

# Improving Investment Environment in the Russian Energy Sector via Legislative Action (Oil, Gas and Mining)

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## General Provisions

The main direction of the work aimed to improve legislation in the oil and gas sector is to secure well-defined, long-term "rules of the game", that are uniform for everyone.

Their absence has already resulted in a stable priority of short-term over long-term interests, both in corporate operations and in state politics as well as in excessive administrative regulation in the fuel and energy complex, i.e. in the encroachment of a great number of bylaws intervening with the regulation of economic relations.

Objectives, principles, and methods of implementation of the state energy policy must be stated in the Energy Strategy that the Government continues to work on.

All the elements of the state regulation of economic processes – subsoil use regulation, taxes, pricing, structural and investment policies – must be based on them, with such elements being defined in the appropriate laws. This is a prerequisite to forming an attractive business environment and ensuring of the energy security of the state.

This is the only approach which will enable a shift in priorities in the oil and gas sector.

It may require amendments to tax, civil, and administrative laws.

## Oil Industry

At first glance, there are no significant problems in the oil industry now. Sales of oil and its products yield a high profit, both in the foreign and domestic market.

The industry has an investment surplus and is one of the donors of the national capital outflow. However, the industry still critically depends on the

world commodities prices. This, in turn, brings the country's budget to a similar dependence.

The oil industry continues to remain a source of investments, but mainly into a raw materials sector, with low capital investments in activities providing a higher share of the added value (mostly oil refining), which is fraught with further evolution of the Russian economy towards a reliance on raw materials.

Besides a deformed structure of capital investments, the following problems should be considered as other problems of long-term development of the oil industry:

- ! Division of the market between cartels;
- ! Ineffective use of mineral stock;
- ! Decline of the raw-materials base development, absence of new explored oil fields;
- ! Inadequate work to upgrade oil refineries and low quality of oil products. And, as a consequence, lack of opportunities to expand exportation of oil products.

For many years an inflexible tax policy has actually been the only tool used by the state to influence business relations in the petroleum industry. The tax policy has proved not to be efficient.

Industry's fiscal orientation and internal unpredictability predetermined the short-term cycles of investment planning and the absence of economic incentives to mine oil fields with reserves difficult to extract.

Poor sensitivity of the tax policy to identification and collection of a reasonable economic rent in oil production and sales resulted in ineffectiveness of the oil sector taxation system and its inability to provide sufficient budgetary revenues.

The state has not duly mastered the efficient tools of regulating the domestic market of oil and oil products.

Excessive administrative regulation in the sector that ideologically reminiscent of the tools of the planned economy (balance assignments), though yielding occasionally a short-term effect, have damaged a long-term investment environment in the oil industry.

Development of both small and medium oil producing facilities making a significant contribution in engagement of small fields and less profitable oil bores in business turnover is a special problem.

Major oil holders that have an opportunity to mine significant oil and gas fields have no interest in the use of small fields.

Obviously, the most promising directions of the state policy in the oil industry should include the following:

- ! Optimization of the tax policy, subsoil use regulation, support of small and medium oil businesses to assure a more rational structure of oil production and development of small fields and less profitable oil bores in business turnover;
- ! Development of competition in the domestic oil and oil products market;
- ! Incentives for oil companies to invest significant capital in investment-deficient economic sectors;
- ! Support of the development of oil refining facilities by implementing protectionist measures to encourage investments in this sector, and development of transport and export infrastructure for oil products;

Abandonment of measures of short-term administrative regulation of the oil market in favor of long-term mechanisms to improve production set ups and investment environment, and to re-orient the business of oil companies towards long-term development interests.

The implementation of these measures would depend on adoption of a new comprehensive law on oil and gas that details principles of a long-term oriented state policy in this sector and ensures conditions for qualitatively new trends of its development.

That is the content of a new Act on Oil and Gas that the Energy Ministry and the State Duma have begun to develop.

## Gas Industry

Russia's gas sector is characterized by a deteriorating production base of the principal natural gas supplier, the Gasprom joint stock company, holding a 90% share of the domestic gas market and a monopoly position in gas export.

At the same time, the conditions conducive to development of independent gas producers are lacking in the industry.

Development of independent gas producers is hindered by the monopoly of Gasprom joint stock company and the conflict of interests expressed in the combination of ownership of a long-distance transport infrastructure and participation in gas sales.

Producers are compelled to act under conditions of the permit access system to the pipeline infrastructure and, due to unclear prospects of obtaining rights to access pipelines, do not have an opportunity to properly assess the prospects of gas production business.

The general pressure of extremely low gas prices in the domestic market predetermining the residual nature of the demand for the gas produced by the independent producers is an additional obstacle for the development of the latter

Though the existing explored gas reserves are sufficient, their rate of growth has been extremely low (two or three times lower than production in the recent years).

"Eating away" of the raw minerals base is one of the features of the gas industry today.

The gas industry also faces new challenges in looming liberalization of the European gas market and Russia's accession to the Treaty to the Energy Charter.

There is a need in a flexible state policy of the development of gas export that, on the one hand, would allow Russian gas companies to participate in the open system of pan-European gas trading and, on the other hand, reduce losses of gas proceeds by Russian gas companies and insurance of risks of change-over to gas spot trading in Europe.

The long-term state policy in the gas sector should be directed to:

- ! Expand the area of application of gas market prices within Russia, with concurrent de-monopolization of domestic gas trading;
- ! Increase efficiency of the internal structure of Gasprom OJSC and improve its economic performance;

- ! Rationalize the use of resources, maintaining an adequate level of production and capital concentration in order to ensure the efficiency of Gazprom OJSC as the main gas producer in the country;
- ! Remove obstacles on the way of development of market institutions in the system of gas trading inside Russia;
- ! Encourage development of new gas fields, first of all, by independent gas producers (as the main source of satisfaction of the domestic gas demand not covered by the main gas producer – Gazprom OJSC);
- ! Upgrade the role of Gazprom OJSC in supplying strategically and socially significant consumers with gas; concentrate its functions as the guarantor of these supplies, and remove the social burden from the liberalized gas market.

Maximize benefits from gas export for the national economy; based on a civilized participation of national agents in the open international trading in gas.

Implementation of these aspects of the state policy in the gas sector will require amendments to applicable laws as well as creation of new laws.

### Tax Legislation

The work to improve tax legislation in the oil and gas sector in the near future should be conducted in the following direction:

- ! To pass the Tax Code chapter devoted to taxation of product sharing agreements;
- ! To review the mechanism of taxation in extraction of minerals (the Tax Code chapter on the tax on mineral extraction);
- ! To pass a new Tax Code chapter dealing with prerequisites in hydrocarbons extraction.

Two alternative versions of the Tax Code chapter devoted to taxation of product sharing agreements are in the works in the State Duma.

The version of deputies basically corresponds to the Russian Act On Product Sharing Agreements, as amended in 1999, and is aimed to specify and strengthen an applicable tax provisions on product sharing agreements in the Tax Code.

Passing of this bill, with insignificant amendments and addenda, would become a great accomplishment and would serve as an important signal that Russia's investment climate in the oil and gas sector is changing for the better.

The Government's version initially may have been characterized as an attempt at complete revision of the basic principles of the Act On Product Sharing Agreements.

However, as a result of a long and diligent work, the authors of both bills will have to gradually choose the version suitable for both sides.

It is necessary to point out here the constructive stand of the Government that allowed it to achieve noticeable progress on this issue.

### Legislation on Subsoil

The latest plans of the State Duma envisage an in-depth modification of the Act On Subsoil.

Nowadays, the subsoil legislation is of a framework nature.

A recent inspection by the Ministry of Natural Resources suggested that 20% of current licenses to use subsoil do not comply with the legislation.

The bulk of agreements are also of the framework nature and does not reflect the entire set of obligations of the subsoil users. The majority of license agreements do not contain any parameters of prospecting and mining of deposits.

They lack scopes or terms of prospecting, technical and technological parameters of field mining as well as the volume of extraction.

Information of subsoil users' obligations to the state is often confidential, which makes unbiased control over their implementation more complicated.

The license holders often take advantage of this confidentiality and are slow to mine fields. Many oil producing companies, using new licenses, stake out new lots for the future and treat them only as a tool to increase the company's capitalization.

Moreover, failure to fulfill the obligations stipulated in license agreements does not result in the expected consequences, e.g. license revocation, due to the absence of a well-defined mechanism of enforcement of sanctions in the legislation.

Analysis by the Ministry of Natural Resources suggests that only about a half of license agreements are being implemented without substantial violations, however, only a tenth of such licenses have been revoked.

The license revocation mechanism is used selectively, mostly it is enforced on small companies forcing them to transfer the license to another subsoil user as soon as possible. For instance, out of

more than 1,000 licenses revoked in 2001/2002, not a single one belonged to a large company.

Therefore, it is necessary to have a full set of direct action laws governing the entire process, including all constitutional aspects of subsoil use. Such set of direct action laws should, in particular, contain a well-defined mechanism of control over implementation of license agreements, mechanisms for making a decision to revoke a license, and a mechanism for implementation of such a decision.

Then it is necessary to reconcile earlier issued license agreements with the new law, in particular to openly provide for all the controlled parameters and conditions, such as:

- ! Authorization nature of granting the rights to use subsoil certified by a state license;
- ! A uniform list of grounds for granting and terminating the right to use subsoil;
- ! Rational and composite use of subsoil within the limits of allotted sites;
- ! Economic sanctions for deliberately hoarding mineral reserves, and for violation of approved mining projects;
- ! Fixed-term use of, and payment for, use of subsoil;
- ! Subsoil lots are subject to return;
- ! Forced withdrawal of unused subsoil sites;
- ! As minimal as technically possible impact on the environment while using subsoil;
- ! State geological, environmental and other control over the operations of subsoil users

Funding of prospecting has reduced drastically in the recent years. Nowadays, neither budgetary nor private sources provide funding of prospecting in the desired amount.

Since 1991, mineral raw materials are mostly produced at the expense of the earlier explored reserves, and the growth in reserves is achieved at the expense of prospecting in the long-gone years. At the current production level, this growth does not make up for the reserves exhaustion.

The state lacks the necessary funds for prospecting, as budgetary revenues from mineral mining are used for other purposes.

State management in reserve reproduction should be based on principles of assets management.

Funding of prospecting should be regarded as an investment in the capitalization of these assets.

Availability of quality geological information on sections of subsoil offered for the tender will allow bidders to submit diligently put through the mill solutions to mine sites, and will allow the state to pick the best offer and gain the highest income.

To increase the efficiency of budgetary funds used for prospecting, there is a need to work out a mechanism to retain contractors for prospecting on a competitive basis.

To reimburse the state for prospecting-related costs there should be a mandatory unitary assessment on a winner of a subsoil exploitation tender. That unitary assessment to be funneled into the subsoil reproduction fund.

Legal regulation of the procedure of granting a license is worth a separate consideration.

Obviously, the best, in terms of budgetary revenues, offer must be held a winner in the competition.

For the state, the economic effect of field prospecting – first of all, revenues of the budgets at all levels – is formed from the unitary assessment and tax proceeds during the entire field exploitation, and reduction of the budgetary spending should a socio-economic development of the territory succeed.

Technological and environmental parameters should, on the contrary, be “acceptable”, i.e. should meet all the mandatory standards.

To assess bids from the point of tax revenues during exploitation, the index similar to one mentioned earlier with regard to the state may be used.

It is such index rather than the amount of the starting lump sum payment that must serve as an integrated parameter to assess the economic efficiency of the bidder’s application for the license.

Therefore, the most efficient procedure for granting the license is not an auction but a tender (competition), with well-defined technical parameters of calculation of the economic effect for the benefit of the state.

## Conclusion

All the above approaches and principles must be carried out by passing direct action laws. This is the only approach to ensure investment attractiveness of Russia’s oil and gas sector. □