

IMPROVING THE INVESTMENT CLIMATE IN THE OIL AND GAS SECTOR: MEASURES TO BE TAKEN

1. Predictability of the investment climate in Russia's oil and gas sector needs to be improved considerably.
 - a. Development of oil and gas resources is long term and capital intensive business. Heavy investments are required upfront production start-up and the return on capital invested will come in many years delay. Project life time accounts for several decades. These factors put an investor in highly risky and vulnerable position. The risks can be reduced to acceptable level only through establishing predictable and stable rules for investors.

2. Reviewing the new legal framework for foreign investments in the Russian oil and gas sector. The new system introduced in 2008 (the Law on strategic industries and relevant amendments to the Subsoil law) brings more clarity, but also more constraint on foreign investment in the oil and gas sector. It is particularly (and excessively) restrictive in the following respects:
 - a. A foreign investor is called a controlling shareholder and falls under rules and procedures of the new complicated legislation if it owns 10 % or more of a company developing a subsoil area of federal significance. 10 % is a very low threshold (for example the threshold for entering other strategic industries like military\air\space industries is 50 %).The threshold of 25% (minus one share) would provide the same level of protection for the Government as 10%, but it is the minimum requirement for foreign investors in terms of booking reserves and be able to consider their resulting investments significant in terms of their portfolios.
 - b. Even fields as modest as 70 mil tons of oil and 50 bcm of gas are considered of federal significance and fall under the new system. These thresholds are also very low and discouraging.
 - c. The definition of "national security reasons" is opaque in the law, yet it allows depriving a foreign investor of rights to develop a discovered field. Compensation approach to such cases is unlikely to work. It is worth eliminating this serious risk for foreign investors – there is a concern that this rule can be applied in an arbitrary and non-transparent manner. As a minimum requirement for foreign investors the companies with foreign investment controlled by the Russian Federation should be exempted from the possibility of depriving such company of rights to develop a discovered field. Another option would be to establish a mechanism of specific Governmental authorization—when a foreign controlled investor asks for an exploration license for a, most likely, strategic field, the RFG looks at the "national security" factor for this field/area and informs the investor, whether the "national security" provision can be exercised in this particular case.
 - d. We suggest including a special provision in the Subsoil Law (Art. 9) prescribing the method to define direct or indirect control of the Russian Federation over legal entities - users of subsoil areas of federal significance located at the Russian Federation continental shelf (similarly to the definition in the Gas Supplies Law Art. 15).
 - e. Assuming preservation of foreign restrictions we suggest including a special provision in the Subsoil Law that would guarantee that RFG control in a subsoil

- user implementing a project on an area of federal significance of Russian Federation continental shelf will be maintained through the life of the project;
- f. In terms of the requirement of experience for the development of continental shelf projects the Law should provide a precise procedure of determination of the 5 year period. The separate current and consecutive experience of joint venture founders should be allowed to count in meeting the 5 year experience rule.

3. Improve the Tax Regime

- a. Taxes are too high and inefficiently structured (being price and not profits based)
 - In the short run export duties should be cut and the time lag in duty calculation be further reduced
 - MET further differentiated and MET holidays be introduced for more areas
 - But the strategic focus should shift towards moving the tax regime to a profits basis
 - b. Need to have a constructive tax regime for green fields projects
 - Greenfield projects should have a tax regime with a lower tax burden to become attractive
 - High marginal revenue tax rates in Russia are discouraging development of green field complex projects in remote areas with severe climate conditions (such as East Siberia, the Arctic and offshore). Relevant tax concessions would result in considerable growth of capital expenditure.
 - c. Implementation of VAT refund routine for existing PSA-based projects in daily practice
 - For the time being underdeveloped legislation and poor enforcement set up barriers to proper order in the refund procedures.
 - d. Reduced depreciation period:
 - The current depreciation schedules are too lengthy.
 - e. Looking longer-term, a more radical tax reform, which would substitute profit-based taxation for the current revenue-based one, would be beneficial for both operational and capital expenditure (even if a move to profit-based taxation will require solution to the long pending transfer pricing problem).
4. Truly competitive tenders/auctions: now any acreage of importance is given to a pre-determined winner
- a. Specific RFG decisions on awarding licenses to be taken in exceptional cases only.
5. Non-discriminatory access to gas transportation capacity for independent gas producers and oil companies (as exists for oil).
- a. Support of the Federal Antimonopoly Service initiative to simplify and make more transparent access to the unified gas supply system by non-Gazprom producers.
6. Ability for independent gas producers and oil companies:
- a. To sell gas domestically at a market rate
 - b. To export LNG independently (Gas Export Law should be clarified in this regard)
 - c. To enjoy benefits from gas exports (Gazprom to share the benefits with producers of exported gas)

7. The State should make an unequivocal commitment not to allow government administrative and regulatory agencies to be used in commercial disputes against foreign investors (there were examples of that in the recent years). Such a commitment would bring significant comfort to foreign investors and would be consistent to Russia's commitment to the rule of law.
 - a. All disputes to be based on fair and transparent arbitration procedures, not through the use of "administrative resources".

8. Fiscal and legal conditions in place at the time of license award should be maintained for the life of the license
 - a. If they are not the investors should be protected in economic terms by meaningful stabilization mechanisms.

Petroleum Advisory Forum
Moscow

11 February, 2009