Payment Today, Delivery Tomorrow

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The Energy, Investment Policy, and Project Financing Fund

How to resolve financial problems of Russian manufacturers involved in PSAs

The conceptual program for building up Russia's petroleum industry reviewed by the Government in October 1999 stipulates that government guarantees issued on the strength of the state's share of future profit production under PSA contracts would help to overcome the present investment shortage in the industry. The Protocol of the Russian Government of August 31, 2000 «On Drafting and Implementing Production Sharing Agreements» provides for a preferential treatment of Russian entities in awarding contracts under production sharing agreements. Below follows a description of a procedure that might potentially facilitate the use of Russian contractors.

With its present low credit rating Russia in unlikely to succeed in securing significant loans needed to finance long-term investment projects under conventional agreements. However, project financing in such a key industry as fuel and energy could provide a solution to the problem through production sharing.

It is the PSA mechanism that could ensure maximum legal and tax stability to investors in long-term investment projects. The mechanism proposed by the Energy, Investment Policy, and Project Financing Fund would level off the starting conditions for Russian and western companies with respect to PSA projects, specifically in terms of borrowing capabilities. The proposed mechanism is designed for raising competitiveness of Russian companies (both in the production and processing industries) in the best interests of energy users and, hence, the entire Russian population.

Future Income Used as Collateral

The mechanism we propose is based on the use of the state's share of future profit production from PSA projects to secure loans for Russian oil and gas companies involved in PSA projects as investors and/or operators. The same scheme may apply to Russian manufacturers (potential PSA contractors and subcontractors) and enable them to secure financing for their projects facilitating production of competitive goods and services.

The proposed fiscal scheme includes two options: long-term banking loans or the issuance of bonds.

The first option implies that the Russian Federation uses its share of profit production under the PSA as collateral for securing a guarantee from a multilateral financial institution (the IBRD or the EBRD, since Russia is a member). Such guarantee should then be used for obtaining loans for such PSA from commercial lenders. As is known, the IBRD and the EBRD provide the softest loans on the market, but their beneficiary may be either a State or an entity capable of providing an adequate state guarantee. The government should sell its profit crude share through an authorized petroleum company (be it a government-owned or private winner of a competitive bid). The sale revenue should be paid into a special bank account in an authorized bank (e.g. the Russian Bank for Development or the EBRD) for the purpose of debt servicing and principal repayment (see *Financing Secured by the State's Share of Profit Production*).

The second option is an alternative to commercial bank loans backed by guarantees from multinational lending agencies. The Russian Federation may issue bonds backed by the State's share of profit production from a given PSA project. Such borrowed funds may be deposited in an authorized bank (e.g. the Russian Bank for Development, EBRD) and the proceeds from the sale of the State's share of profit production used to repay the loan may be accrued in the project's account in the same bank (See. Government Bonds Backed by the State's Share of PSA Profit Production).

The State's share in future PSA production used as a security (under Government's guarantee) may enable Russian producers to obtain loans on more beneficial terms and help Russian PSA sponsors to maintain higher financial ratings. Financing costs may be lowered and the projects' rates of return may be raised. The recoverable costs may then be reduced by the amount of financing cost savings. The amount of profit oil will increase and the production sharing scale could thus be changed to the benefit of the State. In that case the State may benefit both from a larger share of profit production and a larger profit tax take. In sum, the State will make PSA projects more beneficial to the federal budget.

The Government presently has two options for handling its share of production from any given PSA project, which thus far has not been used as a financial asset. If treated as a source of future cash flow, the Government's production share may greatly facilitate project financing and improve economic effectiveness of PSA projects. These options may specifically imply that such financing structures should involve exclusively Russian organizations (e.g. the Russian Bank for Development) or may contemplate the involvement of multilateral agencies (e.g. EBRD), private oil companies, banks, etc. The final structure may be defined at a later date when actual financing arrangement is finalized.

The bond issue has a number of considerable advantages over bank loans in terms of schedule and interest rates (see *The Terms and Viability of Various Loan Instruments*). Bonds as a borrowing instrument enjoys higher liquidity, circulation on the secondary market and favorable taxation (elsewhere, but not yet in Russia). The bond borrowings are more transparent because all market players analyze the financial strength of the bond issuer. Bonds allow a better spread of investment risks and borrowings with longer maturity. In addition, a fixed interest rate is more acceptable to this category of borrowers.

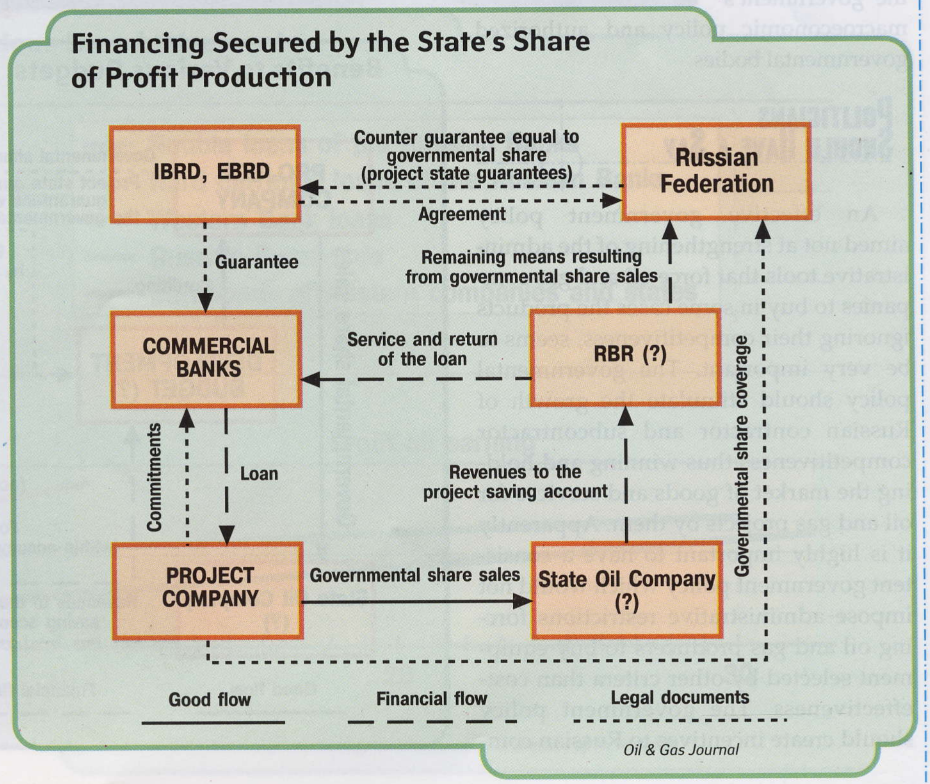
A preliminary analysis has shown that the most viable financial instrument for PSA oil and gas development projects may be secured bonds with coupons with fixed or variable interest rate and maturity ranging from five to thirty years. The interest payable on such coupons would typically be linked to the US Dollar exchange rate, which would reduce investors' risks. The nominal price of a bond is also subject to indexing to the US Dollar exchange rate and the payment on the indexed coupon is made at maturity.

The issuance of bonds is a preferred option for one more reason. Over the last 20 years this debt instrument has been increasingly used in the developing countries at the expense of bank loans. In other words, bonds are commonly used security for attracting project investment funds.

Government Project Guarantees

We propose, in fact, a new type of a government guarantee, namely the government Project Guarantee. Such a guarantee should warrant that the funds raised under a certain arrangement would be used to finance a given project. The financial arrangement envisions the use of the state's share of the future production as collateral (be it a bank loan or bond instrument). In this way political risks in a particular country would be minimized because the cash flows are limited to a specific PSA project.

Our estimates show that the proposed scheme would allow accumulation of considerable financial resources prior to project startup, i.e. way before first oil production and first actual returns. This opportunity is very important because the money raised with the help of the state could be used to finance the production of goods and services by competitive Russian companies instead of just buying such goods and services. These funds could also be used to finance modernization and retooling of manufacturing facilities with proven capabilities. The borrowings secured by the government's share of future production in this case may be



Financing Secured by the State's Share of Profit Production

compared to tied loans when the borrower is obligated to buy competitive domestically produced goods (works and services).

Our estimates indicate that up to 50% of the total (direct plus indirect) benefits to the Russian Federation from PSAs are not directly related to petroleum sales income and reach beyond the oil producing region. This percentage varies depending on project specifics and the anticipated scope of technological upgrading triggered in related industries. Thus, an additional flow of budget revenues from the machine building industry would begin long before the first oil is produced under the PSA projects. Hence, an efficient financing arrangement would facilitate modernization of Russian manufacturing companies and improve their competitiveness. The ultimate effect of these changes may be more significant to the country than sales revenue, which would occur much later (see *PSA Benefits to Various Budgets*). I believe that capturing such indirect benefits should be the major objective of the government's macroeconomic policy and authorized governmental bodies.

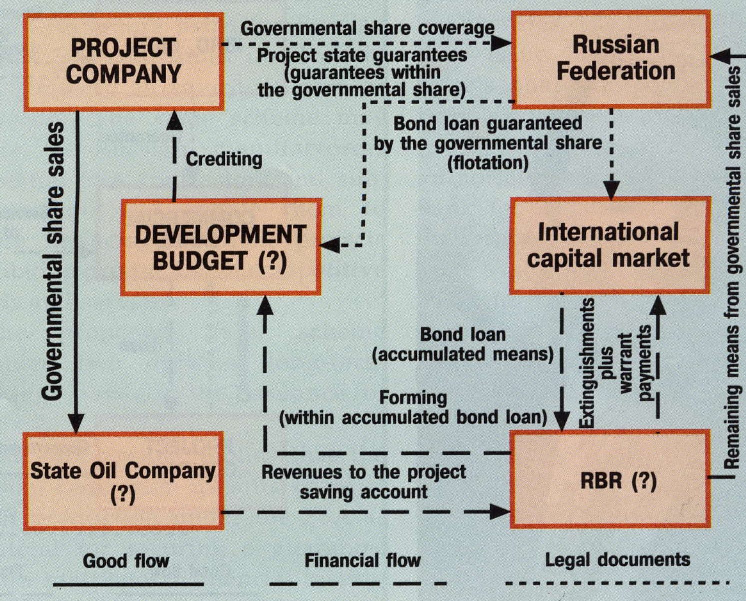
Politicians Should Have a Say

An effective government policy aimed not at strengthening of the administrative tools that force oil and gas companies to buy in some cases the products ignoring their competitiveness, seems to be very important. The governmental policy should stimulate the growth of Russian contractor and subcontractor competitiveness thus winning and holding the market of goods and services for oil and gas projects by them. Apparently it is highly important to have a consistent government policy which would not impose administrative restrictions forcing oil and gas producers to buy equipment selected by other critera than cost-effectiveness. The government policy should create incentives to Russian com-

Government Bonds Backed by the State's Share of PSA Profit Production

PSA Projects	Budgets		
	Federal	Regional	
		Recovering	Machine-building
Considering one technological limit			
Land			
minor	20	50	30
major	20	30	50
Sea	40	20	40
Considering five technological limits			
Land			
minor	30	50	20
major	30	30	40
Sea	50	20	30

Benefits to Various Budgets



Energy, Investment Policy, and Project Financing Fund

The Fund is an independent non-governmental and non-profit organization aimed primarily at attracting investment in Russia's economy. The Fund is seeking to ensure proper accumulation of investment capital and its efficient use through establishing a stable, long-term and mutually beneficial balance of interests of the State, the investors, and all legitimate participants of project financing in the fuel and energy industry.

The Fund's major activities include:

- Drafting proposals to potential investors and government bodies involved in preparing and financing investment projects (including actual negotiations, expert evaluations and relevant studies);
- Drafting proposals for investment funds accumulation and distribution (among other things, for project financing purposes);
- Preparing recommendations with respect to securing, placing, servicing, and repayment investment loans;
- Drafting laws and regulations governing investment relationship;
- Monitoring the Government investment policy and investment legislation, drafting proposals for its improvement;
- Studies of international and domestic capital markets, as well as regional and industrial markets of goods and services;
- Analysis of financial and economic performance of individual companies and groups.

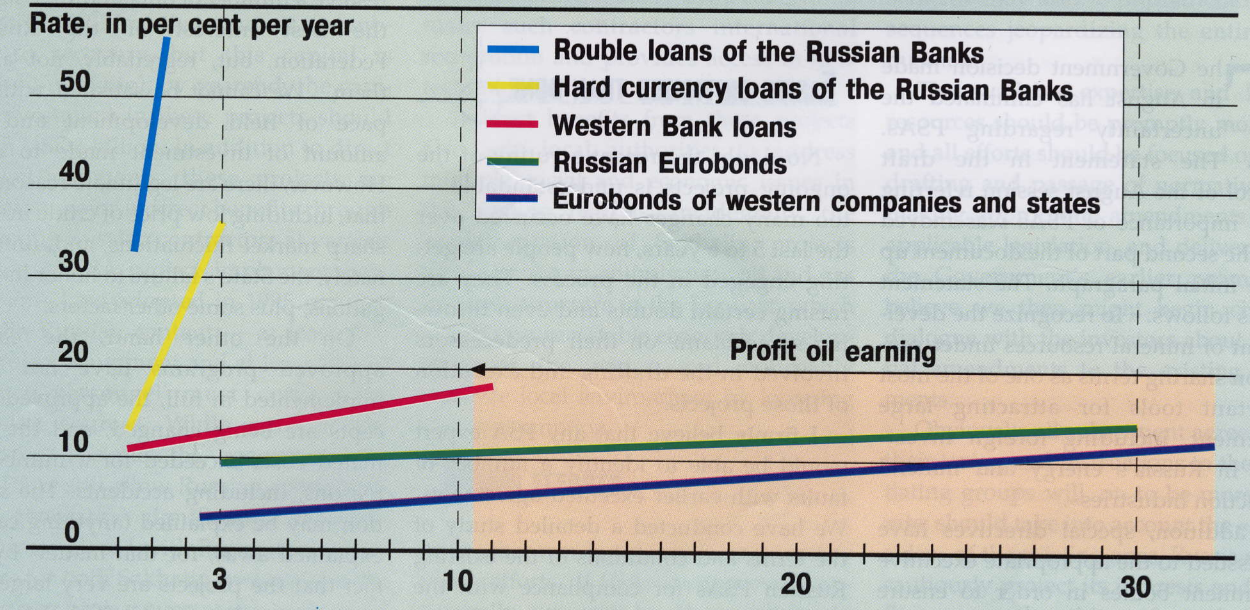
to Russian companies for improving their competitiveness in order to fnd a market for their products and maintain their market positions.

The Ministry of Economic Development and Trade apparently should focus on mesures to improve competitiveness of Russian contractors and subcontractors in order to make PSA project more economically viable to the Russian Federation. Contractors and subcontractors acount for almost a half of cash revenues to the host country from PSA projects. If that is the case, an emerging competition among three government ministries for control over PSA could be replaced by coordination of their joint efforts with each ministry being responsible for:

- Further increase of direct cash flow from PSAs for both hydrocarbon and non-hydrocarbon projects through efficient interaction with the producing companies (the Ministry of Energy and the Ministry of Natural Resources);
- Further increase of indirect cash flow generated as the PSAs' multiplier effect (the Ministry of Economic Development and Trade, probably in conjunction with the Ministry of the Industry, Science and Technology).

This presentation has addressed an economic mechanism of attracting financing on the strength of the ownership of future production in order to meet the above targets, and described PSA's borrowing potential. The legislative measures required for the implementation of this mechanism are obvious and need only a political will.

The Terms and Viability of Various Loan Instruments



Remark: the diagram is composed and prepared by Mr Fediashin