

Alternative Investment Regimes for Direct Foreign and Domestic Investments in Russian Subsoil

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CONTENTS:

- **A piece of theory**
 - **Licensing oil tax regime of the 1990's**
 - **Licensing oil tax regime reform of 2002**
- **PSA history in Russia (since 1994): up and down**
 - **Which way to go further?**

“THREE-LEVEL” OIL TAXATION SYSTEM

First level: extraction by the state, as the provider of public services, from all the subjects of business activities in all the spheres of economy a reasonable portion of their “entrepreneurial income” (through the mechanism of profit-tax);

Second level: extraction by the state, as the subsoil-owner, from all the subjects of business activities in mineral-extraction industries (usually: mining + non-renewable energy resources) a reasonable portion of “mineral/resource rent”, i.e. of income generated “by nature” (through the mechanism of royalty or similar government takes);

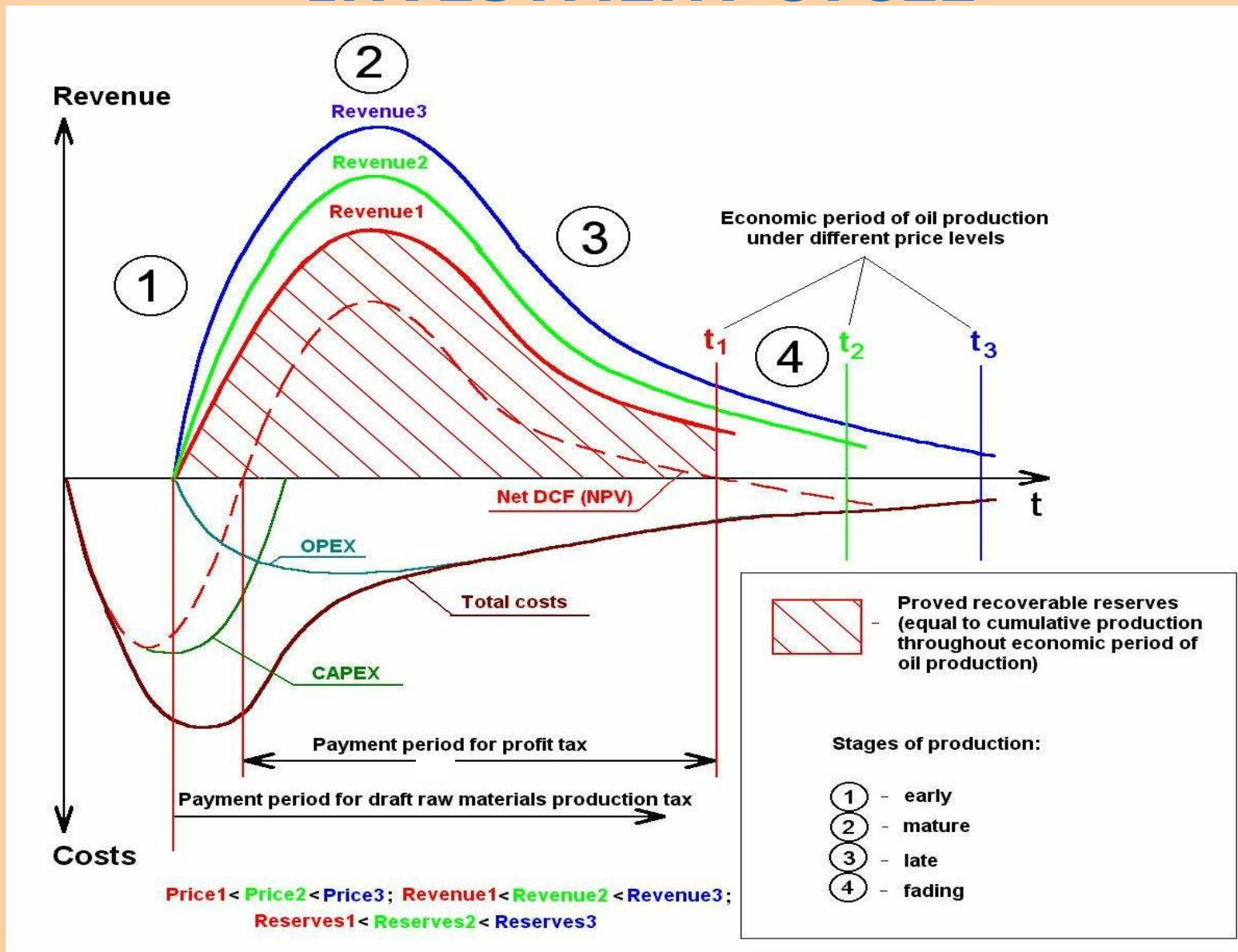
Third level: extraction by the state, as the subsoil-owner, from all the subjects of business activities in mineral-extraction industries a reasonable portion of the “differential economic rent” (incl. windfall profits), which has been received by some subsoil-users due to development of projects located in better natural conditions compared to the projects of other subsoil-users (through the mechanism of special oil taxes).

WHAT IS EFFECTIVE DIFFERENTIATED OIL TAXATION ?

To be effective, oil taxation need to implement
“**double differentiation**”:

1. “**Between**” the individual projects – to consider different natural conditions (geology, geography, etc.) of each individual project for maximum efficient extraction of the differential rent generated by this project compared to others;
2. “**Within**” the individual projects – to consider different stages of oil field development through which every investment project has been passing (early, mature, late, fading stage) for maximum efficient extraction of the changing portion of the economic rent in the oil price from one stage of the investment project to another.

FINANCIAL FLOWS DURING OIL-FIELD INVESTMENT CYCLE



INVESTMENT-RELATED STIMULI IN UPSTREAM OIL TAXATION : GENERAL CONSIDERATIONS

Stages of oil field development	Pro-investment stimuli in oil producers' taxation under the concept of its efficient (non-fiscal) formation
Early	Diminishing of tax burden, especially of revenue-based taxes, shift of tax burden from early to mature stage: tax holidays, tax credits & tax-related uplift at oil field investment stages
Mature	Sliding scale (project-to-project differentiation) of taxation linked to the factors of mineral rent formation
Late	Reserves depletion allowance, dependent on system of factors
Fading	Reserves depletion allowance, dependent on system of factors, up to zero rate of special oil taxes

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OIL TAX DEVELOPMENTS OF THE EARLY 1990's

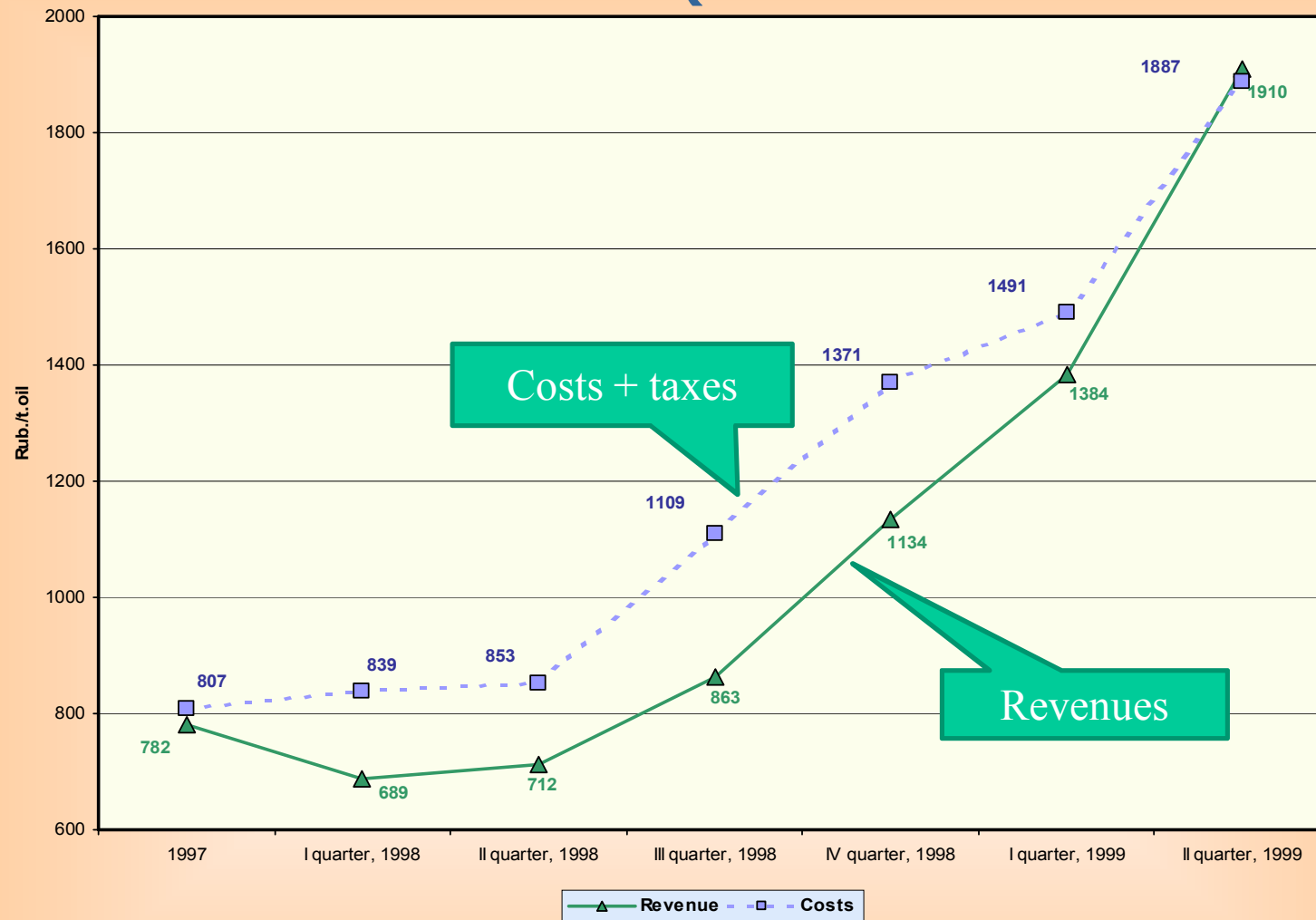
- New oil tax system was developed to represent the changes from “administrative” Soviet-style state economy to a market-oriented economy of post-Soviet Russia:
 - from 100% state oil business => to private oil companies;
 - from free-of-charge subsoil use => to chargeable use of the subsoil;
 - from “indirect” taxation Soviet-style (administratively diminished domestic energy prices, calculated on cost-plus/cost-minus basis, and state monopoly on external trade) => to direct taxation of oil operations (liberalization of domestic prices and of oil export, plus export customs duties);
- Financial crisis/budget deficit of early 1990s => strong demand for fiscal-oriented oil taxation; strong debates between fiscal-oriented and investment-oriented Ministries => fiscal-oriented has won the battle.

RUSSIAN OIL TAXATION OF THE 1990s

Oil taxation of the 1990s reflects the negative features of the starting phase of economy in transition facing strong financial crisis:

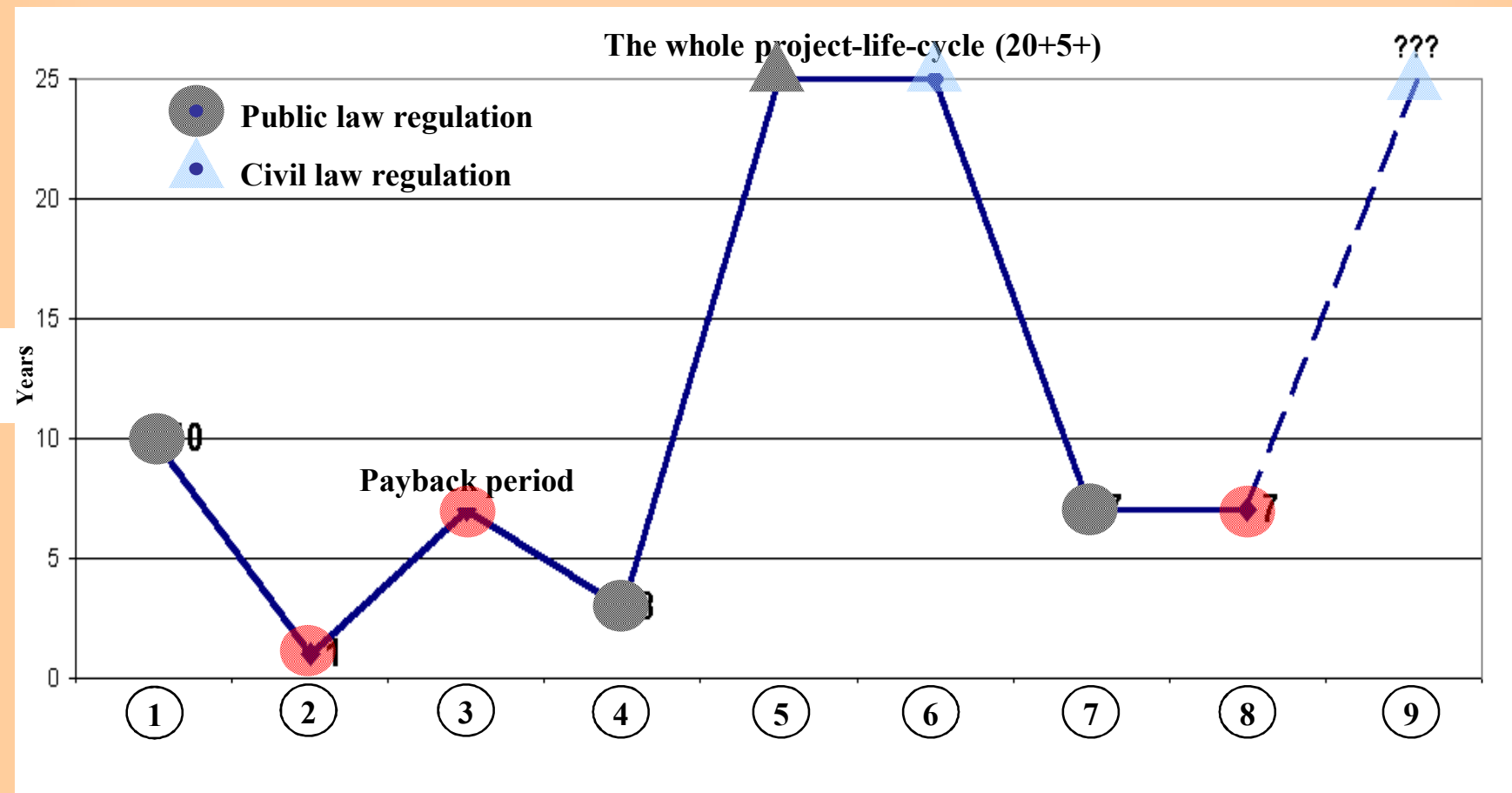
- Revenue-based, not profit-based => at low-price periods costs plus taxes exceeded oil price;
- Permanently increasing number of taxes at federal, regional and local levels (once up to maximum of 47 in total);
- Increase of effective aggregate tax rate into the range of “excessive” values which stipulated low tax collection (effect of “Laffer’s curve”) & non-payments;
- Lack of transparency in tax administration (contradicting regulations);
- No stability & predictability;
- De-stimulated new investments;
- Destroyed existed investment projects based on “project financing” principles (JVs).

GROSS REVENUE AND FULL PRODUCTION COSTS OF RUSSIAN OIL INDUSTRY (second half of the 1990s)



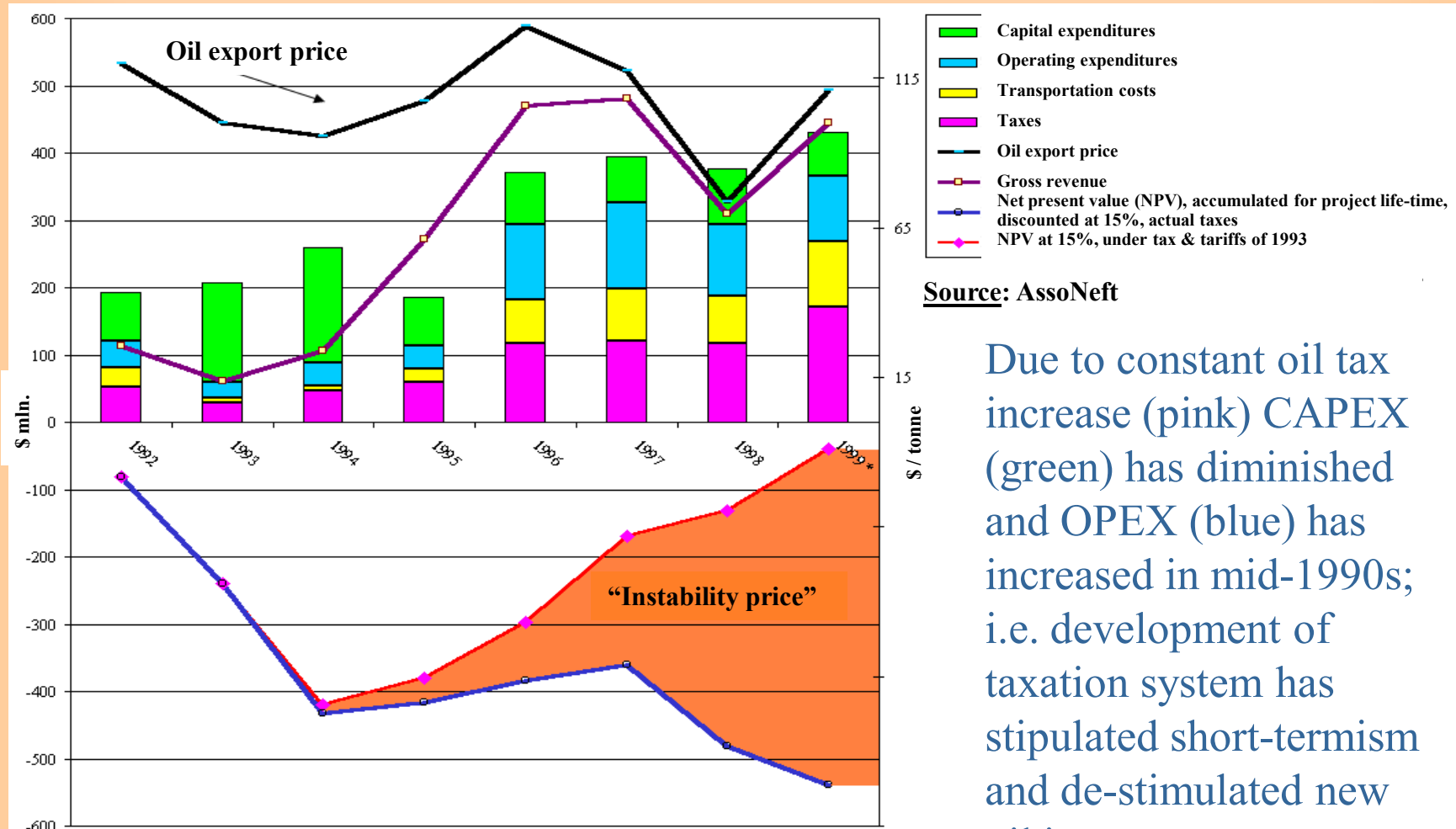
Source: Основные концептуальные положения развития нефтегазового комплекса России. – М., Минтопэнерго, 2000 («Нефтегазовая Вертикаль», 2000, №1, спецвыпуск)

DURATION OF THE "GRANDFATHER'S/STABILIZATION CLAUSE" IN RUSSIAN INVESTMENT-RELATED LEGISLATION



1. Fundamentals of the USSR legislation on Foreign Investments (June 1991)
2. Law "On Foreign Investments in the RSFSR" (July 1991)
3. Decision of the Government of RF №1375 (July 1992)
4. Decree of the President of RF №1466 (September 1993)
5. Decree of the President of RF №2285 (December 1993)
6. Law "On Production-Sharing Agreements" (December 1995)
7. Law "On Investment Activities in RF, Implemented in the Form of Capital Expenditures" (February 1999)
8. Law "On Foreign Investments in RF" (July 1999)
9. Draft Law "On Concessions" (2003+?)

“INSTABILITY PRICE” OF THE RUSSIAN TAX LEGISLATION (for a group of non-integrated oil companies)



Source: AssoNeft

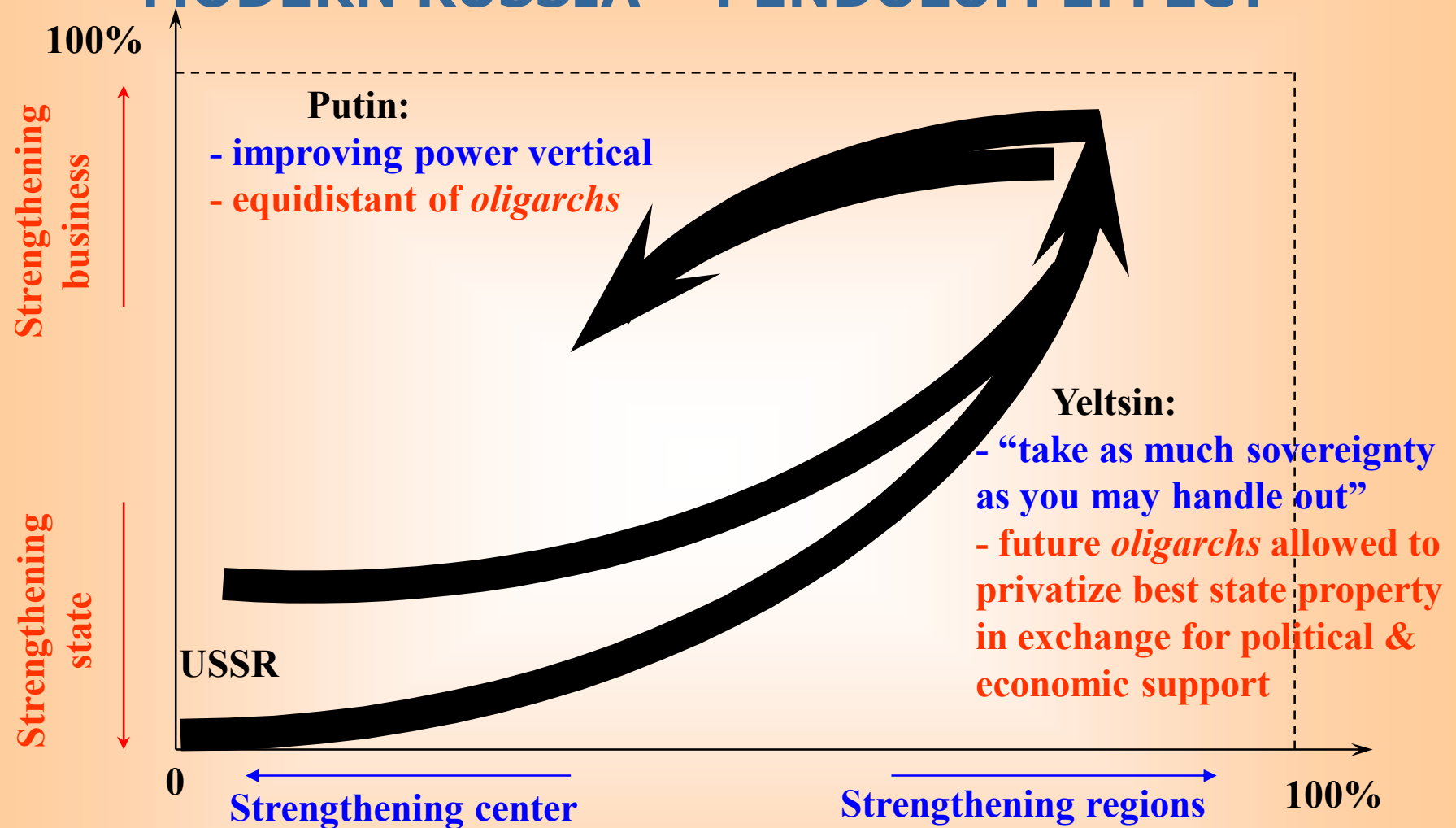
Due to constant oil tax increase (pink) CAPEX (green) has diminished and OPEX (blue) has increased in mid-1990s; i.e. development of taxation system has stipulated short-termism and de-stimulated new oil investments

In the 1990s negative NPV has increased almost 2-fold (“instability price” equals almost 100%) => killing existing JVs established on project financing basis

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EVOLUTION OF STATE ECONOMIC POLICY IN MODERN RUSSIA – PENDULUM EFFECT



2002 OIL TAX REFORM TASKS

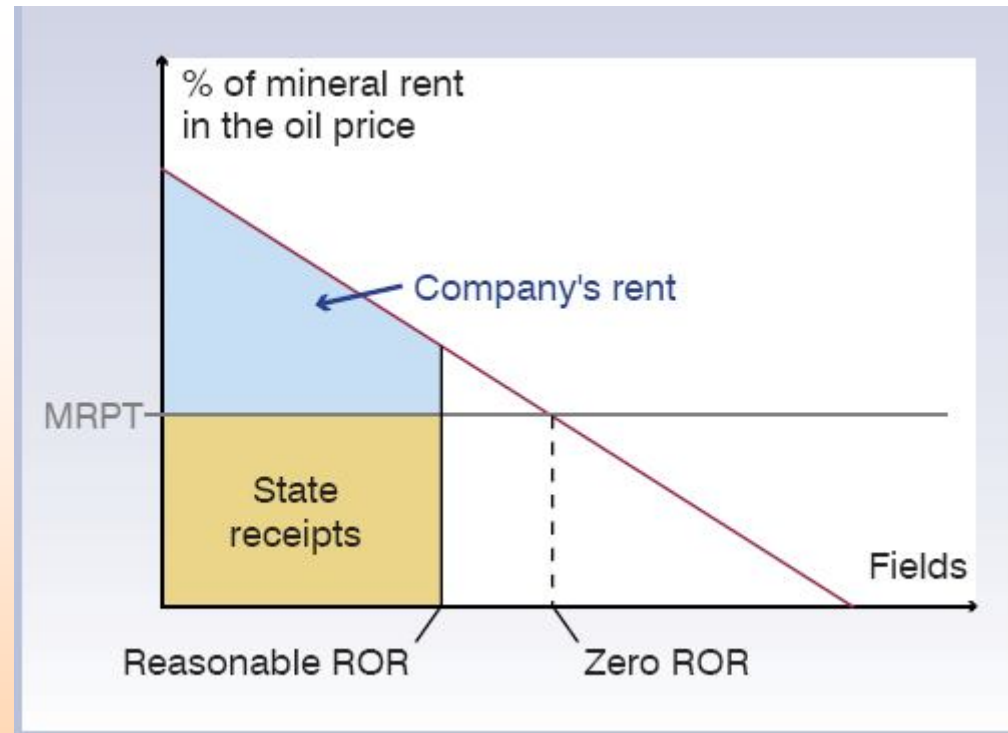
- To liquidate transfer-pricing within oil industry (from *ad valorem* tax calculation to specific/flat rates) =>
- To increase tax-collection;
- To ease tax-administration (to diminish number of taxes by combining the taxes that have the same pre-tax base, i.e. to substitute a number of “similar” taxes by the single one with retaining the same tax pressure on tax-payers) =>
- To increase transparency of tax system + its simplification;
- To redistribute tax revenues allocation in favor of increased federal share =>
- To increase centralization of tax collection and decrease region’s intentions for self-dependency and autonomy (*de facto*: from “strong regions = strong Russia” to “more dependant regions on economic transfers from the federal centre”);
- To extract higher portion of economic rent from oil-producing companies and to redistribute it through the federal budget to priority areas of government spending (reflect increasing state role in the economy), etc.

NDPI (MRPT) rate vs. oil price



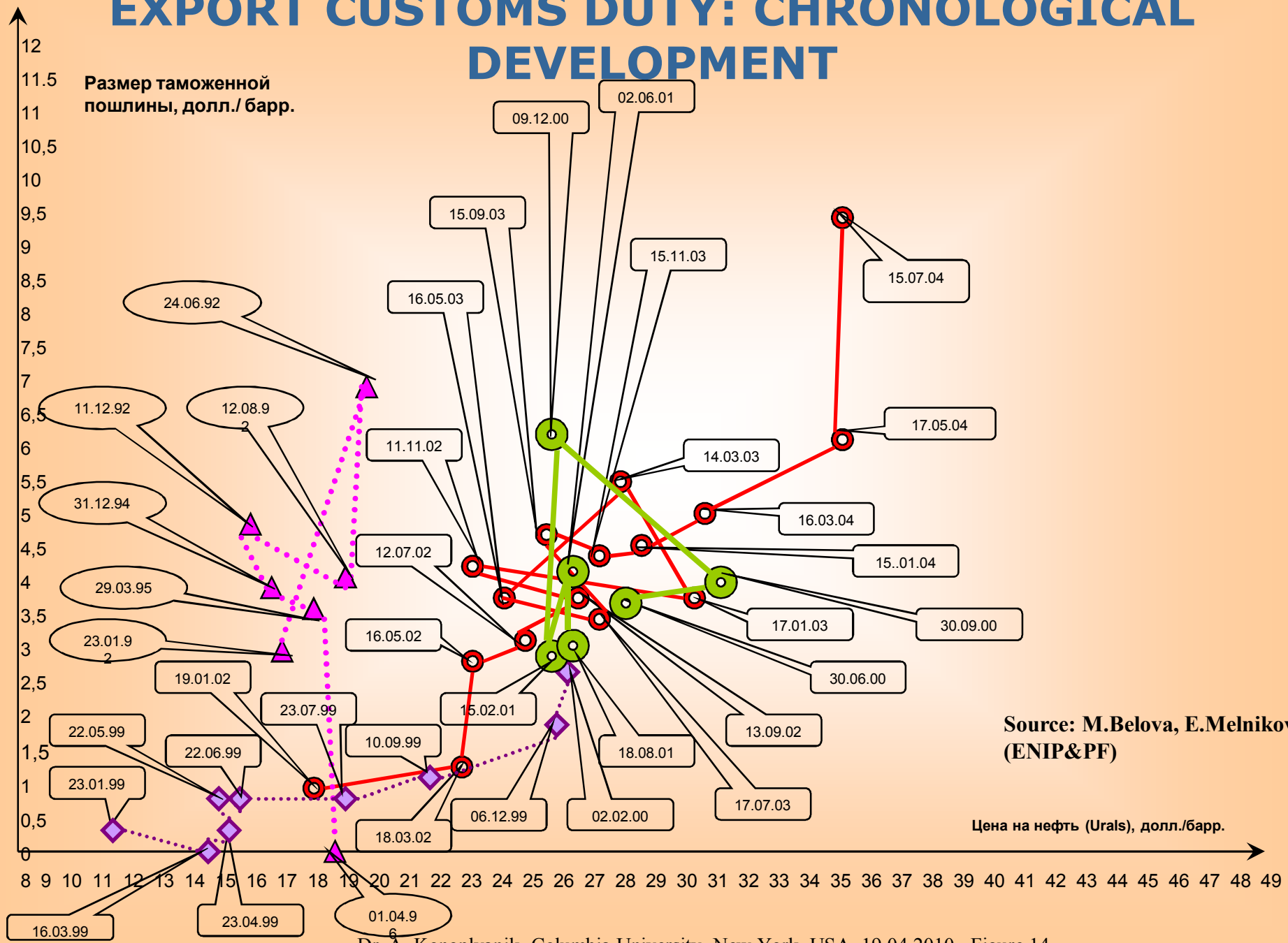
Source: А.Мещерин. Налогообложение: ножницы Кудрина и пряники для избранных. – «Нефтегазовая вертикаль», 2010, #5, с.21.

Flat-rate tax system: why & what the state loose



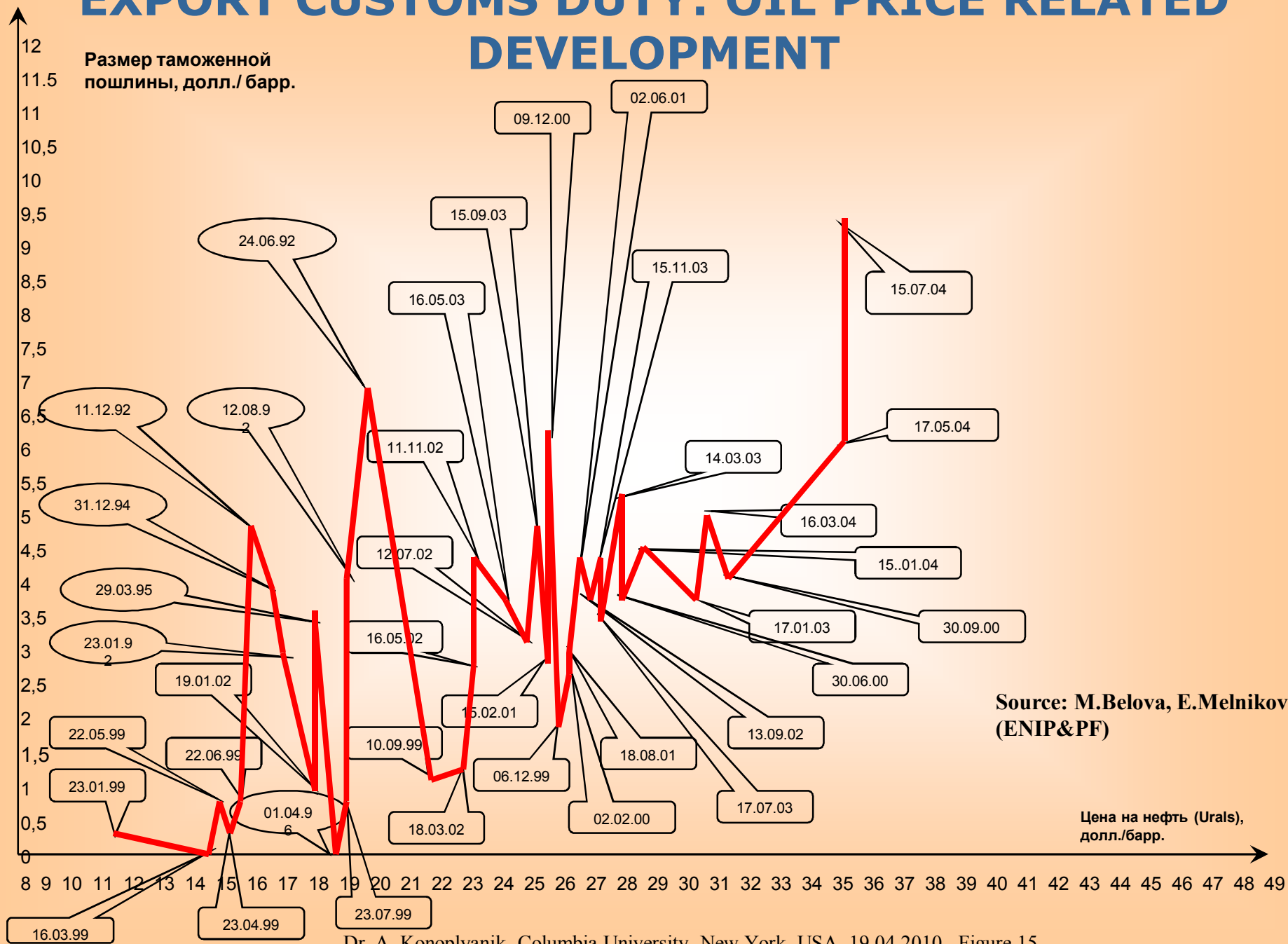
Source: A.Konoplyanik. A struggle for mineral rent. - *"Petroleum Economist"*, August 2003, p. 23 – 24; Андрей Конопляник: «Ухудшение экономических условий возвращает на повестку дня законодателей вопрос целесообразности реабилитации СРП». – *«Нефть и капитал»*, 2009, № 3, с.18-23.

EXPORT CUSTOMS DUTY: CHRONOLOGICAL DEVELOPMENT



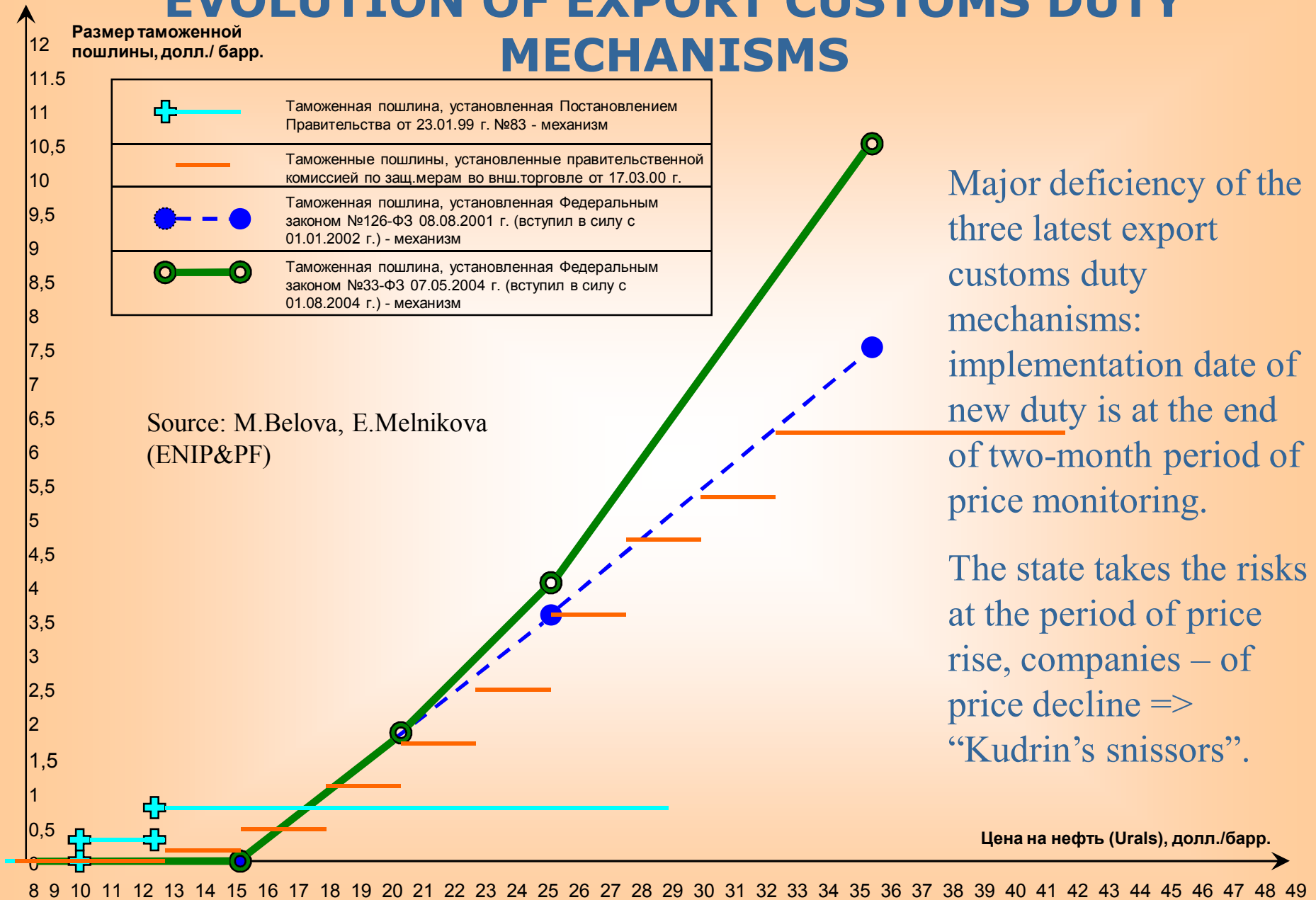
Source: M.Belova, E.Melnikova (ENIP&PF)

EXPORT CUSTOMS DUTY: OIL PRICE RELATED DEVELOPMENT



Source: M.Belova, E.Melnikova (ENIP&PF)

EVOLUTION OF EXPORT CUSTOMS DUTY MECHANISMS



Major deficiency of the three latest export customs duty mechanisms: implementation date of new duty is at the end of two-month period of price monitoring.

The state takes the risks at the period of price rise, companies – of price decline => “Kudrin’s snissors”.

“Kudrin’s snissors” (difference between “fair”/justified & factual oil export duties)



*) “Fair” duties are calculated based on actual formula & factual average monthly prices

Source: А.Мещерин. Налогообложение: ножницы Кудрина и пряники для избранных. – «Нефтегазовая вертикаль», 2010, #5, с.23.

INVESTMENT-RELATED STIMULI IN UPSTREAM OIL TAXATION IN RUSSIA UNDER LICENSING SYSTEM: pre vs. post 2002

Stages of oil field development	Pro-investment stimuli in oil producers' taxation under the concept of its efficient (non-fiscal) formation	Presence of pro-investment stimuli in taxation of oil producers:	
		In pre-2002 Russian tax legislation	In post-2002 Russian tax legislation
Early	Diminishing of tax burden, especially of revenue-based taxes, shift of tax burden from early to mature stage: tax holidays, tax credits & tax-related uplift at oil field investment stages	Partly existed (investment-related concession on profit tax up to 50% of the tax-base of the latter)	No
Mature	Sliding scale (project-to-project differentiation) of taxation linked to the factors of mineral rent formation	Partly existed in indirect form through negotiable character of establishing royalty value in licensing agreement	Basically no; except one common factor (reflecting changes in world oil prices, i.e. Brent spot dated) which does not consider stages of field development, different oil qualities, domestic price changes, real export quotas, etc.
Late	Reserves depletion allowance, dependent on system of factors	Basically no. Few regions (i.e. Tatarstan) has been using it for marginal wells/fields via mechanism of diminishing a regional portion of the profit tax	No
Fading	Reserves depletion allowance, dependent on system of factors, up to zero rate of special oil taxes		No

2002 OIL TAXATION REFORM: MAJOR **POSITIVE** RESULTS

New tax system (MRPT):

1. Rather transparent and easy to collect (flat rate),
2. “Exclude” transfer pricing – increase in budgetary revenues,
3. Provide higher predictability of budgetary revenues,
4. Provide opportunity to fill in newly established Stabilization Fund to diminish foreign debt (but which remaining resources are to be invested not into Russian, but into Western economy).

But: All benefits – on fiscal side

2002 OIL TAXATION REFORM: MAJOR **NEGATIVE** RESULTS (1)

New tax system (MRPT):

1. Allows the companies working in new producing areas, on younger fields (usually being received from the state in the course of privatization/loans-for-shares-auctions free-of-charge), to earn incremental profits which are not shared with reserves-owner but mostly transformed into shareholders dividends =>
 - Most of younger oilfields were received by the newly established Russian VICs owned & managed by the “new” oilmen, e.g. mostly people originated from the outside of the oil industry, with the short-term financial mentality; for them their newly owned companies were mostly financial assets – easily/cheaply received and to be profitably re-sold ASAP (preferably to Western IOCs) => short-term-oriented management decisions =>
 - in the longer run provokes non-recoverable losses of oil in-situ, decreasing recovery rates & recoverable reserves volumes, diminishment of the economic base for tax collection
2. Does not consider natural differences in productivity of oil fields and quality of crudes produced, and deprive the companies working at mature and marginal fields (unfair competition);

2002 OIL TAXATION REFORM: MAJOR **NEGATIVE** RESULTS (2)

New tax system (MRPT):

3. Deprive small and medium non-integrated companies, which possess 1-2 producing licenses, usually at marginal fields, and which supply oil at domestic market, contrary to VIOCs that possess in their portfolio bigger number of licenses, incl. larger and highly productive fields;
4. Creates prerequisites for the bankruptcy of small and medium companies by VIOCs, for further monopolization of the oil industry, depriving competition - *but* older resource base demands stimulation of independent oil sector;
5. Stimulate sample development of highly productive fields only. Prevent comprehensive subsoil management and complete extraction of non-renewable energy resources;
6. Deprive exploration, especially in Greenfield areas.

But: All negative consequences – on investment and macroeconomic (through indirect and multiple effects) side =>

MRPT = simplification/primitivisation of subsoil payments system in favour of increasing tax collection *but* depriving rational subsoil use

Oil Taxation since 2006

- 2006 = maximum strengthening of MRPT pressure, since then
 - few attempts to stimulate oil investments:
 - 2007: MRPT allowance for highly depleted (>80%) fields (based on good experience of Tatarstan & Khanty-Mansi region) – but proposed MRPT differentiation was neglected,
 - 2007, 2009: Individual concessions for Greenfields => MRPT holidays (up to 7-10-15 years & up to 10-15-25-35 mln tonnes cumulative oil production per project) in new provinces (East Siberia & offshore),
 - 2009: non-taxed by MRPT minimum price level increased from 9 to 15 \$/bbl, profit tax rate diminished from 24 to 20%, depreciation premium increased 3-fold, oil export duties cancelled (temporary?) for new East Siberian fields.
- but still fiscal equalization spread over the whole country (forbidden differentiation) – no alternatives to fiscal “MRPT + export duty” concept.

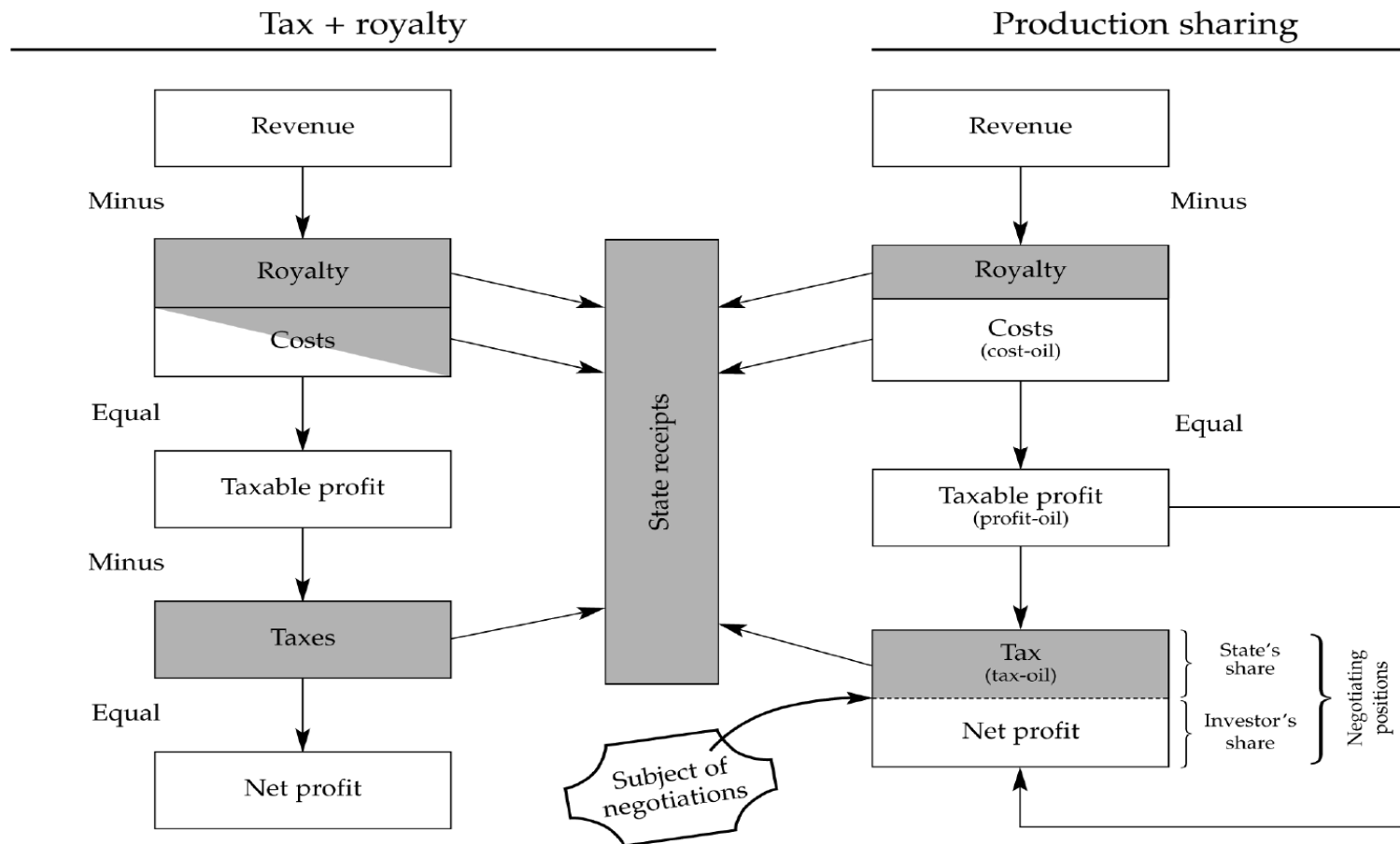
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PSA LEGISLATION: MAJOR TASKS (as foreseen by its drafters in 1993-1996)

- To create legal basis for “project financing”,
- To introduce civil law (contractual law) principles into Russian legislation, incl. mutual responsibility of the State and the Investor,
- To provide legal and tax stability, transparency, predictability for the projects with highest CAPEX per project value, longest investment cycle and project’s life-time,
- To introduce competition between two mutually-equal investment regimes for investor thus increasing their investor-friendly character,
- To introduce profit-base taxation with “double differentiation” – based on common mechanism (sliding scale of IRR-based production-sharing) but being individualized for each particular project, etc.

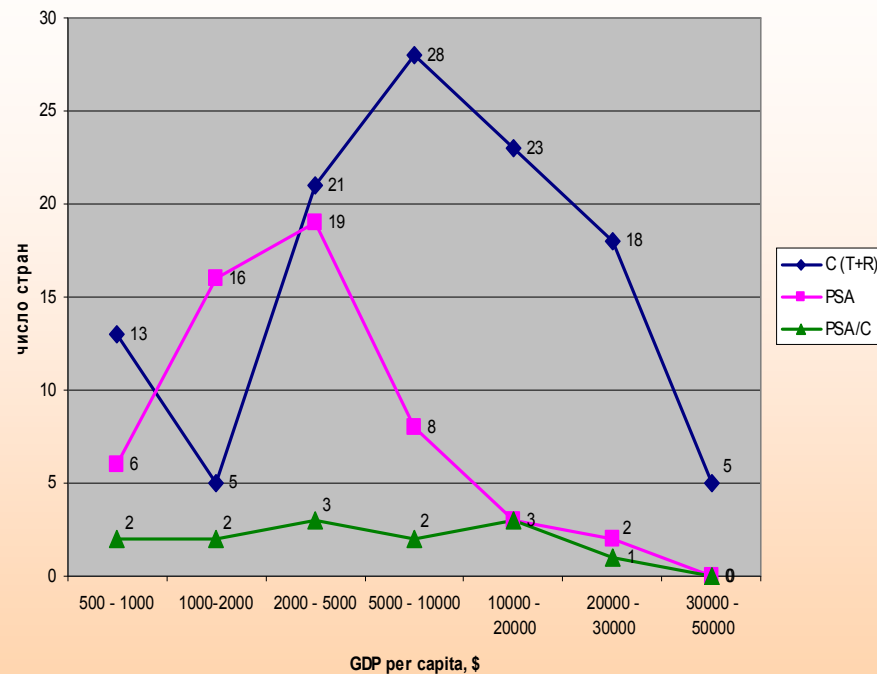
Basic difference between tax plus royalty and PSA regime



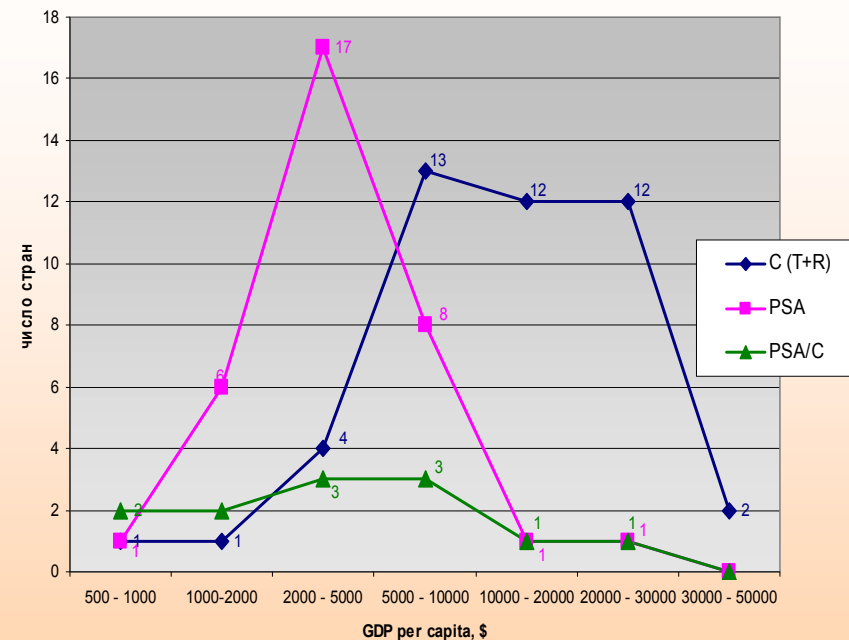
Source: A. Konoplyanik. *Complex approach for attracting foreign investments into Russian energy*. Dissertation in form of scientific presentation for Doctor of Economics degree. Moscow, State Academy of Management named after S. Ordjonikidze, 1995, p.81.

Concessions (T+R) vs. PSA worldwide: Distribution curves (2004)

(A) By numbers of the states

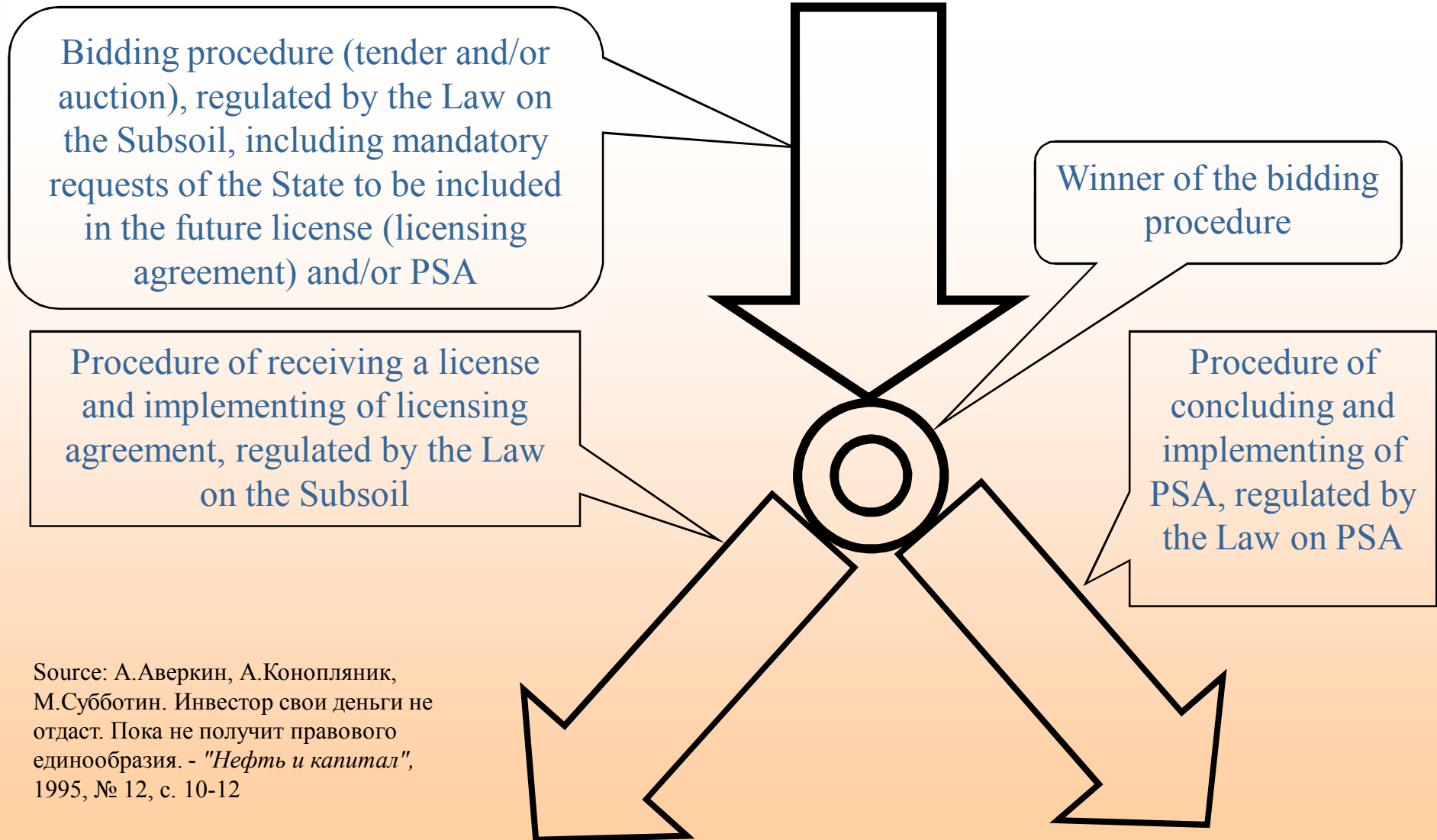


(B) By number of the oil-producing states



Calculated by ENIP&PF (M.Belova) with involvement of data provided by Barrows Inc.

Two equal regimes (author's historical proposal)



Source: А.Аверкин, А.Конопляник, М.Субботин. Инвестор свои деньги не отдаст. Пока не получит правового единообразия. - *"Нефть и капитал"*, 1995, № 12, с. 10-12

Comparison of flat-rate MRPT and PSA systems

Figure 1: Flat-rate tax system

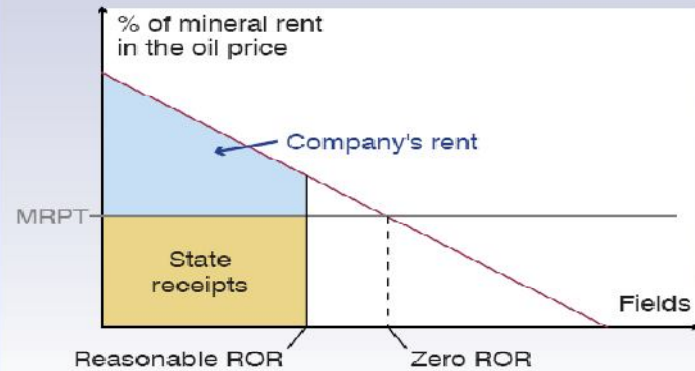


Figure 2: PSA

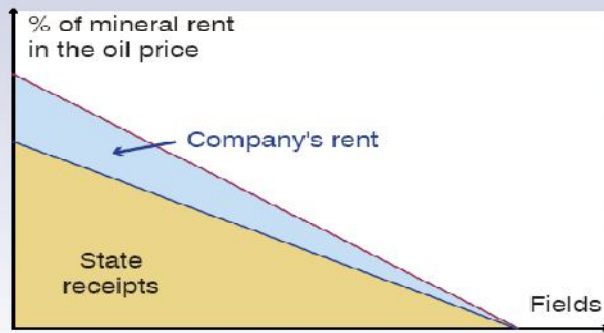
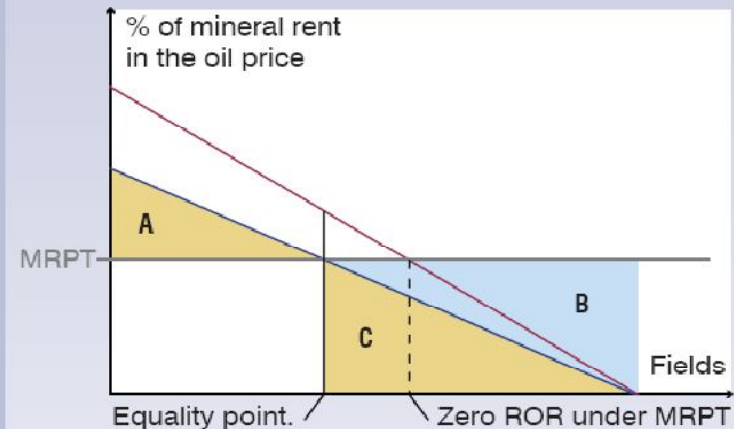


Figure 3: Transfer from MRPT to PSA



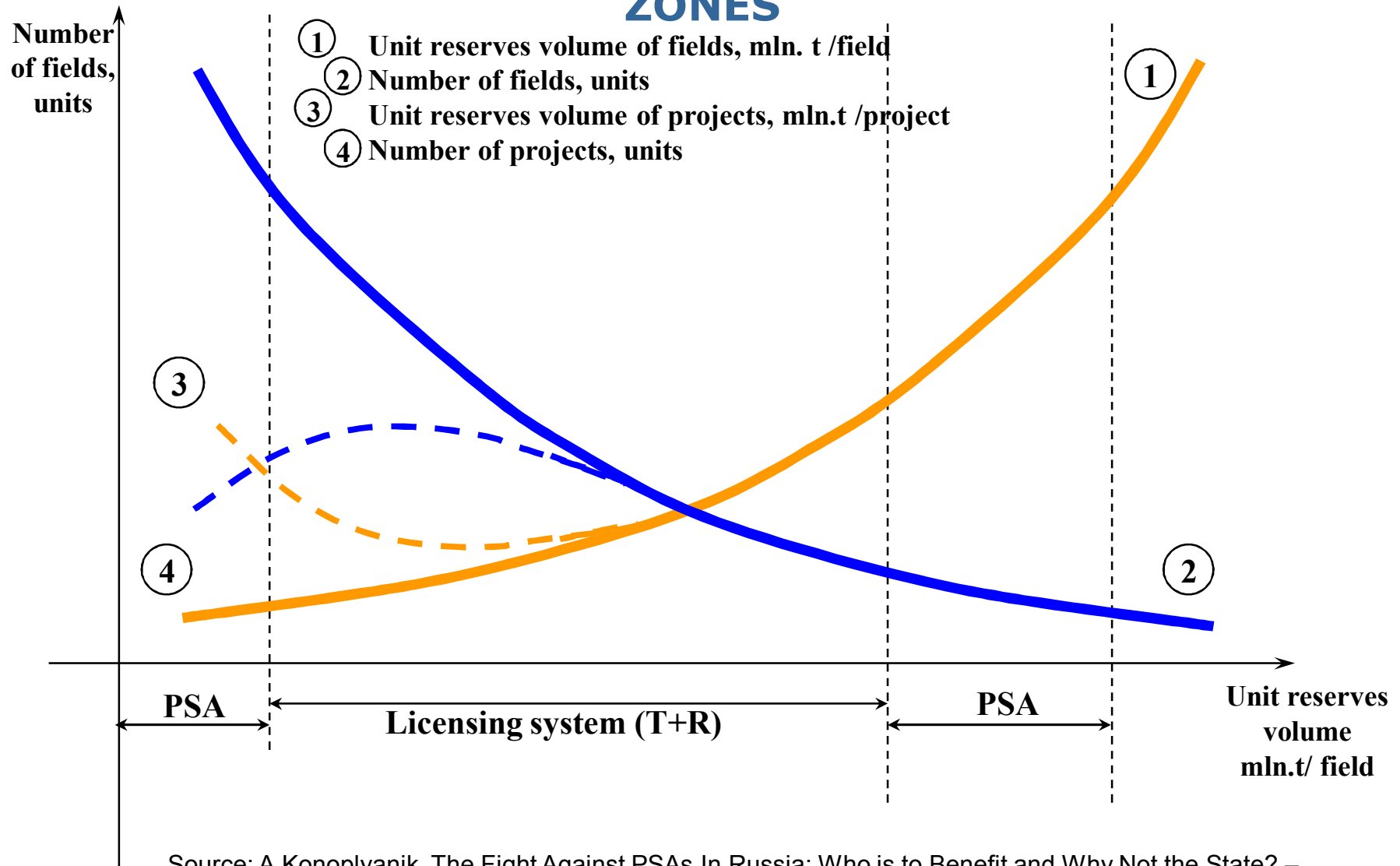
A: Companies' incremental rent-type earnings under MRPT, which transferred into state take under PSAs

B: Revenues that the opponents of PSAs wrongly claim are lost to the state under transition to PSAs

C: Incremental state earnings under PSAs through development of non-profitable fields under MRPT with flat rate

Source: A.Konoplyanik. A struggle for mineral rent. - *"Petroleum Economist"*, August 2003, p. 23 – 24; Андрей Конопляник: «Ухудшение экономических условий возвращает на повестку дня законодателей вопрос целесообразности реабилитации СРП». - *«Нефть и капитал»*, 2009, № 3, с.18-23.

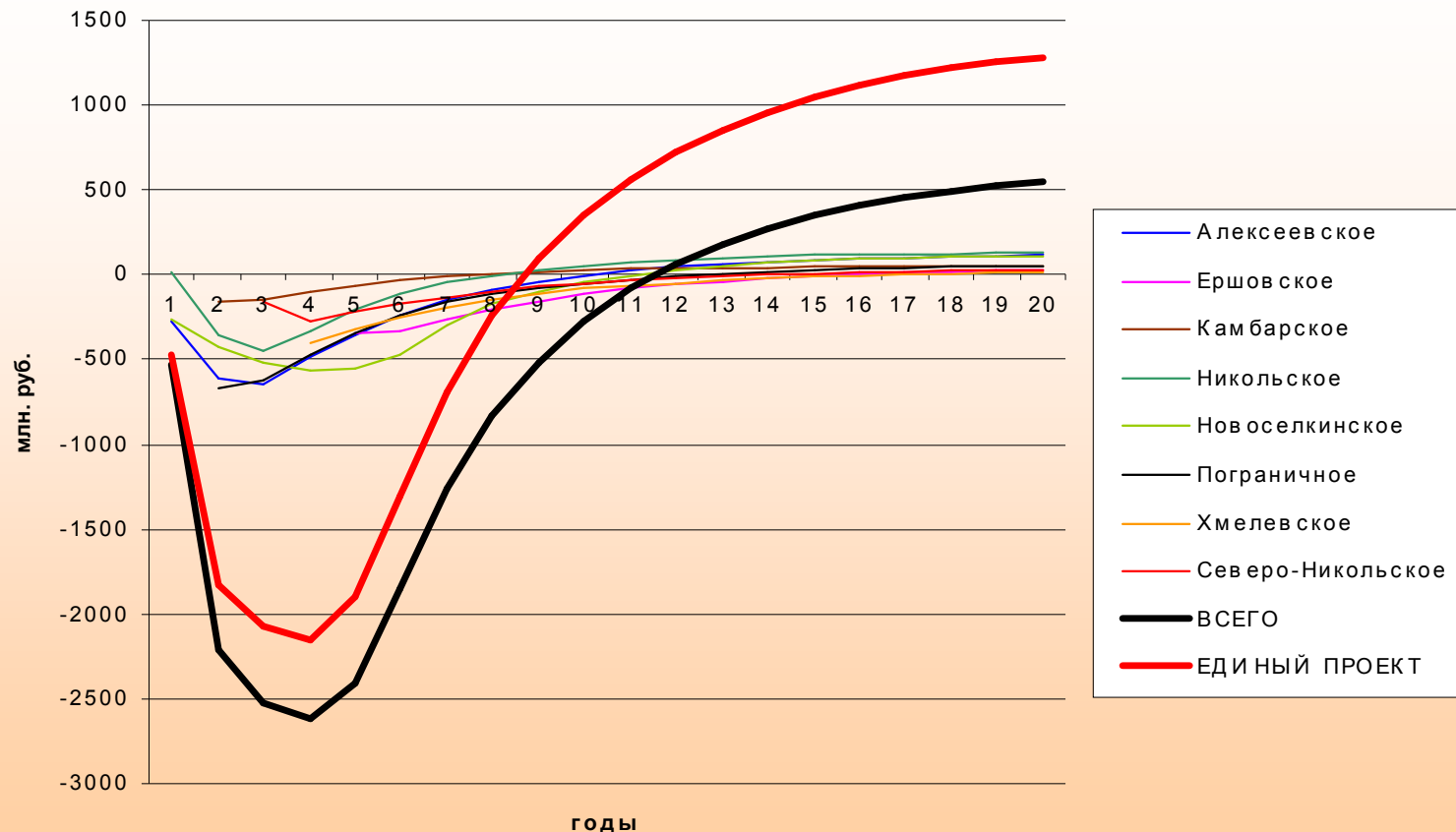
PSA vs. LICENSING (T+R) PREFERENTIAL APPLICATION ZONES



Source: A.Konoplyanik. The Fight Against PSAs In Russia: Who is to Benefit and Why Not the State? – *“International Energy Law & Taxation Review”*, Issue 10, October 2003, p.277-286.

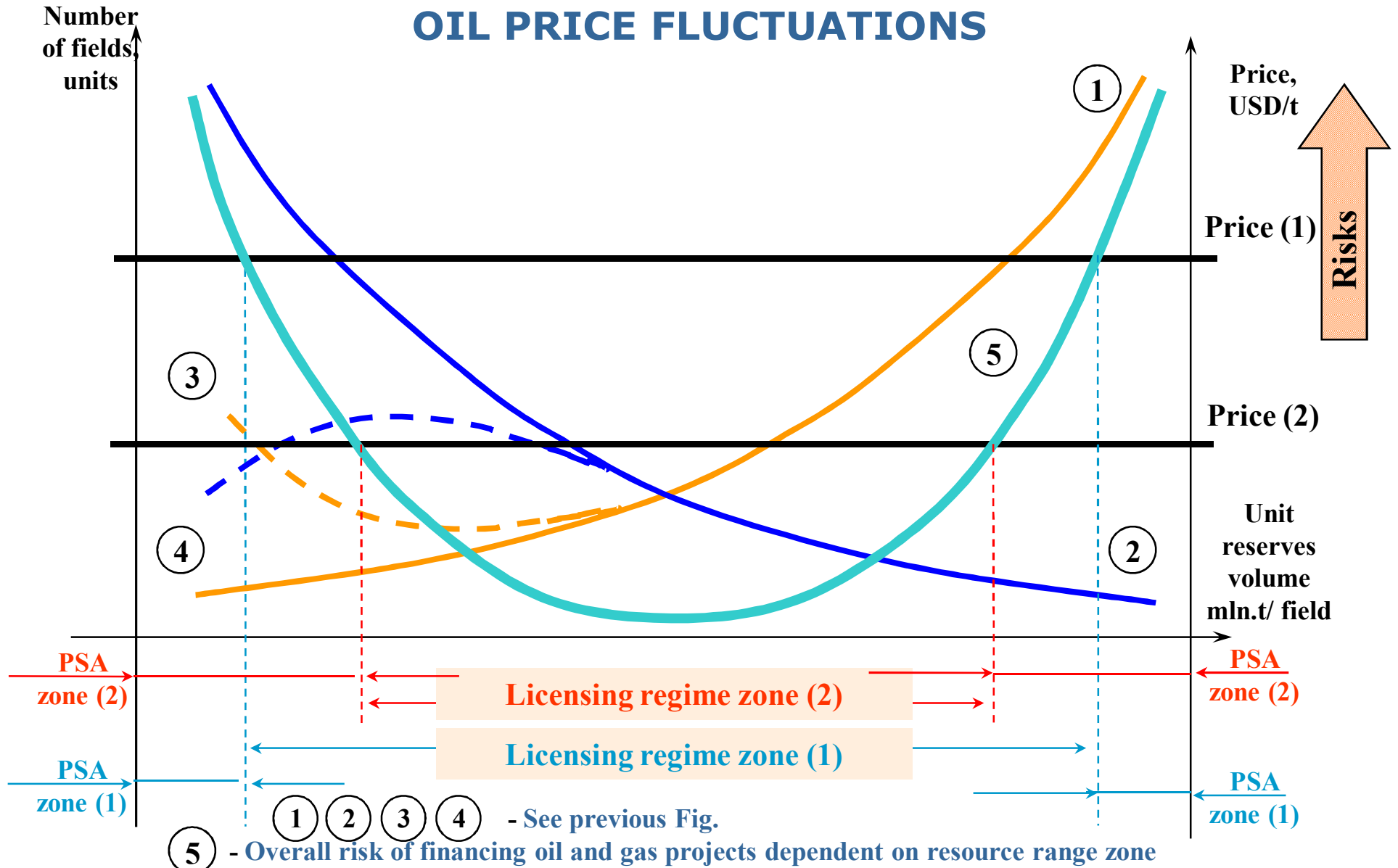
Cumulated DCF/NPV of individual fields and united project (Udmurtia project case)

Чистый дисконтированный доход по каждому месторождению и в сумме



Source: В.Грушин, А.Конопляник, Н.Оксенгорн. О порядке перевода мелких месторождений углеводородов на режим СРП (в порядке обсуждения). – «Нефтяное хозяйство», июнь 2002, № 6, с.83-89.

CHANGING RANGE OF PSA vs. LICENSING ZONES WITH OIL PRICE FLUCTUATIONS



Source: A.Konoplyanik. The Fight Against PSAs In Russia: Who is to Benefit and Why Not the State? – “International Energy Law & Taxation Review”, Issue 10, October 2003, p.277-286; Андрей Конопляник: «Ухудшение экономических условий возвращает на повестку дня законодателей вопрос целесообразности реабилитации СПГ». – «Нефть и капитал», 2009, № 3, с.18-23.

PSA STORY: MAJOR CURRENT RESULTS

- PSA regime has been marginalized (from open-end list of 250+, first to 3+28, now to 3+5 (?) PSA projects): window for small PSAs is closed, window for mega-projects is narrowed as much as possible;
- Losers: Russian state and project-oriented foreign investors; plus most of Russian oil companies; plus Russian manufacturers which lobbied against PSA;
- Winners: were expected to be two particular “Russian” VIOCs, who lobbied against PSA in order to increase their own selling price;
- No new PSA projects can be foreseen as a general rule in the nearest future (only on a pure exceptional basis), until PSA regime would be effectively restored;
- Sakhalin-2 story is not the fault of PSA system;
- PSA regime is to be and would be restored (hopefully rather soon) since this is in the long-term interests of Russia

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- 3. Licensing oil tax regime reform of 2002**
- 4. 10 years of PSA history (1994-2004): up and down**
- 5. Russian oil taxation: current plans**
- 6. Which way to go further?**

HOW MANY INVESTMENT REGIMES/TAX SYSTEM NEEDED?

Russia is not obliged to implement domestically only one legal regime for subsoil use, especially because of huge geographical dimensions and geological complexities in different areas of the country.

Russia allowed application of licenses, concessions, PSAs, risk-service contracts within its territory by the law “On the Subsoil” (1992, Art.12).

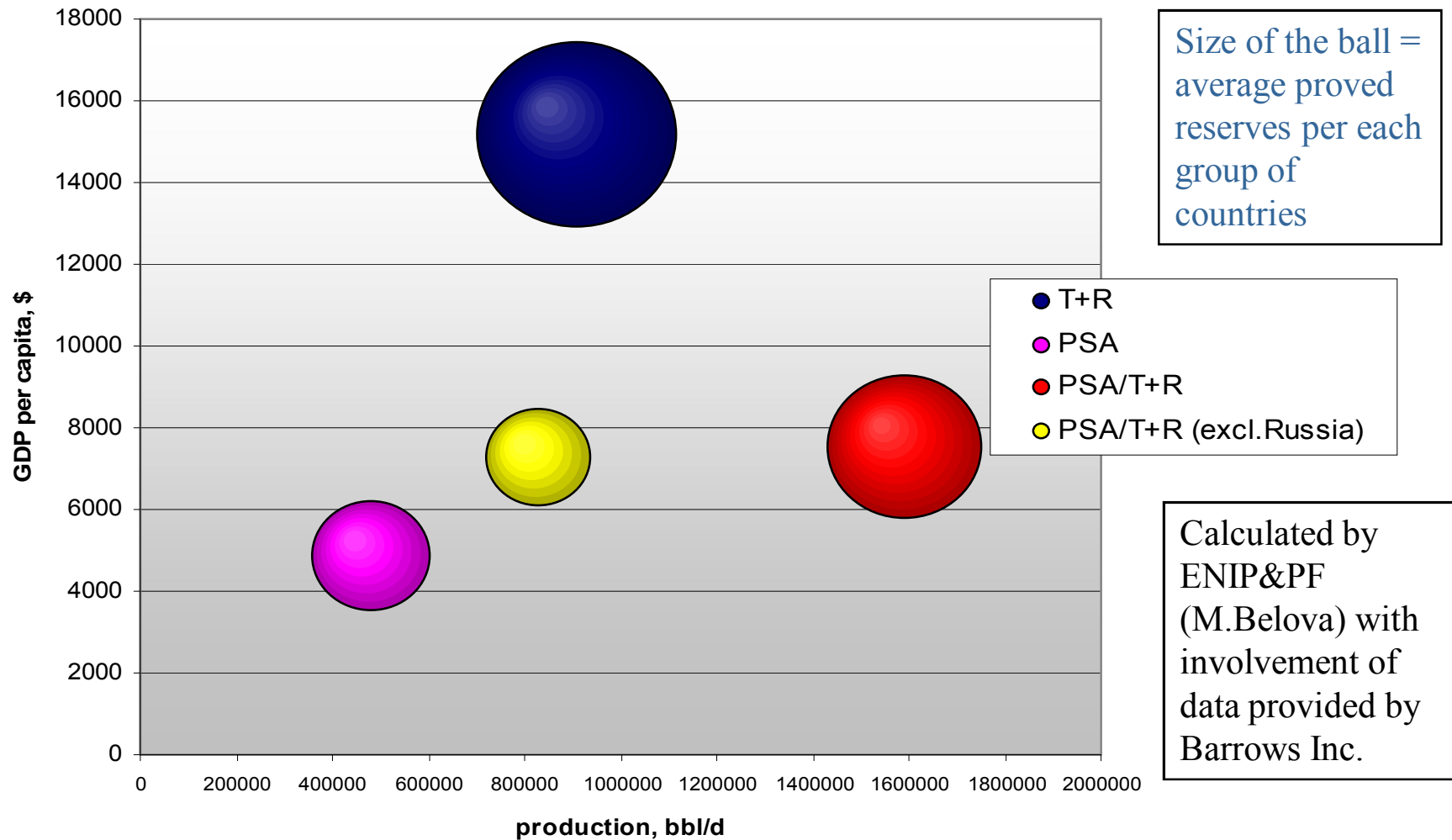
Russia has already implemented (since 1996) two regimes for subsoil use in its legislation (licensing system and PSA), but the latter has been consistently marginalized.

Russia is one among 13 oil-producing countries (with cumulative proved oil reserves equal to 9.1% and crude production to 23.2% of worldwide) (*) that implement more than one legal regime for subsoil use.

Russia is placed on the economic development scale between the more developed countries with one (licensing) regime and less developed countries with one (PSA) regime.

(*) Source: ENIP&PF/Barrows/2004

Oil taxation models vs. average GDP per capita, oil production and reserves (2004)



Source: A. Konopliyanik. Russian Oil Taxation System Development (a continuous debate between supporters of fiscal-oriented and investment-oriented approaches). - 15th International Petroleum Tax Conference, 11-12.11.2004, Oslo, Norway

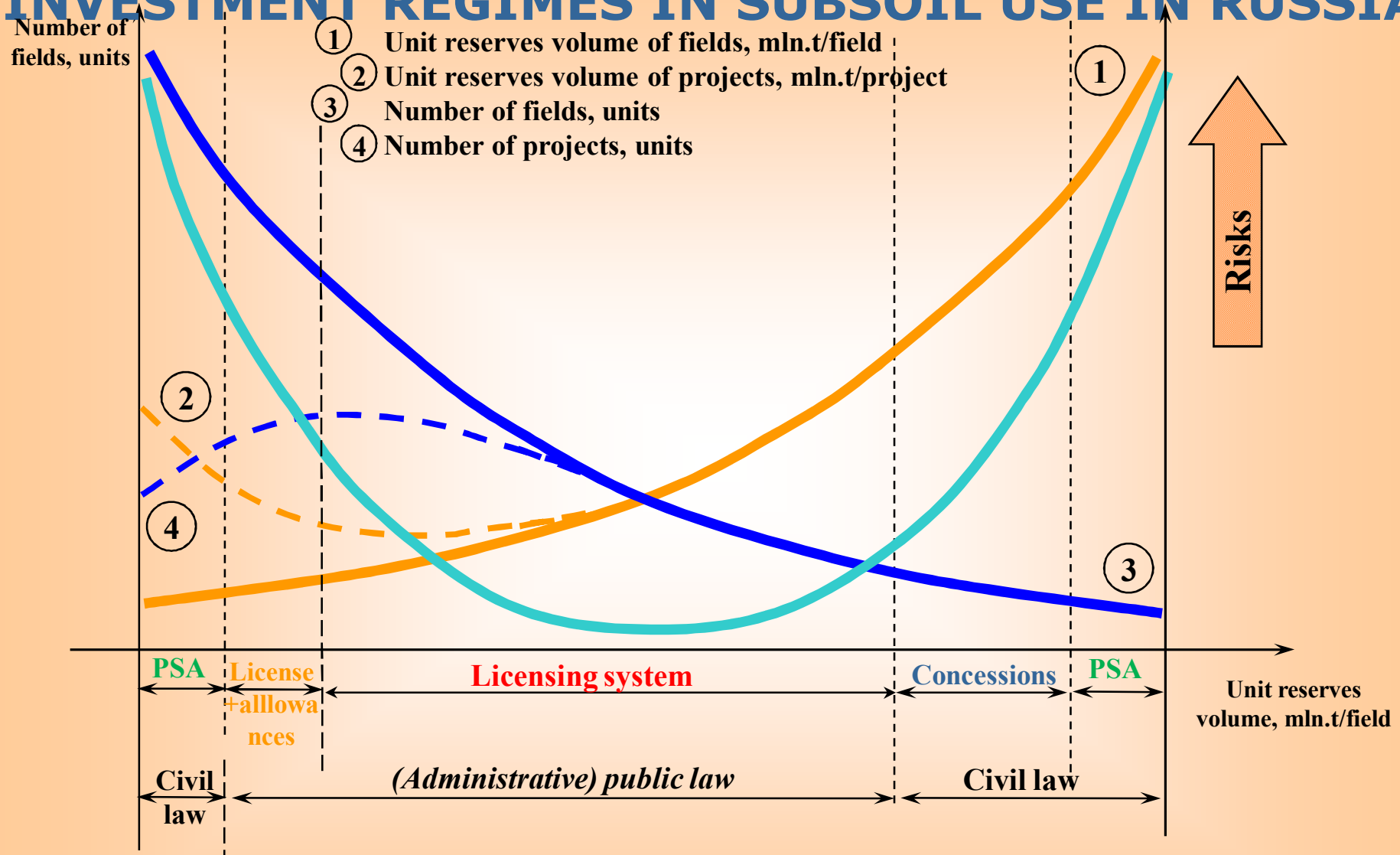
POSSIBLE COMPOSITION OF INVESTMENT REGIMES (LEGAL + TAX SYSTEM) IN RUSSIAN SUBSOIL USE

		Legal system	
		Administrative (public)	Civil
Tax treatment	General (common)	Licenses	Concessions
	Special (incl. individualized)	Licenses with allowances (differentiated licensing regime)	PSAs

DIFFERENT INVESTMENT REGIMES IN SUBSOIL USE: COMPARATIVE LEGAL & TAX ADVANTAGES/DISADVANTAGES

Investment regime	Investment regime's characteristics during project life-time	
	Tax pressure	Stability
Licensing	Non-optimal (high), established unilaterally	No
Licensing with allowances (special/differentiated tax regimes)	Non-optimal (high/diminished), established unilaterally	No
Concessions	Non-optimal (high), established unilaterally	Yes
PSA	Optimal, negotiated	Yes

PROPOSED APPLICATION ZONES FOR DIFFERENT INVESTMENT REGIMES IN SUBSOIL USE IN RUSSIA



Thank you for your attention

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