

Product Sharing Agreements (PSA) in the Russian Mining Industry

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If one disregards all so-called transaction costs caused by switching to a product sharing regime, the product sharing agreement (PSA) is a splendid opportunity to overcome tax, license and other challenges present now in the mining industry

A few words about the essence of the Russian model of the PSAs. Produced product is divided into two parts: the first one is a compensatory product used to cover mining and primary processing costs; the second is the profit part, which remains after deducting the costs of production Royalty (mining tax), of course, is being withheld first. The state and a subsurface user share the profit according to a ratio stipulated in the agreement. The ratio is subject to negotiations.

A profit tax is levied on the share of the profit transferred to the investor (subsurface user) at the rate established by law. Under the ideal model only royalty and profit tax but no other taxes such as export duties, import duties on mining and other equipment imported for the implementation of the agreement, are collected. The investor is not a Value Added Tax (VAT) payer but rather its bearer, i.e., initially VAT may be deducted, but it must be reimbursed later on. Product sharing is, in essence, a kind of intranational export, it resembles VAT. This means that one may purchase everything without paying the VAT if the seller agrees to sell on such terms; one may sell one's product without obligatory inclusion of the VAT in its price.

Sakhalin-1, Sakhalin-2 and Kharyaga in the Nenets Autonomous Okrug are three oil projects now working under the above scheme, with the Sakhalin-2 project being the most successful and cost-effective of them. Nearly 6 million tons of crude oil were produced over three years and about \$1 billion was recovered due to high crude oil prices during that period. According to statistics of the parties to the project, investment expenses came to about

\$2 billion, i.e., the project has already recouped half of the expenses. In the future, it will become even more profitable.

Oil companies have already appreciated the advantages of PSAs. In the near future, about 30% of the country's total proven reserves are expected to be transferred to development using product sharing terms. It is worth noting, somewhat jumping ahead, that the law limits to 30% of balance reserves that may be developed on a PSA basis. The limit of crude oil reserves of PSA-eligible deposits is practically exhausted: 27-28% of the reserves have been transferred to subsurface users that may work under the PSA regime.

The work on the development of mineral deposits on a PSA basis has not started yet.

An amendment introduced last year into the Federal Act On Product Sharing Agreements (hereinafter the PSA Act) simplified to the highest degree possible the scheme of product sharing. In this model, called "direct product sharing", produced product is divided into three unequal parts, i.e., the investors pay only single payroll tax. And nothing else! The remaining product is divided into the investor's share and the state's share. Thus, the notions of the compensatory product and product costs are eliminated. The ratio of sharing is subject to negotiations between the state and investors. The Russian Federation, represented by the government and/or constituent subjects of the Federation, on which territories the mineral resource site is located, and the investor, i.e., the subsurface user, are the parties to the agreement. This civil-law contract, with some public law elements, between the state and investors is a very simple scheme. It calls for payment of no taxes that are debated heatedly right now.

PSAs were introduced in Russia by foreign oil companies who had been the only users of PSAs

abroad. At the same time, western mining companies that entered our market in the early 90s were not familiar with the PSA regime. However, small and medium companies that prepared to accept some risk are already making attempts to introduce the PSA regime into mineral mining and actively lobby the inclusion of some mineral resource sites into the list of PSA-eligible deposits.

There are five deposits included by federal acts in the list of mineral resource sites where PSA-based rights to use may be granted. They are well known to gold-miners Kuronakskoye, Taseyevskoye, Maiskoye and Nezhdaninskoye with total gold reserves of about 1,000 t, and Yakovlevskoye iron ore deposit located in the Belgorod Region.

However, so far not a single contract has been signed to use these sites. Aldanzoloto continues working at the Kuronak group of deposits under the common license regime, the Taseyevskoye deposit sits relatively idle, the design stage has just started at Maiskoye, and only small amounts of gold are mined from Nezhdaninskoye. There are subsurface users and there are license holders. The law provides for the opportunity to switch from the common license regime to PSAs without withdrawing the license and offering deposits for a new tender or auction. In other words, the rights of subsurface users bear no risks. PSAs, nevertheless, are not being entered into. Various reasons account for this fact: from the slump in gold prices in 1998-1999 to the weakness of potential investors today.

The development of deposits under the PSA regime is, by the way, very promising. It might be of particular interest for those enterprises that intend to develop their ore bases, i.e., the ones that are creating, so-called, vertically integrated mining and smelting companies. Ural-based mining and smelting company Uralelektromed, for example, is interested in the development of the Udokan deposit, which is vacant now. All economic calculations show that the development of such a huge deposit as Udokan occurring in severe conditions would not be profitable under the current tax system while it may turn out quite cost-effective under a PSA.

What is a subject to sharing? The PSA Act does not specify what type of product is to be shared. Anything, i.e., metal, cable, any final product may be shared. The Act imposes no restrictions. One may select the optimum, the most liquid produc-

tion. Not only product itself, but also money received from its sale may be shared.

A few words about the procedure of placing mineral resource sites onto the list of PSA-eligible deposits. Deposits of strategic minerals are included on the list by the enactment of the federal act. Federal acts are not required for gold ore deposits with reserves of below 50 t, and there are numerous deposits of this type in the country. For these types of deposits to be included onto PSA-eligible list: either the decision of the RF Government or the decision of the constituent subject of the Federation is necessary. In addition, no federal acts are required for the development of deposits of such nonstrategic minerals as, for example, iron ores and coal. The decision of the Government and the decision of the constituent subject will be enough in these circumstances, although it is easier said than done. For example, an attempt was made to transfer the Leningradskoye oil shale deposit into the PSA regime. The idea was to share at the choosing of the State either gas produced as a result of oil shales refining or money obtained from its sale. A draft resolution was submitted to the government nearly a year ago, there has been no progress on this issue. Theoretically, any prospect may be switched to the development under PSA terms if one succeeds in overcoming the resistance of bureaucrats. The Ministry of Economic Development and Trade, which is in charge of PSAs now, has even set up a special PSA department. The department exists for more than a year, but it is impossible to understand what they are busy with.

What is the difference between the PSA and license regimes legally? Under the PSA regime, the agreement is a document creating rights and obligations. It may be cancelled only by the consent of the parties to the agreement or by the decision of the court. The user may not be deprived of his right to use mineral resources by an administrative decision as is the case under the regime of license. This may be one of the reasons some departments are leery of PSAs.

The PSA, in essence, is a particular case of concession, the civil law contract on the use of state property, i.e., the subsurface. The Act on Concessions inherited by the Duma from the late Supreme Soviet is shelved in the State Duma for about 10 years despite being passed in the first reading in 1996. The adoption of the Act is blocked by the government. □