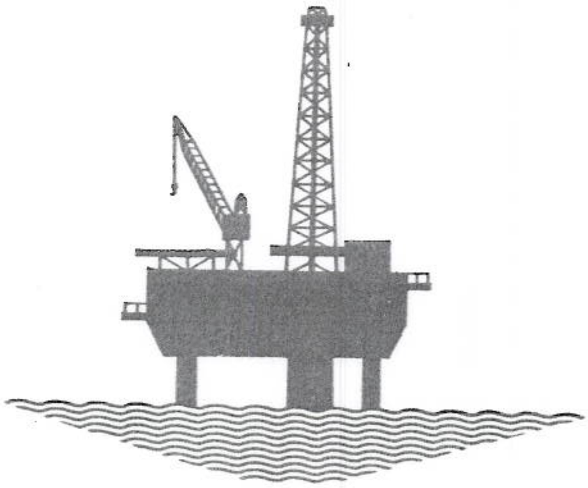
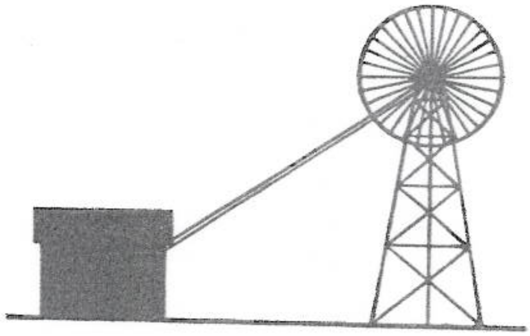
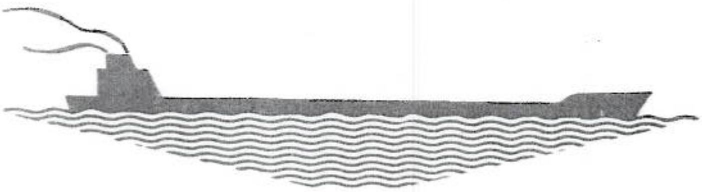
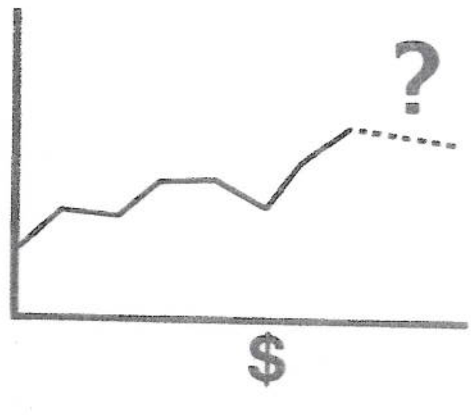
Volume 8 Number 3 January - March 1998

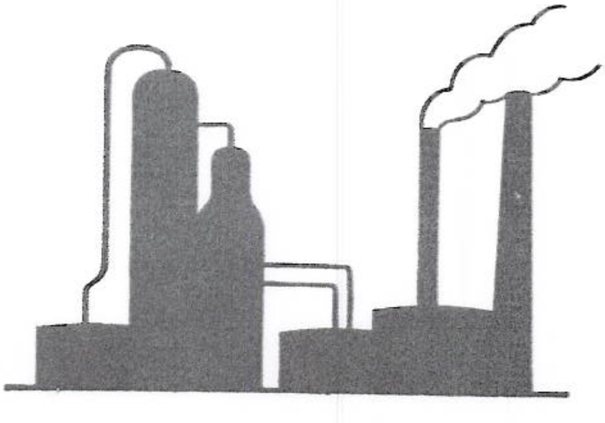
ENERGY BUSINESS REVIEW

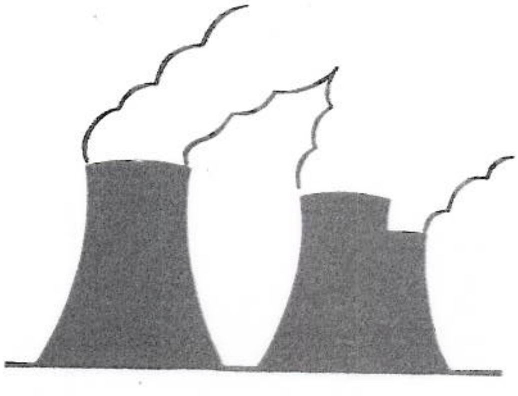












DEVELOPMENT OF LEGISLATIVE & INVESTMENT PROCESS IN RUSSIA UNDER THE FEDERAL LAW

'On Production Sharing Agreements'[1]

ENERGY BUSINESS REVIEW • VOL 8, No 3 • P.O.Box 3896 • FAX No: (357-2) 350265

At a RF Government meeting dated 11 September of this year, discussion of a Government investment program triggered a no less heated discussion of factors and "locomotive forces" of economic growth in Russia. An opinion was voiced that the growth of direct investments into the tangible sector of the economy is too early to be reckoned upon, that investments are most likely to "turn to production" between 1998 and 1999, and that their growth would initially be encouraged by the motivated effective demand. Our conference may substantially clarify that discussion, by demonstrating already today the preparedness of Russian and Western companies for direct investments into the tangible sector, provided that such sector is represented by the oil and gas industry (and, via this industry, into high-tech conversion businesses of the military-industrial complex (MIC), that investments into the Fuel and Energy Complex will be made on the basis of product sharing agreements (PSA), and that PSA legislation will be further backed up by meaningful steps.

1. Oil And Gas Industry As A Locomotive Force Of Economic Growth in Russia

The oil and gas complex is characterized by both high and stable domestic and export (i.e. effective) demand for its own products (oil, gas and products made therefrom), and a high multiplicative effect, i.e. it creates a high level of demand for the products of related industries. Estimates provided by NOF and the Commission for the Productive Natural Resources (KEPS) of the Russian Academy of Sciences (RAS) have shown that for Russia the oil and gas multiplier is equal to 1.9 and corresponds to that for other oil producing industrialized countries. Calculations made by the author for the Ob area project have shown that the revenues of the Russian party along the machine building line (via the placement of orders among Russian vendors, carriers, etc.) may be twice as high as the revenues from the oil line.

With the shift of oil and gas production eastward, northward and particularly towards the shelf of the Arctic seas, the oil and gas producing complex generates an ever growing competitive demand for scientific, high-tech engineering products. The main scientific production potential of the country is concentrated in the industries of

[1] A paper by Dr. Andrei Konoplyanik, Executive Director, Russian Bank for Reconstruction & Development; Advisor to the Ministry for Fuel & Energy and Ministry of Economics; Head of Consultants to the Committee on Natural Resources, State Duma of the Russian Federation; and Head of Drafters of the PSA Legislation of Russia.

the MIC. Its conversion into an industry producing oil and gas equipment is entirely an economic task. It consists in providing a guaranteed pay-back for investments into the production of equipment for oil and gas production, and, finally, through the selling of hydrocarbons produced in the course of the development of oil and gas fields encouraging the demand for such equipment. Thus, there is an objective basis for beneficial interaction between the industries of the Fuel and Energy Complex (FEC) and the MIC.

The implementation of this task promises big positive results for the economy as a whole derived from investments into oil and gas projects being implemented on the basis of PSA, with due account of direct and indirect effects from the investments. Calculations made by the NOF and KEPS RAS for six projects based on PSA and with a material share of foreign participation have shown that the share of the Russian component in the expenditures is in excess of 70% (from 56% in capital construction to 100% in transportation services, and as the result, almost 90% of the total income (that is both direct and indirect) from the implementation of these projects remains in Russia. In the course of the implementation of further PSA projects, wherein the Russian involvement is likely to be much higher (for both investors and contractors), the positive impact of the PSA on the Russian economy, particularly so in respect of indirect income, will be even more substantial. This will be even more so if we manage to involve on a large scale the MIC industries for the production of equipment for the FEC.

With due account of the specific nature of MIC production (its being aimed at the production of individual items with unique properties) and the fact that the FEC requires exactly such equipment to develop the continental shelf in general and the Arctic shelf in particular, the interaction of the MIC and the FEC industries in this area seems to produce a unique situation in which the technical capabilities and know-how of the MIC (shipbuilders) only naturally correspond to the requirements of a potential customer. Thus, we are approaching the creation of a new and competitive industry. More so that all necessary technical and technological prerequisites are available.

Consequently, the fundamental condition for investing into the Russian economy via the FEC-MIC industries is to pursue reasonable economic policies in respect of both oil and gas producing and related industries, and, above all, those MIC industries which are being converted into oil and gas equipment producers. Investments into the FEC may ensure intensive economic growth in many Russian industries. The Law on PSA creates all necessary start-up economic and legal prerequisites for that.

2. Law On PSA - Legal Basis For Project Financing

The basic element of reasonable economic policies consists in creating a favorable investment climate encouraging investors to place industrial and financial capital into long-term and money-intensive oil and gas projects. The basic characteristics of such favorability are as follows:

- legislation shall provide stability;
- taxation shall be moderate and rational;
- the institutional environment shall be transparent.

Only the combination of these factors may provide for necessary stimuli for the investor to implement a project and for financial banking community to finance such projects. Consequently, what is meant here is the need to create a legislative basis for financing project.

A first step in this direction was made with the adoption of the Law on PSA in its current version. Further improvement is to be made along the line to increase the financing rate for this section of legislation, i.e. to introduce into the Law on PSA and related laws the norms reflecting the balance of interests of not only the State (in the capacity of its federal and regional authorities) and the investor as parties to the PSA, but of all other participants to the process of "project financing" (i.e. related contractors) without which not a single PSA project can be implemented. What is meant here is, above all, financial and banking community (lesser risks of loan financing) and equipment producers if only government policies envisage the encouragement of domestic competitive production.

In view of sophisticated (and often insufficiently transparent) financial position of many domestic production companies, the mechanism of project financing provides them with a real and more preferable possibility to organize large-scale financing of oil and gas projects as against corporate financing.

In this we assume that government (budget) financing ceases to be a significant source for financing investment projects in mineral and raw material producing industries.

3. PSA: Zone Of Application

While creating the PSA regime as an alternative to the existing licensing regime, the designers had no intention to replace all licenses with the PSA. The idea was to establish two parallel and equally legal regimes for using mineral resources (that of licensing and that of the PSA) competing for an investor. This would create additional stimuli towards improving each of the regimes and eventually improve the investment attractiveness of the Russian mineral and raw material complex as a whole, and would provide the grounds for early financing of projects in the real sector of the economy by the financial and banking sector. Thus, the key idea was to establish a balanced competition between two investment regimes each of which being regulated by its own laws: the licensing regime, by the law "On Subsoil Assets" and applicable assessment legislation, and the PSA regime, by the law "On the PSA". This approach being combined with the principle of project financing would provide a clear boundary between the areas for the application of these two fundamental laws and exclude the possibility to construe and apply in more than one way any section of the legislation: project being implemented on the basis of the PSA would be regulated by the PSA Law, whereas the rest would be regulated by the Law "On Subsoil Assets".

The PSA regime was incepted and developed by its sponsors as a mechanism for optimizing the share of taxes in the price in the process when two equal parties are negotiating (the government as the owner of natural resources and an investor) the sharing of end products and the mechanism used to achieve such shares. However, the reconciliation commission, in late 1995 added substantial revisions to the original version of the law "On the PSA" adopted by the Duma in third reading in June of the same year which fact resulted in the emergence of unreasonably high bureaucracy in the mechanism for the achievement of such optimized sharing. Hence, " the price for the achievement of optimal product shares may in a number of cases exceed the expenditures of an investor under the non-optimized taxation system of the licensing regime.

The result being an unbalanced competition between two investment regimes wherein the survivability level for the PSA, at the federal level, appears to have been lifted too high and aimed at bigger objects. At the federal level - mainly by legislative power, much has been done to create multiple and often redundant barriers on the way towards the implementation of the PSA. One of such redundant barriers was the need to approve by a federal law a list of sites the right to use of which can be granted on the basis of product sharing.

However, with time there may appear the opportunity for the involvement on the basis of the PSA and without resorting to overcomplicated procedures granting access to the subsoil assets of numerous small deposits falling into the jurisdiction of local authorities; for instance, on the basis of Agreements on the sharing of jurisdiction and authorities between the bodies of state government of the RF and respective political entities of the RF. In such cases (in respect to certain objects consisting of a multiplicity of small deposits) "two keys" appear to be in one hand - that is in the hand of government authorities of a respective political entity of the RF, which fact may result in a compensating simplification of the procedure used to permit the exploitation of subsoil assets on the conditions of the PSA (that is making up for its more sophisticated form at a federal level).

Thus, a zone to which the PSA may apply is likely to gradually include only very big and very small deposits. In either case the number of objects being developed on the basis of PSA will be a very rare rather than massive occasion. The rare occasion of major deposits is understandable. Whereas the rare occasion of the PSA in the second case can be explained by the fact that to overcome the breakdown point and to ensure project financing, several small deposits are to be combined into an independent project (for example, a recent tender in Udmurtia, wherein 12 deposits were combined into a single project). Thus, this becomes the case of piecework production wherein the preparation and implementation of the PSA takes place under strict both executive and legislative power supervision.

Thus, the PSA regime remains to be physically applicable for only very big and very small deposits. The midrange of resources may in fact become inapplicable for the PSA because of an excessive bureaucracy involved in the procedures for their preparation and implementation, emerging from the natural desire to increase government supervision over the exploitation of subsoil resources.

Thus, instead of being a massive mechanism for the development of Russian subsoil resources, the PSA is being pushed back to the periphery of the nature exploitation processes and becoming not one of the two equal mechanisms for the access of an investor to the resources (the licensing system and the PSA), as it was originally incepted, but rather remains to be an exception from the general rule applied to receiving a permission to use subsoil resources (wherein the rule is the still applicable licensing system).

This provides for additional stimuli for increasing the efficiency of the taxation system applicable within the framework of the existing licensing system as a dominating system for nature exploitation. However, analysis of the improvements to the existing tax system built in the Tax Code (replacement of excise duties by a tax for additional income, the modification of the collection mechanism and a gradual lowering of tax rates covering the reproduction of the mineral and raw-material base, etc.) has provided no grounds yet for maintaining that outside the zone where the PSA is applicable all the three interrelated problems will be solved (the stability of laws, moderate and reasonable taxation, the transparency of the institutional environment) within the scope sufficient to provide for the large-scale project financing of investment projects in the sphere of the production of minerals and raw materials within the framework of the existing licensing system. Though, only naturally, the trade-offs achieved within the XV and XVI sections of the Special Part of the Tax Code make the burden of special taxes (royalties) on the producing companies less unbearable as against the existing system of taxation.

As the result, the improvements of the tax system offered by the sections XV and XVI of the Special Part of the Tax Code which appear to be insufficiently progressive for the investor produce a sort of compensating effect for the inadequacies of the PSA regime and again increase its competitiveness as an investment regime in comparison with the licensing system.

4. Oil And Gas Economy: Demand For Investments

Accurate estimates of the level of demand for investments in the oil and gas complex were obtained in the course of compiling a list of sites the right to exploit of which can be granted on the basis of the PSA.

- for 23 objects - $53.3 billion ($5-9 billion a year),
- for 31 objects - $61.7 billion ($6-10 billion a year), and
- for 33 objects - $66.9 billion ($7-11 billion a year).

Extrapolation of the level of capital intensity of the objects in the existing list of subsoil asset sites specified in the government bill to the whole potential list of oil and gas objects (38% of industrial deposits of oil in the country) gives an aggregate level of demand for investments in the oil and gas complex equal to $132-140 billion dollars. Given an average investment cycle of 6 to 10 years, the annual demand for investments amounts to a figure in between $13-14 to $22-23 billion dollars/year. This level of demand is likely to be understated, because the capital intensity of the development of deposits from a potential list which have not been included in the current list will only naturally be higher.

The Law "On List....." No.1 has reduced the Government-sponsored list to five oil and gas objects. The investment capacity of this law has reduced almost fivefold as against the investment capacity of the potential list prepared in 1996 by the Government of the RF, to reach the level of $28 billion.

A draft bill "On List..." No.2 is prepared, consisting of nine oil and gas objects. Its investment capacity is almost twice as lower as comperad to the law "On List..." No.1 and amounts to $16 billion.

Yet, notwithstanding sharp lowering of the investment capacity of the law "On Lists..." and consequently sharp lowering of expected direct and indirect effects from the development of deposits under the PSA for the economy of this country, the figures are quite comparable with the annual volume of foreign investments (direct and portfolio) into the economy of Russia as a whole and substantially exceed the capabilities of the government budget to finance projects in the FEC

Thus, whereas the annual investment capacity of the law "On Lists ..." No. 1 is within $3-5 billion and that of the draft bill No.2 is $2-3 billion, (for the sake of comparison):

- the total volume of direct foreign investments in the economy of Russia in 1996 was only $1.5 billion,
- allocations for the FEC envisaged in the Federal investment program financed from the 1997 Federal budget amount to 1,400 billion rubles ($0.25 billion),
- the total 1997 development budget amounts to 18, 100 billion rubles ($3.2 billion),
- allocation for the servicing and repayment of domestic debt in 1997 is 37,000 billion rubles ($6.5. billion).

Consequently, the only real source for the financing the FEC remains to be non-government investments, both domestic and foreign. Whereas the only condition for their appearance in this sector is a favorable investment climate (the main features of which have been discussed earlier).

Thus, if PSA norms appear to be a full-fledged feature of applicable law even after its being further improved, the inflow of investments from the domestic and international markets guaranteed by the PSA projects will multiply n-fold the existing levels of capital investments in the real sector of the Russian economy.

5. Investment Supply Capabilities Of Internal And External Capital Markets

Foreign investments. The present-day level of foreign investments (some $3.5 billion in 1996) is less than 1% of the world direct foreign investments. Of which sum, as it was mentioned earlier, $1.5 billion was used in direct production investments, whereas the remaining sum ($2.0 billion) were portfolio investments (securities). This testifies to the following:

- that foreign investors are not prepared for full-scale investments even into the most attractive (oil and gas) industries of the Russian economy,
- that the Russian economy is not ready to provide foreign investors with acceptable conditions for pouring in investments into the real sector comparable with the conditions in the countries competing with Russia on the international market of direct production investments.

Today, Russia's investment niche on the market of direct foreign investments is small and continues to shrink, including as the results of objective trends on the world capital market. Should the investment climate in Russia continue to be tougher than in the countries which are our country's competitors on this market (specifically in the oil and gas sector), investments will go past Russia in spite of its being attractive for investors in terms of the volumes of hydrocarbons available, the availability of high-tech in a number of industries (particularly in the MIC) and of qualified labor resources.

The level of competitive demand for the investments in the FEC of other countries is comparable with that in Russia. Apparently, Russia's FEC main competitor on the market continues to be the Middle and Near East. Thus, in Saudi Arabia alone the official requirements of the country for investments in oil and gas up until the year 2020 is about $135 billion, an equivalent of the investment capacity of the potential list for operations under the PSA prepared in 1996 by the Government of Russia and in annual figures ($5.5.-6.0 billion/year) it exceeds the actual investment capacity of the law "On List....." No.1. The annual demand for investments in the oil and gas sector of the Middle and Near East hits the level of $20 billion half of which has to be covered from foreign sources.

What are the countries the fuel and energy complex of which is most likely to receive project investments from the world capital market?

Up until very recently most investment projects in the energy industry of the Middle and Near East were financed from government sources. After the Gulf War project financing has been used increasingly often.

The currently existing profitability level of long-term and virtually zero-risk investment (in government securities) characteristic of Western markets is between 1-7%, with a lever of 4 to 10 years. The acceptable level of internal profitability rate (IPR) for direct investments into the energy projects of the Middle and Near East making up for political and economic risks characteristic of the region is evaluated to be at 20% annually in real terms. At the same time, in modern Russia the acceptable (admissible-?) for the Government basic IPR rate applicable to PSA projects is around 15-18% (naturally, provided there is a sliding scale for the sharing of oil as profit in case basic IPR rates increase).

By guaranteeing the above level of IPR the countries of the Middle and Near East will pump out the ever increasing share of international non-government finances and attract all the investments which otherwise may go to other countries, including the FEC of Russia.

The only real alternative to such a scenario the implementation of which will make project investment into Russia's fuel and gas complex more preferable for the world capital market than investments in other countries, is accelerated further development and streamlining of PSA legislation thus reducing risks of project financing in the mineral and raw-material complex of the country.

By losing the attractiveness game to other countries we shall inevitably face the large-scale drop in the potential investment proposal of the international capital market for the FEC of Russia because of huge investment capacity of the domestic energy markets of our competitors.

Domestic market: nervous yet optimistic expectations. Today, the Russian financial market offers to a potential investor a whole range of instruments guaranteeing a profitability level in excess of the IPR characteristic for investments into oil and gas projects, with more encouraging terms of investment and capital intensity, the 1997 decrease in financial interest profitability notwithstanding.

The volume of only one market - that of GKO-OFZ is around 270,000 billion rubles, which puts the investment potential of Russian bank to a level of $50-60 billion. Certain specialists tend to believe that forceful reduction of profitability on the market of government securities (today the profitability of investments into GKO has gone down to reach 19%, whereas the effective profitability, that is after-tax income, decreased to 16%) would cause non-government investors working on that market to switch to the market of industrial investments. However this is not the case and cannot be on the following grounds:

- the financial instruments market and the market of production investments belong to different types of market (by the term of transaction, capital intensity and types of risks). The market of production investments into mineral and raw-material projects is the longest term market with the highest capital intensity and the broadest range of risks (including nature-related risks not characteristic for other markets);

- these markets are characterized by different types of investors (speculation exchange brokers and strategic investors). The first type investors expect high income within a short lever, agree to higher risks, the second type investors gain from the scope of profits, minimize long-term risks and agree to a lower profit rate.

Thus, the real watershed lies not between the domestic and the international capital markets but rather between the long-term industrial investment markets and the financial instruments markets (which is most characteristic for transition-type economies and developing markets).

Therefore, in the absence of favorable conditions for investments into industry, investors squeezed from the market of GKO are joining and will continue to join other segments of the Russian financial market (forex, inter-bank loaning, promissory notes, municipal and other obligations, the market of shares and corporate securities), which are likely to be more profitable than the market of GKO, or join the markets of other countries. As it follows, within the framework of the Russian financial market, the investors are provided with a broad range of opportunities for more profitable, shorter-term and less risky investments than investments into real economy. In such conditions Western strategic investors will only show their flag in Russia. The population, a potential holder of long-term (investment) money would prefer to save money in treasure pots already accumulated, according to the Ministry of the Economy, some 83,000 billion rubles ($14 billion).

Under such conditions any delays in the further development of the laws on the PSA will result in closing the country for production investments into the real sector of the economy, leading to that the efforts of the Government and the Central Bank to push financial capital back from the market of financial instruments affect only one type of investors, but fail to produce more comfortable conditions for the other type of investors (strategic) willing to finance investment projects. This means that in the absence of a trend towards lower loaning risks involved in long-range project investment resulting from lack of progress in the development of law ensuring project financing, potential investors will continue to first establish their control over companies taking part in a project and then to cause that the projects undertaken by such companies be financed.

Thus, instead of only recently anticipated (according to spring and summer statements made by the Government) two-stage scheme for direct squeezing of financial capital from the GKO market and for switching it to the market of direct production investments, the country sees a more protracted process of a three-stage flow of capital from the market of financial instruments to the market of industrial investments postponing the commencement of large-scale implementation of project financing in the country's economy.

Stage 1: Accumulation of financial resources (at the financial instrument market) - almost finished,

Stage 2: Corporate financing (gaining control over companies and businesses) is in full swing, a one more stage of the redistribution of property is under way,

Stage 3: Project financing (investments into projects undertaken by such companies and businesses) is mostly ahead.

6. PSA: Consequences For The Budget And The Country's Economy

The earliest adoption of regulations resulting from the Law on the PSA will increase the inflow of investments into Russian mining industry (and, via it, into other engineering industries), expand the taxable base and, consequently the scale of budget revenues of all levels and better tax collection.

Such conclusion is backed up by, firstly, economic theory (specialists know the effect of Laffer curve).

Secondly, that transition to the PSA regime increases the volume of budget revenues is confirmed by calculations which have shown that:

- application of the PSA regime provides for the opportunity to attract five to eightfold (depending on the object) more additional mineral resources as against the regime of the applicable tax system (ATS). Simultaneously, unit capital investments into mining decrease from those 1.5-2 times the world price of oil characteristic for the ATS to those 3-5 times below the world price under the PSA, i.e. to an acceptable level of capital intensity per ton of produced oil, ensuring the launching of such deposits into operation and their profitable exploitation under the PSA condsitions.
- rationalization of tax burden thanks to the transition tc the PSA increases the taxable base and leads to the 2.6 to 3.5 fold growth of budget revenues, depending on a specific gas or oil field featuring in various versions of the bill and the law No. 1 itself, "On Lists of Subsoil Asset sites...". The highest growth rate (3.5 times) as against the regime of the ATS would be ensured by the adoption of the Government-sponsored version of the bill (with a maximally expanded current list) which was rejected by the State Duma. The law No. 1 "On Lists..." adopted by the Duma with the narrowest possible list decreases budget revenue growth thanks to the PSA to a minimum - 2.6 fold "only" for the first five deposits allowed by law to be operated under the PSA conditions. This apparently may be reckoned fo as an additional argument in favor of the fact that rejection by the majority of th Duma of an expanded (preliminary) version of the law on the lists is based around reasons lacking any economic grounds.

7. Financial Mechanisms Of Transition To PSA (Problem Of Budget Revenue Dropouts)

At an initial stage of the transition to the PSA (in the course of several initial months of operations in the regime) actual budget revenues under the PSA may even go down as against the nominal (anticipated) tax collections from deposits calculated (charged) under the conditions of the ATS). This principal difference at an initial stage between the actual revenues under the PSA and anticipated revenues from the ATS is considered by certain representatives from a number of government agencies as "dropout" revenues of the budget calculated without due account being made of the actual collection and put forward as a basic reason against the PSA in Russia.

We do not intend to start a detailed discussion of the economic validity of such arguments, when compared is what appears to me as incomparable, thus making very doubtful any quantitative evaluations and the very fact of the existence of dropout revenues (what is meant here is comparison of the PSA with tax collections under hte ATS withouit taking into account the actual share of set-offs and money substitutes in tax payments under the ATS, etc.).

Let us, nevertheless, consider which principal financial mechanisms can be proposed so as to make up for dropout revenues in case they do exist in the course of the transition from the ATS to the PSA. Apparently, when budget revenues from new project operating under the PSA are compared with the ATS, they in fact are compared with zero, because lack of profits under the ATS make such project unfeasible. Thus, anticipated budget revenues for the two regimes can be compared only when project operating under the ATS are switched over to the PSA.

In this case another cut of the problem of dropout revenues becomes visible: which tax levels under the ATS shall be compared with the PSA - the nominal level which is even theoretically impossible given that a 100% tax collection is unreal under the existing prohibitive taxation or the real level (accounting for the actual tax collection rates which is currently 60 to 65% for the oil and gas complex)?

It appears to me that the answer is self-evident: comparison shall be made against the level of actual tax collections under the ATS, because non-payment is a natural response of business entities to the prohibitive tax system so as to make up for losses. In this case the problem of dropout revenues appears to be far-fetched.

Nevertheless, if the dropouts appear to be a real thing, the state budget can be protected by introducing (on the terms beneficial for the state and the companies operating under the PSA, and for banks as agents on the financial market) a tax loan payable to the government by a project operator company from the future production at a rate fixed separately for each deposit so as to recover the dropouts, given the mechanisms of project financing. It may also take the form of advance payments by the companies to the government secured by the government or any other financial institutions.

The loan can be repaid from the future oil coming as profit of the investor or the oil coming as profit of the government. However, the first approach by aggravating the economy of the PSA projects, on one hand, makes the investor responsible for the recovery of government expenditures under the conditions not encouraging any economic growth, and, on the other hand, reduces the number of investment proposals. To put it differently, such a recovery scheme for dropout revenues under the PSA may become no less prohibitive for investments than thte ATS.

In the second case, naturally, more favorable conditions for investments emerge in the FEC. Moreover, it is this scheme that, to my mind, is economically just and reasonable. It may become one of effective instruments for the economic policy of the government encouraging investments into the real sector of the economy by motivating the PSA. Being a mechanism for the financing of the current budget deficit within the framework of project financing, it increases neither the domestic nor the foreign debt of the country. Each specific sum to which government guarantees are to be incremented can be secured by a truly confirmed source for its repayment (an accurately calculated of the produced oil share due for the government).

Within the framework of an annual report submitted by the Government to the Duma on the results of PSA operations, an opportunity shall be provided to convince oneself that the stated figures are well grounded and coordinated, because the report under the draft law "On Amendments and Addenda" to the law "On the PSA" (article 5) shall be submitted to the State Duma together with a draft federal budget for the coming year. This will provide for necessary transparency of both the progress in PSA projects and the sources for repaying state guarantees given to make the PSA operable.

Therefore, a scheme for state guarantees (to repay dropout budget revenues) secured by the mechanism of project financing (within the framework of the PSA) appears to be more reliable than any similar scheme secured by tax collections for the next year's budget, because the current (low and unstable) collection of taxes under the ATS creates a very volatile foundation for the repayment of government guarantees given against future taxes.

One of the possible instruments to accumulate funds necessary to make such advance payments is a short-term petroleum bond loan issued under the government's supervision and secured by the future share of taxes in the oil due to the government. Russian banks under the control of the Russian government (for instance, banks with direct government share in them united into a Russian Financial Banking Union) may become such issuers to guarantee the high level of transparency of the whole scheme and the possibility for the government to control, including operating control, over the accumulation and use of loan funds, through the government's equity in such banks.

This approach would facilitate the involvement of financial and banking institutions of the country into operations to finance the real sector of the Russian economy.

8. PSA: Motivating Domestic Producers Of Goods And Services

The demand for domestic engineering products can be increased through one of the following alternatives:

- to protect domestic producers, and
- to motivate domestic producers.

In relation to the PSA, the first alternative usually makes mining and engineering industries into competing bidders for insufficient and reducing state budget investments. The second alternative boils down to financing competitive engineering businesses (MIC) by placing orders from the FEC (the FEC-MIC link).

The main problems to be resolved:

- higher competitiveness of Russian engineering,
- economic mechanisms for the conversion of MIC industries into the production of FEC equipment,
- legislative support of processes involved in project financing of conversion and reconstruction of said businesses.

My opinion is that support for the weaker, i.e. protection of the domestic producer by way of direct protectionism, including through customs barriers, quotas and legislation, is a blind alley.

Such approach reproduces technological backwardness of businesses producing non-competitive goods, on the one hand, and via mechanisms of GATT/WTO forces other Western countries whose products appear to be in any way limited, to respond accordingly. The result being that the country may face the possibility of being barred from a potential export market for recovering Russian engineering.

Reproduction of non-competitive domestic engineering and legislation demanding forceful use of domestic products will result in losses in the domestic FEC - because of a lower yield of produced mineral resources. Eventually, the country will receive a fully negative macro-economic effect from protection measures. Plus serious political tension in various government echelons caused by the persisting confrontation between mining and engineering industries.

Is it possible to support machine-building (conversion industries of the former MIC) without inflicting an irrecoverable damage to the Russian FEC (and the Russian subsoil assets)?

An alternative is to support the stronger one, i.e. to economically encourage the processes resulting in higher competitiveness of domestic providers of goods and services.

The chief role in this process belongs to the government. It has already placed the domestic producers of goods and services into a most unfavorable position as against their Western counterparts by introducing a tougher taxation. Therefore, to increase competitiveness of Russian companies one should not push Western companies down to a state of the Russian companies on the domestic market, but rather push up Russian companies to a level of economic conditions provided to Western companies by their governments, that is by decreasing (rationalizing) the tax burden for Russian companies. In this case, they will be given economic grounds to reduce expenditures (and to look for optimal mechanisms to invest into scientific and technological progress): from the struggle for survival (which means to survive whatever the price) to the struggle for markets (and hence, for higher competitiveness of their products achievable through most economically achievable methods).

Possible mechanisms are already known:

- tax loans (in cases when an industry is producing competitive products in every respect but price) similar to existing investment tax loans, but with due account of the specifics and applicable to FEC-MIC industries,
- purpose-oriented investment loans provided through bidding for conversion purposes and/or reconstruction of facilities, given that a business provided and

substantiated a plan for the production of competitive products. Such loaning can be made, for instance, within the framework of project financing, using future products as security, which in its turn can be re-guaranteed (using the following chain: bank - factory - oil company - government) by deliveries of future oil from a PSA project which is also the customer of future equipment to be made; which means that everything is done against a government guarantee,

- timely notification of associations of domestic producers of goods and services, appointment of their representatives as members of bidding, examination and other commissions.

Possible legislative support for the process of increasing the competitiveness of domestic engineering (specifically that for the FEC) - the development of a draft law "On the Motivation of Domestic Producers of Goods and Services" (this is a working title, preparation has been started by a group involved in the development of product sharing legislation) which would be able to legalize new mechanisms and instruments of governmental economic policies in respect of the above category of businesses and to eliminate the existing disadvantages of applicable law. Thus, for example, the operating law "On Investment Tax Loan" (dated 20.12.91) is in fact inapplicable to capital-intensive large-scale FEC-MIC businesses, but even if applicable it would only produce rather limited stimuli for such industries to invest.

A major element of increasing the competitiveness of Russian equipment manufacturers for the FEC is the formation of an effectively competitive market for such equipment and streamlining its mechanisms involved in organization and self-regulation.

Today, such market consists of scattered segments interacting not unlike Brownian motion or within emerging industrial holdings uniting upstream companies which have already acquired certain specialized machine building facilities.

There are opportunities for more orderly relations between the government, equipment manufacturers and financial institutions so as to create conditions to make domestic FEC related engineering more competitive by way of a self-regulating and effectively controlled market. Such market can be created under the condition that these three corporate participants learn how to interact effectively.

The government has already produced a starting point by signing Decree No.694 dated 08.07.97 "On Measures for the Implementation of the Federal Law "On Product Sharing Agreements", under which a commission of the RF Government was set up for the PSA, under the head of First Vice Prime Minister B.Nemtsov. The powers of the Commission are regulated by Resolution of the RF Government No.1132 dated 02.09.97, "On Measures to Facilitate Government Control Over the Observance of the Rights and Interests of the Russian Federation in the Course of the Conclusion and Implementation of Product Sharing Agreements".

I do not dare to reckon, which scheme will be selected by the Commission in respect of the encouragement of domestic producers of FEC equipment, but I do believe that one of the possible mechanisms for the organization of an efficient and competitive market of equipment intended for the PSA can be made.

In this case certain additional institutional elements of market infrastructure are to be set up to combine (link together) the participants of the market into a single system capable of providing Russian manufacturers to timely do the following:

- to obtained centralized information on PSA projects being planned;
- to make decisions in respect of their participation in the bidding for orders to produce equipment necessary for such PSA projects;
- to formulate requests (for instance, to the Government PSA Commission) for government support and the grounds for such,
- to prepare respective business plans, etc.

Apparently, this most naturally requires that a consortium be set up of coordinators responsible for the placement and financing of orders for the production of PSA-related equipment. The consortium is to be most likely joined by large organizations working for the market of equipment for mineral and raw material producers and representing the interests of its major groups. For the oil and gas industry, the consortium of coordinators may unite the PSA-related interests of such organizations as Kompomash, Rosshelf, Neftemash, Sojuzneftemash, Spetsmachinostrojeniye i materialy, RANKO Holding, Rosneft Trading House, etc.

Since one of the key elements of the organization of financing for competitive production of such equipment should be (might be) the use of government motivation mechanisms (for instance, investment tax loan in its expanded - as against applicable law - meaning), as well as a project financing plus bidding scheme, such consortium should (can) incorporate both the manufacturers and the government, and government-controlled banks through which the government may implement the above mentioned economic support measures by way of its indirect participation in project financing. One of such financial institutes capable of performing such functions, is, as it was mentioned earlier, the Russian Financial and Banking Union.

Financing conversion and reconstruction of engineering facilities can take various forms. For one, (similar to the above proposed obligation loan to finance the dropout budget revenues), they may take the form of special obligation loans issued to secure loans for engineering industries and eventually re-guaranteed by both the future share of investor's oil and the profit share from the oil due to the government.

An inter-industrial information and analysis and consulting and examination working center may become a linking element between the consortium of coordinators, the government commissions on individual aspects of the PSA, the Government Commission, with the aim to summarize the available experience gained from the preparation and implementation of the PSA in Russia and its use in further PSA projects, dissemination of such experience with specialists from Russian government agencies, producing companies and financial institutions, etc.

TBR - ISSN 0959-0072