Tail Whacks Dog: Few PSAs Can Go Forward in Russia

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The expression "the tail is wagging the dog" has carried to the extreme a few months ago, with Russia's enactment in June of the new Amending Law regarding PSAs[1].

This new law was initially conceived two years ago to inscribe into the Tax Code an elaborated special fiscal regime for PSAs, in order to reassure investors (particularly those involved with the Duma-approved priority "List Law" fields) and thus spark much-needed real movement forward on these projects. But it turned out otherwise. The intended pro-PSA tax reform focus was in effect "hijacked" early this year by influential anti-PSA forces outside and inside the government.

As a result, whole new sections were added to the long-simmering draft law in the lead-up to enactment, including some that introduce dramatic negative amendments into the PSA Law (the "PSAL") itself. These fundamental changes, while leaving the PSAL in place as amended, render it practically – and perhaps intentionally – unusable for any new E&P projects (including even most of the List Law fields) beyond the three "grandfathered" ones (Sakhalin 1, Sakhalin 2 and Kharyaga), save for a few exceptional new fields on the Barents Sea and Caspian Sea shelf.

A convergence of political and economic factors brought on this surprising turn of events. The "how and why" analysis is beyond the scope of this memorandum; the basics thereof are well known to most of our readers (industry players and their financial advisors) in any event[2]. We limit ourselves to summarizing what the Amending Law says and appears to mean.

We place primary focus on the "tail" provisions that are of most real importance now (*i.e.,* those that seem to block the PSA path for most fields, and to stiffen the regime for those few that can go forward); and less on the original "dog" (the new Tax Code Chapter 26.4 – Special Tax Regime for PSAs) that is enacted by the new Law and comprises over two-thirds of its overall text, but that in practice may be applied to very few actual projects for the foreseeable future. (This new PSA Tax Chapter as enacted is itself also a good deal less investor-friendly than expected – as reviewed further in Section 4 below.)

A few preliminary words on broad-brush consequences and prospects, as far as we can see:

! Some foreign oil majors and independents, in previously-approved PSA List Law projects and others, may go forward with Russian oil company partners on new E&P projects in Siberia and elsewhere on land (and perhaps even on the Sakhalin shelf) per the standard license regime – *i.e.,* the Subsoil Law (the "SL") and the Tax Code (the "TC") – where the field economics are seen to justify this. Some other projects (including a few large ones) that had been slated for PSA development and whose borderline economics were dependent on the kind of predictability afforded PSAs under law, may now languish.

! There have been two important strands of perceived/real positive development in the overall "Russian

[1] This Amending Law is called in full: "On Introduction of an Addition to the Second Part of the Tax Code of the Russian Federation, Introduction of Amendments and Additions to Certain Other Legislative Acts of the Russian Federation, and Recognition That Certain Legislative Acts of the Russian Federation Have Lost Force," No. 65-FZ, signed into law by President Putin on June 6, 2003, entered into force upon official publication on June 9, 2003.

[2] For readers interested in the fuller background picture, we recommend the recently published article by Mikhail Soubbotin in the Moscow journal Foreign Capital, No. 7, 2003, pp. 13-21, entitled "Radical Change in the Legislation on PSAs" (in Russian). Mr. Soubbotin is a very well informed participant in all the Russian legislative debates and processes involving PSAs (including as a leading member of the Expert Council of the Duma Commission on PSA Matters) from the mid-1990s to date.

For a further useful "insider's perspective", see also the recently published interview with Alexei Mikhailov, the well-known Duma Deputy who has been one of the leading parliamentary champions of workable PSA legislation since initial enactment of the PSAL in 1995 and to date, in the Sovetskii Sakhalin newspaper, July 4 and 5, 2003 – available on the www.public.ru website (in Russian). And see Yuri Kogtov, "PSA: Life After Death," RusEnergy, May 19, 2003 (available to subscribers), Sergei Glazkov, "PSAs Clobbered," Russian Petroleum Investor, May 2003, and Pavel Bakoulev, "Farewell, PSA," Russian Petroleum Investor, September 2003, for other thoughtful views.

picture" over the past few years that would tend to influence foreign companies toward willingness to invest in standard-regime projects: increased political stability, and gradually improving general subsoil and tax law rules. (Further standard-regime subsoil legislation reform has been in the works, though appears to be stalled through the coming election season.) But recent jolting events – such as the state harassment of Yukos executives and veiled threats against the company's ownership right to basic assets – may give some investors reason to pause on E&P ventures, at least for a while. Indeed, the very enactment of this new Amending Law will be seen by some as a notable step backward in terms of legal stability.

! Of course, the large-scale recent M&A activity involving Russian oil majors is in itself strong evidence of foreign investors' willingness to jump into standard-regime development: witness BP-TNK (estimated $7.7 billion total investment), Marathon buying a production company in Khanty-Mansi ($280 million plus forward investments), and the press reports of a few Western super-majors' interest in acquiring a sizeable Yukos minority stake. And there are a number of joint non-PSA E&P projects underway.

! Some Russian industry players and commentators are predicting that PSA legislation and practice will be revived to a useable state (though perhaps not for so many fields) once oil prices go down again and/or Russian majors' disinclination to invest the needed sums for development of difficult new fields is felt by state agencies. A 2-3 year timeline is mentioned. This remains to be seen.

! Investment decisions for Russian E&P projects (in the Siberian heartland, at least) will also depend in no small part on progress in developing new export pipeline outlets, such as the planned Murmansk and China lines. Basic political and legal risks could be more digestible if the current logistical obstacle to free export were lowered. Efforts to create a secure legislative base for private pipeline development and ownership are stalled to date.

Here, then, is our summary presentation of the Amending Law. Further details, in general or as applicable to particular cases, are available on request.

1. Most List Law Fields Cannot Go Forward as PSAs

In terms of immediate practical effect this is the real "zinger" – tacked on near the end (art. 7) of the Amending Law. It provides, in essence:

! The stiff new two-auction hurdle introduced by the Amending Law as prerequisite for PSA-form development (explained at Section 2 below) applies equally to most of the 28 fields/projects that have already passed through the important required step of inclusion on a Duma-approved List Law pursuant to PSAL art. 2 but in respect of which PSAs were not yet signed.

! Thus, such prominent anticipated PSA projects as Kovytka (BP/TNK and others), North Astrakhan (Gazprom affiliate Stroytransgaz and another local company, teamed with Agip), Northern Territories (Lukoil and affiliate Archangelskgeoldobychya, with ConocoPhillips), Sakhalin 3 Kirinsky Block (Rosneft, ExxonMobil and ChevronTexaco), Uvatskoye (TNK, courting various possible foreign participants), Salym (Shell with a local partner) and Komsomolskoye (Rosneft, and perhaps TotalFinaElf), on which the participants thought they were just awaiting the new Tax Code Chapter before moving forward to negotiate and finalize their PSAs with the appointed Government Commission, can now no longer proceed on PSA terms at all without passing through these new hurdles (absent a superseding set of amendments to law pushed through by a more friendly Government and Parliament in the future)[3].

! Existing E&P licensees on any of these fields that do not want to pass through the new hurdles to PSA may continue to develop their fields on standard terms under the Subsoil Law. This is what may well happen now in some cases, as noted, with the would-be PSA foreign investors instead farming in to Russia "Newco" JV companies as permitted under Subsoil Law art. 17.1.

! Only a handful of List Law fields are saved from these draconian new rules and thus may still be pushed forward directly to negotiation/signature/approval of a PSA per the previously established procedures – *i.e.,* those fields that **(i)** are already under standard-regime E&P license as of Amending Law enactment, *and* **(ii)** are located within Russian jurisdiction on the continental shelf, exclusive economic zone, or Caspian sea bed. These "lucky fields" are Shtokman and Prirazlomnoye in the Barents Sea (Gazprom, Rosneft, and possible foreign participants), and Yalamo-Samurskoye and Tsentralnoye in

[3] A commentator has suggested that one or more of these aggrieved companies holding field licenses covered under a List Law may want to sue the Russian government for illegal deprivation of property rights in violation of the Russian Constitution (art. 35) and some other laws. There may be a colorable claim, but we suppose that it will be an unusual oil industry player (Russian or foreign) that will want to risk raising such a challenge, from the government-relations point of view.

the Caspian (Lukoil and expected foreign participants, including Azerbaijan's national oil company SOCAR on the former field and Kazakhstan's national oil company KazMunaiGaz on the latter field)[4]. There were energetic efforts in the weeks leading up to final enactment of the Amending Law to expand this favored sphere of exceptions in various ways, but they did not succeed.

! There is one more stated category of exception from the new PSAL auction hurdles – for those fields "the possibility of [PSA] development of which is established by international agreements of Russia." This should "double-cover" Lukoil's above-mentioned Tsentralnoye Caspian field, which has been expressly earmarked by bilateral treaty for joint PSA development with KazMunaiGaz. There is some uncertainty as to whether this treaty exception extends as well to Lukoil's Khvalinskoye Caspian field, which does not yet have List Law approval but is also contemplated for PSA development by the same Russia-Kazakhstan treaty[5]. (It can also be argued soundly that a *future* international agreement regarding any of Russia's border fields may provide for PSA development on particular terms and thus, once ratified by the Duma, would "trump" the Amending Law obstacles – including the basic List Law and/or new auction requirements if so specified in the international agreement, since such an agreement would have precedence over Russian domestic law.)

! Further, there is a special provision (Amending Law art. 8) for fields covered by PSAs signed after the PSAL was adopted and before the Amending Law – *i.e.,* TNK's Samotlor field alone. That PSA has to be put into compliance with the newly amended provisions of PSAL art. 8 (the basic production sharing terms) within a year or else lose force to the extent contradictory therewith. We understand that TNK does not intend to avail itself of the signed PSA terms for Samotlor in any event.

2. The Auction Hurdles for New PSAs

PSAL arts. 2.4 and 6 are amended to provide a stiff new multi-part obstacle course, which is now to precede the still-required Duma List Law approval for the field and then Government approval/signature of future PSAs. (And, as noted above, these new auction requirements apply as well even to most of the fields that already had List Law approval). Passage through this obstacle course is meant to demonstrate conclusively (per amended art. 2.4) "the absence of possibility of geological study, exploration and production of mineral resources on [standard Subsoil Law terms]," as follows:

First**,** there is to be an auction (*not* a tender) under Subsoil Law terms (see SL art. 13.1 – highest properly qualified bidder wins), and declaration of invalidity of the auction on account of absence of willing/qualified participants. (Commentators have noted that failure at such auctions is unlikely for any worthwhile fields, since one or another Russian major will at the very least want to get control of the reserves in order to boost the company's stock value – and then make only minimal required investment at the field indefinitely. To prevent this, meaningful start prices at these auctions may well have to be established.)

Second**,** if the Subsoil Law auction is held and fails, the field is eligible for Duma enactment of a List Law for PSA development, *if the following additional conditions can be met in the view of the government* (these being somewhat of a restatement of the previously established PSAL 2.4 conditions) – *i.e.,* development of the field **(i)** can help preserve employment levels in populated areas, while closing down work on the field "would lead to negative social consequences"; **(ii)** is necessary in order to bring onstream mineral resources "located on the RF continental shelf and in areas of the Far North and analogous locales, and are situated in regions having no population points, transport or other infrastructure; and **(iii)** requires the use of "special high-cost technology for difficult-to-develop significant-volume mineral reserves located in difficult geological conditions". (It seems clear from the revised wording that this is meant to be a high hurdle. But questions of interpretation will arise – including the basic one as to whether all three or just one of the conditions must be satisfied.)

Third**,** once the field has List Law approval, another auction (here again, *not* a tender) must be held under newly-revised PSAL art. 6.1, to determine the investor(s) that may develop the approved field on PSA terms. Again, as with the first auction, the winner of this PSA auction is the participant "offering the highest price for the right to conclude the agreement." (The previous PSAL art.6.2, with its four bases for bypassing the PSA tender/auction, is deleted altogether).

[4] With regard to the Yalamo-Samurskoye and Tsentralnoye fields, there could still be a problem under this exception category – per the Amending Law art. 7 criteria noted above – if the current licensee (a Lukoil affiliate) still holds only an exploration license (as was the case as of mid-2002 when the List Law for those fields was adopted) and not a full E&P license.

[5] Treaty Between the Russian Federation and the Republic of Kazakhstan on Delineation of the Sea Bed of the Northern Part of the Caspian Sea for the Purpose of Effecting Sovereign Rights to Subsoil Use, July 6, 1998. Protocol to this Treaty, May 13, 2002 (regarding joint development of the Kurmangazi, Tsentralnoye and Khvalinskoye fields).

In the case of fields already under a standard-regime license (apparently including most List Law fields) where the licensee is interested in having a PSA, the licensee must first relinquish the license, and then the normal process of auctions and satisfaction of other conditions goes forward. In such case, compensation of the prior licensed user's expenses can be made a condition of the new auctions, assuming that the same user does not emerge victorious. There are basic guidelines provided for agreement on the proper amount of such compensation and for court challenge in the absence of agreement. (Some real money issues could arise regarding costs already expended to date by certain foreign and Russian companies in the lead-up to expected development of certain PSA List Law fields that now cannot proceed as such.)

It may even be intended that the existing List Law fields go through the (newly stiffened) PSAL art. 2.4 List Law qualification/approval process anew as well, between the two required tenders, although this is not entirely clear.

The prior PSAL art. 2.5 exception from the List Law requirement for so-called "small fields" (less than 25 million tons of oil, less than 250 billion cu.m. of gas) has been deleted. (No PSAs were approved/signed for such fields to date.)

Two additional clarifications as to conclusion of PSAs, once all the hurdles have been passed:

! Per revised PSAL art. 6.3, the Government Commission for negotiation of the PSA must be formed no later than six months after announcement of the winner of the second (art. 6.1) auction. Then the PSA has to be negotiated (in compliance with the auction terms) and signed within a year following appointment of the Commission (arts. 6.1, 6.5). And (per amended art. 21), the PSA has to "enter into force" as to the production sharing and taxation aspects per PSAL arts. 8 and 13 within a year after signature, or else the PSA automatically terminates.

! The separate requirement of another Duma "confirming law" is retained for PSAs covering continental shelf fields – and it is now clarified expressly (per previous consensus interpretation) that even amendments or additions to such PSAs require separate Duma confirmation as well (PSAL art. 6.1).

3. Further New Stringent Rules for PSAs

For any field projects that can satisfy all of the above requirements and achieve a fully approved/signed PSA, a number of additional important stricter rules (for operations, production sharing, and termination) will apply, as follows:

Russian content: the existing "70% rule" (PSAL art. 7.2) is substantially toughened – to perhaps unattainable extreme one might say, at least for the near future. Namely:

(i) A newly established "Russian origin" criterion is satisfied only where equipment/technology/material is "produced by Russian legal entities and/or citizens on Russian territory, from [component parts], representing not less than 50% of the overall monetary value, that are produced on Russian territory by Russian legal entities or citizens." (This more sophisticated local-content test resembles what Kazakhstan had already instituted and what has long been applied in contexts such as qualification for US Eximbank and other countries' ECA export finance guarantee programs.

(ii) The requirements extend not just to purchased but also to all equipment that is leased, rented or obtained by any other means.

(iii) And this 70% level must be achieved during every calendar year of project operation – or else the costs for acquiring and using such equipment may not be recoverable. New Tax Code art.346[38](10) reinforces this. (Presumably, cost recovery would be lost only on the annual value of the portion of non-Russian origin equipment exceeding 30%.)

(iv) The prior helpful PSAL art. 7.2 provision – that satisfaction of the percentage requirement is subject to the availability of Russian equipment that is competitive in terms of reliability, quality and delivery terms – has been dropped. It is thus no longer clear that investors could now include such a condition in their PSA, as has been the universal practice to date.

Interestingly, the Amending Law drafters have included a provision whereby any part of this tightened local content requirement found to violate WTO rules upon Russia's eventual accession is to be considered rescinded at that time. This is a remarkable acknowledgment of impending legal vulnerability.

In any event, the stiffened content rules, pushed hard and successfully by Russia's heavy industry lobby, will likely have little practical effect for the time being. Much more important to Russian industry, in the negative direction, would appear to be that very few new PSAs will be undertaken, and thus very little further industrial contracting will ensue at all. And the three grandfathered PSAs (particularly Sakhalin 1 and 2), on which billions of dollars are

being spent (including much, if not quite 70%, on Russian contract work), will not technically be subject to the tougher new rules. In this regard Russia appears to have "cut off its nose to spite its face." At the same time, standard-regime field development goes forward, much of it involving Russian oil majors alone, without any regard for percentage of Russian content (said to be running at about 55% these days), untouched by any local content rules under general law.

***Production sharing*:** There is some tightening here as well, although the practical effect of the changes to PSAL art. 8 itself may not be so great. (The related substantial toughening of the cost recovery rules per the new Tax Code PSA Chapter is another matter.)

(i) With regard to classic PSAs (that is, those providing for cost recovery and royalty / mineral production tax, and then profit production split – see PSAL art. 8.1), a ceiling is put on production available for cost recovery (*i.e.,* "cost oil"): *75%* for fields on land, and *90%* for fields on the continental shelf. (These respective "cost-stop" caps are in any event not lower than what has been negotiated in Russian PSAs to date.)

(ii) The cost recovery rules themselves have undergone change – for the worse on some key points, as it turned out – by art. 346[38] of the Tax Code. These new provisions supersede Government Decree No. 740 of July 3, 1999 on PSA cost recovery, and in the drafting stage had been intended to improve the regime to investors' general satisfaction. But the cost recovery principles in some important respects fell prey to the same "hijacking" as did other PSA regime elements in the Amending Law as finally adopted. See further discussion at Section 4 below.

(iii) With regard to direct-sharing PSAs (that is, no separate cost recovery or taxes except for the social tax – see art. 8.2), a ceiling is put on the investor's direct share: 68%. (There is precious little precedent here. The only direct-share PSA to be signed to date – for TNK's Samotlor field – provided for a higher cap; but that PSA is still not functioning as such.) The revised art. 8.2 also clarifies that direct share must be specified in the corresponding auction for PSA rights, and that a PSA cannot provide for switching one PSA form to the other.

***Taxation*:** The previous PSAL art. 13 detail as to taxes payable, stabilization from non-conforming, regional and local taxes, etc. has been removed to the newly adopted Tax Code Chapter (see Section 4 below).

***Accounting*:** In the previous PSAL art. 14 sentence, "The procedure for [PSA] accounting shall be determined *by the agreement* in accordance with [Russian law]," the italicized words have been removed. This may be intended to discourage or prevent future PSA parties from agreeing on the typical detailed accounting annex attached to the PSA; the meaning is not yet clear. In any event, there remains in effect a 1999 Ministry of Finance Order No. 53–n regarding PSA accounting, which the PSA investment community had been pushing to improve.

Banking and currency: PSAL art. 15, which originally stated special assurances and exceptions for PSA investors, has been cut back to a simple requirement to have segregated ruble and/or hard currency bank accounts for all PSA operations. The previous assurance that hard currency export sales proceeds could be maintained in and used from foreign accounts, and that PSA investors (and their contractors, suppliers and transporters) are immune from the general mandatory currency conversion rule, have now been dropped. It may be that this change is meant only to eliminate the loopholes for Russian company investors, while foreign companies would effectively maintain such rights/exemptions under liberalized general law in any event.

Termination: See the added PSAL art. 20 provisions, referred to above, regarding termination of PSAs that have not entered into force with regard to production sharing and taxation within one year after signature.

4. Taxation; Cost Recovery

As noted above, the bulk of the Amending Law is taken up in introducing the new PSA Tax Chapter (Chapter 26.4) of the Tax Code. There are a number of interesting developments here – most of them negative, as measured against the heavily negotiated and much touted Government/Duma/ industry "compromise draft" of 2002 which was not adopted. One could well take the position that this whole area is of largely academic interest for the time being, given the unlikelihood of many new PSAs per the stiff new Amending Law hurdles (and considering the grandfathered status of the only three functioning PSAs, immune from general tax law provisions that contradict the PSA terms). Thus, we will just briefly highlight the new features here[6].

[6] See the Soubbotin article ("Radical Change in the Legislation on PSAs"), cited at footnote 1 above, for more detail in this area. For further critical analysis, see also A.S. Kim and A.G. Svistel'nikov (both of Rosneft), "On the New PSA Tax Regime," Oil, Gas and PSAs No. 4, July-August 2003, pp. 41-42. The Big Four firms will no doubt also come out with their own tax analyses in due course, which will be of value.

***Roster of taxes and other levies*: PSAL art. 13 has been amended to list all the non-tax subsoil-related levies to be payable by PSA investors. This is essentially all the same levies generally payable by standard-regime licensees under Subsoil Law art. 39. The investor's responsibility to compensate the state's prior exploration expenses, and harm done by operations to indigenous populations, is also now stated expressly. As for taxes, the PSAL now only cross-references to the Tax Code (meaning essentially the new PSA Tax Chapter), which in turn gives a laundry list of taxes that excludes very little from the general Tax Code universe. The only notable advantages remaining over the standard regime appear to be **(i)** exemption from the property tax – on assets that are to be turned over to the state under the PSA; **(ii)** a very limited rate advantage on the mineral production tax (see below); and **(iii)** exemption from customs tariffs on production exports and on equipment imports. (And the existing PSA mechanism of exemption and remedy from regional and local taxes is essentially retained.) This newly darkened tax picture has prompted one Russian commentator to quip that the PSA regime is no longer one of "production sharing in place of taxes", but "production sharing plus taxes."

***Stabilization*:** There is a useful, long-sought restatement of full stability, and prevalence of agreement terms over the Tax Code and any other tax laws, for the three grandfathered PSAs. There are also some stability-like provisions, but softer, regarding taxation of all other PSAs. (See TC arts. 346^{35}(10)-(15), 346^{38}(15).)

***Deemed price*:** A term "oil price" is introduced for the PSA context, defined to be the sale price chosen by the parties, "but not lower than the average price of Urals blend crude for the accounting period" (Mediterranean and Rotterdam). This price level *must* be used for determination of cost production due the investor, for the sharing of profit production, for determination of the investor's taxable profit, and for some other statutory purposes. (See TC arts. 346^{34} and 346^{35}(3).) There is already concern in the industry as to how this enforced price term will "cut", all things considered, given that Russian crude production in fact would not always command as high as the Urals-blend price. It is pointed out, namely, that much PSA production will have to be sold domestically at the considerably lower prevailing market price (at least for the foreseeable future), that some production that could be exported outside of the Transneft pipeline system (*e.g.,* from northern shelf fields like Prirazlomnoye) will be lower quality/price than Urals blend, and even that Urals-blend price in East Asia is a bit less than the Mediterranean/Rotterdam levels.

***Mineral production tax*:** When this relatively new tax (which replaced the royalty, mineral resource replenishment tax, and excise) was introduced in 2002, there was a 50% rate discount (from 16.50% to 8.25% – this rate calculation originally to have been effective as of January 1, 2005) for PSAs – see TC art. 342.2 and the Chapter 26 enacting law. This seemed fair, taking into account (among other factors) that PSA investors had already been exempt from the replenishment tax and excise in the first place. But now the Amending Law (new TC art. 346^{37}(5), (7)) provides that the 50% discount is removed as soon as the agreed "commercial production" level is achieved, after which the tax must be paid at the full standard rate. And the general TC provisions on standard rate have been evolving since 2002 as well[7]. (The mineral production tax and its calculation, use and planned adjustments over time – and the link to Russian producers' transfer pricing practices – is a complex subject unto itself, beyond the scope of this article.)

Cost recovery*; *tax deductibility: The lengthy new TC art. 346^{38} is devoted to this. A few unpleasant additions, worthy of note:

! Costs running over the above-noted recovery caps (75% for land fields, 90% for shelf fields) are simply not recoverable. And any "capital costs" that cause the limit of 30% for non-Russian content (as Russian content is now more rigidly defined and enforced) to be exceeded may also not be recoverable. See art. 346^{38}(10).

! The normal TC amortization rules (arts. 256-259) will not apply to equipment and other approved PSA project expenses that are cost-recoverable under the new rules (art. 346^{38}(9)). On the other hand, such equipment/property purchases that cause the required Russian-content level to be violated, and that are thus not cost-recoverable, will evidently just be tax deductible under the standard TC amortization rules. The whole intended treatment of PSA expense amortization now under the Amending Law bears close attention by specialists in that area.

! Investors' management/administrative/overhead expenses are recoverable in accordance with agreement terms, "but not over 2% of the overall sum of expenses recoverable in a given accounting period." Excess expenses of this type are evidently still to be tax deductible. (Art. 346^{38}(9), last para.)

[7] See Law on Introduction of Amendments and Additions to the [Tax Code], No. 117-FZ, July 7, 2003, art. 4 (amending a previous similar Law No. 126-FZ, August 8, 2001, art. 5).