INVESTMENT AT AN IMPASSE: RUSSIA’S PRODUCTION-SHARING AGREEMENT LAW AND THE CONTINUING BARRIERS TO PETROLEUM INVESTMENT IN RUSSIA

I. INTRODUCTION

The Soviet Union was once one of the world’s largest producers of oil.\(^1\) By the time it collapsed in 1991, however, the Soviet Union had already faced years of declining oil production due to a lack of capital investment and an eroding infrastructure.\(^2\) Although the Russian Federation inherited most of the former Soviet Union’s oil reserves, it has been unable to exploit these resources as both new drilling sites and investment capital become increasingly hard to find.\(^3\) Without a massive infusion of capital, Russia will be unable to find and produce the oil it needs both to fuel domestic industry and to export in return for hard currency.\(^4\)

Because of Russia’s limited resources, its policy makers have turned to foreign investment to acquire the capital, management expertise, and technology needed to revitalize domestic oil production. However, these same policy makers have frustrated Russia’s interest in foreign investment by erecting nearly insurmountable legal barriers to foreign investment.\(^5\) Perhaps the largest barrier is the fact that there is no law which deals specifically with foreign investment in

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1. See Gary B. Conine, Petroleum Licensing: Formulating An Approach for the New Russia, 15 H OUS. J. INT’L. L. 317, 319 (1993). In 1991 the Soviet Union was the world’s largest producer of both crude oil and natural gas. Perhaps less well known is that Russian oil production rivaled and even “eclipsed” that of the U.S. during the 1870s, making it the world’s largest oil producer for a short while during the last century. See id. at 320.


3. See Conine, supra note 1, at 319.

4. See generally Gorst & Rumyantsev, supra note 2, at 3. The World Bank estimates that Russia will need US $20-25 billion over the next ten years to fund exploration efforts, modernize refineries, repair or replace pipelines, and develop other necessary infrastructure. See id.

5. For purposes of this Note, “foreign investment” is used narrowly to refer only to investment in Russian oil. Similarly, the term “foreign investors” will be used, as it is in Russian legislation, to refer to international oil companies capable of initiating and sustaining large scale oil exploration and extraction projects.
Russian oil. Until a comprehensive law regulating oil is passed, foreign investment will be governed by a patchwork of decrees and laws which foreign investors find confusing, contradictory, and hostile to their interests. Most notable among these laws are the Law on Foreign Investment and the Law on Subsoil Resources which, although intended to encourage and facilitate foreign investment, have only added to the existing legal morass.

One redeeming feature of the Law on Subsoil is that it alludes to the need for a law on production-sharing agreements (PSA law). A PSA law would enable the state and investors to conclude production sharing agreements (PSA contracts) similar to those used around the world since the 1960s. In a PSA contract, a host country grants a foreign investor the right to explore and develop a specified area for a limited duration of time, in exchange for a percentage of the actual oil produced. Similarly, the host country covenants to accept a percentage of oil in lieu of taxes and to shield the investor from supervening legislation which could render the project unprofitable. The primary appeal of a PSA contract, however, is that it enables the state and the investor to conclude a self-contained contract which disengages the terms of the agreement from the hostile legal regime of the host country.

On December 30, 1995, President Yeltsin signed Russia's Law on Production-Sharing Agreements. Although it is modeled after

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6. There are two drafts of a comprehensive oil and gas law currently being considered by the Russian legislature. One draft was sponsored by the Fuel and Energy Ministry and the other by the Russian oil industry. See Kevin J. Vaughan, Russia's Petroleum Industry: An Overview of Its Current Status, the Need For Foreign Investment, and Recent Legislation, 25 LAW & POL'Y INT'L BUS. 813, 832 (1994).


9. Law on Subsoil, supra note 8, art. 12.


11. A PSA contract is “self-contained” in that it is only governed by its own provisions and the provisions of the PSA law. This allows the investor to be certain about his legal rights and obligations before committing significant capital investment to a new oil project. See generally James W. Skelton Jr., Investing in Russia’s Oil and Gas Industry: The Legal and Bureaucratic Obstacles, 8 NAT. RESOURCES & ENV’T. 26 (1993).

successful PSA laws enacted in countries around the world, Russia's PSA law fails to provide the certainty and protection foreign investors require before undertaking multi-billion dollar investment projects. The chief problem with Russia's PSA law is that it does not allow the state and the investor to conclude a self-contained agreement. In fact, the PSA law refers directly to both the Law on Foreign Investment and the Law on the Subsoil, effectively shackling any PSA contract to Russia's hostile legal environment.

Part II of this Note discusses the benefits of foreign investment to both Russia and foreign investors. Part III demonstrates how foreign investment is frustrated by Russia's current legal environment. Part IV analyzes Russia's PSA law and explains how it fails to correct the problems associated with the current legal environment. Finally, Part V discusses the legislative alternatives available to Russian policy makers, including amending the PSA law.

II. THE BENEFITS OF FOREIGN INVESTMENT

A. Benefits to Russia

Russia has turned to foreign investment twice this century to boost sagging domestic oil production. In 1921 Lenin was able to attract sufficient foreign capital to salvage Russia's oil industry which had experienced a decline in production by fifty percent in the preceding four years. With the help of foreign capital and expertise, oil production in Russia was restored to its pre-war level by 1928. When oil production began to slide in the mid 1970s, Russia (the Soviet Union) once again invited foreign investors to participate in the location and development of Russia's oil reserves. As before, foreign investment reversed the trend of declining production. By 1987, Russia had established itself as one of the world's largest producers.

13. Initial investments exceeding US $1 billion are becoming common in the global search for new oil reserves. See Rajpreet Basi, Foreign Investment in the Russian Oil and Gas Industry: A Time For Reckoning, 5 INT'L LEGAL PERSP., Summer 1993, at 33, 45 n.82.
14. See Conine, supra note 1, at 325.
15. See id.
16. See id. at 336-38. Two major projects resulted from Russia's invitation to foreign investors. In 1977, the Japanese Petroleum Development Corporation began exploratory drilling off the coast of the Sakhalin Island and a Canadian-Soviet joint venture called Vosei 100 began drilling north of the Komi Republic.
of oil with a production rate of 11.38 million barrels per day. Since 1987, however, Russian oil production has fallen about thirteen percent a year to the current low of 6.1 million barrels a day, which is very close to the output needed for domestic consumption alone.

Declining oil production in Russia is extremely dangerous for two reasons. First, Russia depends on oil export revenues as its main source of hard currency. Russia needs hard currency to pay interest to the International Monetary Fund (IMF) and a host of foreign commercial banks. Declining oil revenues would jeopardize Russia’s ability to service its debt and could ultimately lead to default. The Russians also need hard currency to import basic necessities. Each year Russians import fifteen to twenty-five billion dollars worth of food and pharmaceutical products. A sudden shortage or elimination of these basic items could threaten the health of many in the Russian population and lead to severe political unrest.

Second, declining oil production poses a threat to other domestic industries which rely on relatively inexpensive and dependable access to fuel. Currently, Russia produces just enough oil to supply its domestic industries and export the remaining small amount. If Russia’s oil production falls any farther, however, it will be faced with the difficult choice of either denying domestic industry the fuel it needs or defaulting on foreign loans.

The two keys to increasing Russian oil production are (1) refurbishing and expanding the existing infrastructure and (2) increasing exploration. Both infrastructure and exploration suffered during the 1980s when Gorbachev neglected to reinvest profits from exports back into the oil industry. Instead, oil revenues were used to subsidize other, less profitable industries and to purchase desperately needed consumer goods. Faced with a lack of reinvestment capital and increasing demands from the Soviet central planners, oil managers were forced to cut costs. Understandably, they chose to reduce spending in the areas which needed the least amount of immediate attention: infrastructure and exploration.

18. See Gorst & Rumyantsev, supra note 2, at 3.
19. ‘93 Crude Export Slide is Foreseen by Russia, PLATT’S OILGRAM NEWS, Nov. 23, 1992, at 1.
21. The needed infrastructure includes pipelines, roads, refineries and ports. See id.
23. Id.
The lack of infrastructure maintenance has resulted in massive waste and loss due to leaky pipelines and outdated drilling techniques. Some have speculated that as many as one million barrels of Russian oil are spilled each day due to poor infrastructure. Equally severe, the lack of investment in exploration has led to a twenty-five percent decline in oil exploration from 1989 to 1992.

Foreign investors can provide the capital and cutting-edge technology needed to revitalize the infrastructure and initiate exploration. Investors have already begun considering major undertakings to repair and rebuild the oil infrastructure. Neste, a Finnish oil company, is currently in negotiations with Russian authorities to build a “Baltic Oil Pipeline” which would deliver 700,000 barrels of crude oil a day from the Timan-Pechora basin to the Russian port of Primorsk where additional pipes would take the oil to Finnish refineries. Other projects include constructing a new port on the Barents Sea that would ultimately be the point of departure for an estimated two billion barrels of oil. Parties interested in this project include Texaco, Norsk Hydro, Amoco and Exxon.

B. Benefits to Foreign Investors

Foreign investors want access to Russia’s massive oil reserves. Experts have estimated that sixty billion barrels of oil, or 7 percent of the world’s total oil reserves, are located within Russia’s borders. While these estimates are impressive, they are based only on regions which have been explored and do not factor in the potential for oil discovery in Russia’s vast, unexplored regions. Some analysts have argued that tapping Russia’s unexplored regions would reveal oil reserves rivaled only by those found in the whole of the Middle East. By gaining a foothold in Russian oil production, foreign investors would nearly be assured a steady flow of oil for decades.

24. See Knecht, supra note 20, at 32.
26. See C.I.S. Woes, supra note 22, at 44.
27. See Gorst and Rumyantsev, supra note 2, at 3.
28. See id. at 4
29. See id.
30. See id.
32. See generally Yevgeny Pavlov, Time to Reflect and Time to Drill: The First Should Come First, BUSINESS M.N, January 17, 1996, at 7, available in LEXIS, News Library (reporting on the findings of an academic panel at a conference entitled “Fundamental Challenges Facing Oil and Gas Production” organized by the Russian Academy of Sciences).
In addition to commercial rewards, foreign investment in Russian oil could yield political benefits. For example, a healthy Russian economy with close ties to the West would most likely enable a moderate government to stay in power, thereby reducing national security concerns in Europe and Scandinavia. Additionally, the establishment of a steady flow of Russian oil to Europe and the U.S. would reduce European and American dependence on the oil-producing countries of the Middle East.  

III. PROBLEMS WITH THE CURRENT LEGAL ENVIRONMENT

Despite the enormous benefits foreign investment could bring to both Russia and foreign investors, most large-scale projects have died in the negotiation stage due to Russia’s hostile legal environment. Because there is no definitive law governing investment in Russian oil, foreign investment projects are subjected to a body of “conflicting, overlapping, and rapidly changing laws, decrees and regulations which tend to support an ad hoc and unpredictable approach to doing business, and which often apply on a retroactive basis with no grandfathering provisions.”

Two laws on foreign investment have served as the foundation for this confusing and ever-expanding legal morass.

The Law on Foreign Investment was drafted in 1991 to attract and regulate Western capital and technology desperately needed by Russia after the collapse of the Soviet Union. The law has failed to achieve its stated goal of attracting investment, however, because its broad provisions do not extend the certainty and protection most investors require before committing substantial investment capital. Specifically, the Law on Foreign Investment neglects to shield investors from extremely high risks associated with a lack of centralized authority, a patently hostile tax regime and exposure to subsequent, supervening legislation.

The Law on Subsoil was drafted in 1992 to apply specifically to foreign investment in natural resources. Although it contains several 

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33. See Vaughan, supra note 6, at 822-823.
35. The preamble of the Law on Foreign Investment states: “This law . . . is aimed at attracting and making effective use of foreign material and financial resources, advanced foreign techniques and technology, and management experience in the national economy of the [Russian Federation].” Basili, supra note 13, at 42 n.61.
provisions intended to facilitate investment, the Law on Subsoil fails to correct the problems created by the Law on Foreign Investment.

A. The Law on Foreign Investment

1. Overlapping Federal and Local Authority. For over seventy years, federal and local authorities in Russia have struggled for control of Russia’s oil.36 When the Soviet Union collapsed, local authorities began boldly to assert ownership rights to the oil in their territories.37 Unwilling to challenge these claims, federal lawmakers have tacitly agreed to a system of overlapping jurisdiction.38 Under the current arrangement, both the federal and local governments have power to regulate foreign investment while neither has an incentive to coordinate its legislative efforts with the other. As a result, investors are exposed to tax laws, regulations, excise fees and licensing requirements at both the federal and local levels that often contradict or duplicate each other. For example, an investor might be required to pay a 20 percent “land use” tax to the federal government as part of an exploratory drilling project only to learn that the local authorities also require a 20 percent “land use” tax. In other words, because there is no coordination between federal and local authorities, the investor would have to pay “rent” to two landowners for the same piece of land. Even worse, nothing precludes the local authorities from passing a “land use” tax ex post facto and applying it to the same project after drilling has begun.

The Law on Foreign Investment fails to provide investors with a definitive policy because it explicitly leaves local authorities with overlapping power to regulate foreign investment within their territory. The preamble states that “the provisions of this law operate on the territory of the Russian Federation with respect to all foreign in-

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36. See Conine, supra note 1, at 329. Historically, all mineral resources, including oil, were assumed to fall under the jurisdiction of local authorities. In the 1930s, the Communists took control of all mineral resources under the theory that local governments had “delegated” their authority to the Supreme Soviet. Somewhat surprisingly, local officials during the Communist period made occasional attempts to wrest control over petroleum operations from the central ministries. Then, with the collapse of the Soviet Union and concomitant demise of centralized authority, local governments “asserted that they alone could authorize exploration and development and were entitled to the financial benefits due the state.” Id. at 339.

37. See id.

38. Even the Russian Constitution is hopelessly vague with regard to who has authority over natural resources. See, e.g., KONST. RF art. 9.1 (1993) (“natural resources shall be used and protected in the Russian Federation as the foundation of life and the activity of the peoples living in the corresponding territory.”).
vestors and enterprises with foreign investments.” 39 At first glance, this provision could be read as an assertion of federal authority over all investment activity “on [Russian] territory.” Under this interpretation, the Law on Foreign Investment would suprevene local laws attempting to regulate foreign investment. Upon closer inspection, however, it becomes clear that the drafters did not intend this result. In fact, the drafters left the system of overlapping authority firmly in place. Article 38 of the Law states that foreign investment in land or natural resources is subject to the National Land Code and “other legislative enactments in force on the territory of the Russian Federation.” 40 “Other legislative enactments” is sufficiently broad to encompass the myriad of laws, taxes, regulations, and fees enacted by assertive local governments. Thus, the investor who is able to meet all federal regulations must additionally contend with the unchecked regulatory power left in the hands of local authorities. 41

2. Taxes. The Russian tax regime is the most daunting legal obstacle to foreign investment. The Law on Foreign Investment refers potential investors to the tax laws in force in the Russian Federation. 42 This is unacceptable for two reasons. First, tax laws in Russia have a history of changing rapidly and second, the current tax burden on foreign oil investors is egregiously oppressive. 43 Foreign investors can expect to pay “local taxes of 10 to 20 percent, a tax on profits from which wages cannot be deducted, a 28 percent VAT, a 40 percent income tax, an oil export tax of $5.50 a barrel, a mineral use tax, a mineral rehabilitation tax, an excise tax, tariffs on imported goods and port usage taxes. In the unlikely event that a profit is still being realized, a profit repatriation tax is also imposed.” 44

Of all the Russian taxes, the export tax has been singled out by foreign investors as the most significant threat to profitable investment in Russia. 45 Although the IMF suggested the export tax on oil

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39. Law on Foreign Investment, supra note 7, at 1 (emphasis added).
40. Id.
41. See infra Part IV.C.3. for further discussion on the risks future, supervening legislation poses to foreign investors.
42. Law on Foreign Investments, supra note 7, art. 3.
44. Id.
as a means to reduce Russia's budget deficit,\(^46\) it has had exactly the opposite effect. Because the export tax has made it nearly impossible for foreign investors to realize a profit, they have held back the investment funds desperately needed by the Russian government to reduce the budget deficit. Instead of repealing the export tax, however, the government issued Decree No. 497 on May 19, 1994 which allows exemptions for foreign oil producers in certain circumstances.\(^47\) To date, almost all major oil joint ventures have proceeded contingent on receiving an exemption to the export tax.\(^48\)

3. Exposure to Changing Legislation. According to Yuri Petrov, head of the State Investment Corporation (SIC), “change of legislation is the biggest risk facing potential investors.”\(^49\) As discussed above, investors in the oil industry are at the mercy of changing legislation both at the national and local levels. Because the Law on Foreign Investment fails to address this issue, President Yeltsin established the SIC with the express purpose of protecting investors from changing legislation.\(^50\) The SIC was endowed with 787 billion rubles to establish a fund for compensating those investors who could prove that their investment loss was proximately caused by changing legislation.\(^51\) While the intention is good, the creation of the SIC has failed to attract investors or alleviate their fears of changing legislation because the SIC has very limited funds at its disposal, and proving that changing legislation is the only cause of business failure would be very difficult in most situations.\(^52\) Thus, although the government seems to recognize the concerns foreign investors have regarding changing legislation, it has failed to take effective steps toward minimizing or alleviating the risks.

\(^{46}\) See Imse, supra note 43, at 3.
\(^{48}\) Notable examples include Polar Lights, White Nights, Amkomi, Siberian-American Oil Company, KomiArcticOil and Chernogorskoye. Id. at 107.
\(^{49}\) Basi, supra note 13, at 47.
\(^{50}\) See id. at 47.
\(^{51}\) See id. at 46.
\(^{52}\) Assuming the current exchange rate which fluctuates between 4000 and 5000 Rubles to the dollar, the SIC would have between US $150-200 million dollars with which to compensate foreign investors. While this may be sufficient to cover smaller investments, initial oil investments routinely exceed US $1 billion. See Basi, supra note 13, at 42 n.61.
B. The Law on Subsoil

The Law on Subsoil did not settle the issues of authority, taxes and exposure to changing legislation. However, the law does make one important advance toward the establishment of a more acceptable legislative climate for foreign investors. The Law on Subsoil provides for the use of concession and PSA contracts in conjunction with a licensing system to stabilize the investment environment and to attract foreign capital. For purposes of this Note, however, the Law on Subsoil is important because it sets the stage for the passage of the Law on Production-Sharing Agreements.

IV. THE RUSSIAN PRODUCTION-SHARING LAW

A. History

On December 24, 1994, President Yeltsin encouraged foreign investors by signing Decree No. 2285, “on Production Sharing Agreements For The Use of Underground Resources.” Although the Decree did not establish PSA contracts as a legal form of investment, investors regarded it as a “goodwill gesture” and an indication that substantive legislation would follow. The investors were correct. Very soon after the decree, both the Economic Policy Committee of the State Duma (Duma) and the Ministry of Fuel and Energy (Ministry) began preparing drafts of legislation that would finally raise Russian investment options to world standards and attract desperately needed foreign capital.

Both the Duma and the Ministry completed drafts of a PSA law by early 1995. While both drafts created a legal basis for production sharing, the Duma draft was far more friendly to foreign investors. For example, the Duma draft contemplated a new, more flexible system for the granting of development rights. In contrast, the Ministry draft left unchanged the rigid system of tender offers found in the

53. For example, the Law on Subsoil sets out a system whereby authority over the assignment of development rights and other regulatory functions are to be shared equally by the federal and local governments “in the interest of the people.” See Conine, supra note 1, at 429.
54. See id.
55. See Mikhail Y. Galyatin, A Hazy Future for the Law on Production-Sharing Agreements, PATTERSON, BELKNAP, WEBB & TYLER LTD. NEWSL. (Moscow, Russia), 1996, at 3 (on file with the Duke Journal of Comparative & International Law).
56. See Hobér, supra note 47, at 100.
57. See id.
Law on Subsoil. 58

More importantly, the Duma version provided for a tax structure characteristic of typical PSA legislation. In a PSA, the foreign investor pays the host government a share of the oil produced in lieu of taxes. 59 The percentage of oil the state receives should total in value that which the state would have received from income, VAT, export and other taxes. Under the Duma’s draft the government would accept oil for taxes and release the investor from further tax liability. 60 The Ministry’s draft, on the other hand, included a long list of “taxes, duties, charges, deductions to social funds and other payments, thus firmly anchoring the foreign investor to the Russian tax system.” 61 The Ministry’s draft added nothing new to the existing legal framework for oil production. While foreign investors could call their agreement a “production sharing agreement,” they would have been forced to navigate through the existing system of tender offers, licences and full exposure to a hostile tax regime.

In a victory for investors, the Duma draft prevailed and was sent to the Federation Council for ratification. 62 The victory was short lived, however, because the Federation Council vetoed the law. After an unsuccessful attempt by the Duma to overturn the veto, the draft law was sent to a Settlement Committee to seek out a compromise. 63 After two months in the Settlement Committee, the Duma proposed a watered-down version of their original draft on December 6, 1995, and sent it to the President to be signed into law. 64 After hearing arguments from supporters and opponents of the law, President Yeltsin signed the Law on Production-Sharing Agreements on December 19, 1995, stating that, in his opinion, “a bad law is better than none at all.” 65

B. Typical PSA Laws

PSA laws enable the state and the investor to conclude PSA contracts. PSA contracts have been used since the 1960’s to attract foreign investment in the oil industries of countries such as Indonesia,

58. See id.
59. See infra Part IV .B. for a more detailed discussion on the mechanics of a PSA contract.
60. See Hobér, supra note 47, at 100.
61. Id.
62. The Federation Council is the upper house of the Russian Parliament.
63. See Galyatin, supra note 55, at 2.
64. See id.
65. Id.
Egypt, Libya, the Philippines, Peru, and Kenya. Typical PSA contracts protect foreign investors by enabling them to contract around the hostile legal environments often present during times of economic or political turmoil.

The foreign investor contemplating an oil project and the host state negotiate a contract enumerating all the rights and obligations of the parties which are then enforceable in either international arbitration or the courts of a third country. When oil is produced, the foreign investor is allotted enough oil to cover the costs of the project (Cost Oil), and whatever is left is divided between the foreign investor (Profit Oil) and the host state (Government Take) according to a pre-determined percentage negotiated in the PSA contract.

The principal feature of a PSA contract, however, is that it is entirely self-contained. By concluding a self-contained contract, the foreign investor is able to obviate the existing legal environment and acquire guarantees of certainty and protection directly from the host state. Similarly, the host state benefits by attracting foreign investment while maintaining control over the specifics of large-scale oil projects. This is different from other popular forms of oil contracts such as concession agreements where the state actually transfers ownership of the subterranean oil to the foreign investor.

C. The Key Problem with Russia’s PSA Law: No “Self-Contained” Contract

An investor who concludes a PSA contract with Russia will not have the benefit of a self-contained agreement. In fact, most key provisions of the law expressly refer back to existing legislation.

66. See Conine, supra note 1, at 362.
67. See id.
69. See Smith & Dzienkowski, supra note 10, at 28.
70. See Skelton, supra note 11, at 26.
71. See id.
72. See id.
74. The following areas are expressly exposed to existing legislation: foreign control and use of land (art. 1.2), licensing (art. 2.2), modification of the agreement (art. 17), termination
Thus, any contract formed pursuant to PSA law will be shackled to the same problems foreign investors face under the current legislative environment. Because the PSA law does not allow for self-contained contracts, the investor must face three familiar problems: (1) overlapping federal and local authority, (2) hostile taxes and (3) supervening legislation. In addition, the PSA law fails to offer an adequate system for resolving disputes.

1. **Overlapping Federal and Local Authority.** As discussed above, overlapping authority exposes the investor not only to existing laws which may duplicate or conflict with each other, but to changing legislation as well. Attempting to mitigate these risks, the drafters of the PSA law included a stability clause in Article 17.2. The stability clause states that “in the case that changes in federal or local legislation has a negative effect on the economic result of an investor's project, the terms of the agreement shall be modified so that the investor may obtain the same economic result which would have resulted in the absence of any legislative changes.”

While the stability clause is, in theory, an innovative solution to the problem of overlapping authority, it is too vague to mitigate investors' concerns. The stability clause neglects to define “negative effect” and “economic result” thereby leaving their meaning to be interpreted by Russian authorities. Even if the authorities agree with the investor that the “economic result” is that a particular project has experienced a “negative effect” due to changing legislation, the PSA law does not describe how the agreement may be “modified” to protect the investor's profit margin. Presumably the drafters intended the investor to set off the damages incurred by changing legislation against the government take of the produced oil. If this is the case, then the investor is only protected from local taxation and fees up to the amount of the government take. In the conceivable scenario that a local or federal authority imposes regulations which amount to more than the government take, the investor is left without recourse.

2. **Taxes.** Article 13.1 of the PSA law contemplates a traditional PSA structure where the investor pays the host state a percentage of the oil (government take) produced in lieu of taxes.
However, paragraphs two through five show the Ministry’s influence on the final, compromised PSA law by requiring the investor to pay income taxes, VAT taxes, bonuses, royalty payments, and payments for the use of land in addition to the government take.\textsuperscript{77} These are the same taxes applicable to foreign investors under the Law on Foreign Investment. In fact, Article 13.2 expressly states that income taxes levied against the investor will be regulated by Russian law.\textsuperscript{78} Not only is the investor exposed to income taxes which may be as high as thirty-two percent,\textsuperscript{79} but his taxable income must be derived using Russian methods of accounting.\textsuperscript{80} This requirement forecloses the possibility of designating mutually agreeable accounting methods, such as the international General Accepted Accounting Principles, within the terms of the PSA agreement. Instead, the investor is bound to a system of accounting used exclusively in the Soviet Union during communism.

In addition to the income tax, the investor must pay a value added tax, or VAT, which is essentially a tax on the incremental value the foreign investor’s services add to the final product of exportable oil.\textsuperscript{81} Included in the determination of “value added” are the goods and services the foreign investor must utilize to produce the final product. The VAT is an especially lucrative tax for the Russian government in light of Article 7.2, which mandates that the investor give preferences to Russian products, services and technology. Under 7.2, the investor must not only use Russian contractors, producers and suppliers “when all other conditions are equally met,” but must also stipulate in the PSA contract to using a “minimum percentage of technological supplies that must be purchased in Russia.”\textsuperscript{82} Thus the investor is forced to purchase goods and services in Russia under Article 7.2 which are then subject to the VAT tax under Article 13.3.

The investor may recover the VAT taxes paid only if oil is found and produced.\textsuperscript{83} According to 13.3, when an investor begins producing

\textsuperscript{77} See id. arts. 2-5.

\textsuperscript{78} The first line of article 13.2 states: “Налог на прибыль уплачивается Инвестором в порядке, установленном законодательством Российской Федерации.” [Tax on profit is paid by the investor in the order established by the laws of the Russian Federation]. This is the typical form the drafters used throughout the PSA law to refer back to the existing Russian legal structure.

\textsuperscript{79} See Vaughan, supra note 6, at 826.

\textsuperscript{80} See Law on Production-Sharing Agreements, supra note 12, art. 14.1.

\textsuperscript{81} See id. art. 13.3.

\textsuperscript{82} Moss, supra note 68, at 9.

\textsuperscript{83} See Law on Production-Sharing Agreements, supra note 12, art. 13.3.
oil, he may deduct V A T taxes paid from the total government take. Not surprisingly, this element of the PSA law heavily favors Russia and simply adds another bureaucratic hurdle for investors. To illustrate, if investor A signs a PSA contract with Russia, his V A T liability for the first month of operations may be X. A year later, when oil is found and produced, the investor may recover only the current value of X which has most likely dropped significantly due to double digit inflation. While the investor may recover V A T taxes paid, the ultimate amount will be much less and the effort expended to recover the money from the Russian government could be substantial.

Similar to taxes, the investor who signs a PSA agreement is subject to existing legislation in the area of export duties and tariffs. Article 9.2 states that investors may export oil without limitations “except those found in the Law on Foreign Investment.” One of the “limitations,” however, gives the government power to impose “export tariffs, quotas and licence fees” at will. Thus, when the government uses its authority under the Law on Foreign Investment to raise tariffs and license fees on all foreign investments, it also unilaterally modifies any tariff or license fee structure negotiated in PSA contracts.

3. Future, supervening legislation. In the areas of tax, export duties, and dispute resolution, the PSA law is anchored firmly to existing Russian legislation. More damaging to foreign investment, however, is the fact that the investor is exposed to future, supervening legislation which could destroy a profitable venture. Nothing in the PSA law restricts the Russian government from using the legislative powers granted under the Law on Foreign Investment and the Law on Subsoil to raise income taxes or export duties. Thus, the investor’s profit margin under a PSA contract is constantly at the mercy of new legislation. This is especially dangerous considering that both federal and local governments have a Constitutional right to raise taxes or enact new ones at will.

84. See id.
85. See id. art. 9.2.
86. Id.
87. See Moss, supra note 68, at 10.
88. See id.
89. Compare Konst. RF art. 132.1 (1993) (giving local authorities authority to “manage municipal property” and “establish local taxes and levies”), with id. art. 75.3 (stating that the Federal government may establish a “system of taxes to be collected for the federal budget.”).
4. Dispute resolution. The PSA law also links dispute resolution to existing Russian law. Under Article 22, the government and investor may stipulate that disputes will be submitted to either a Russian court of ordinary jurisdiction or to international arbitration. Because the PSA law is so closely tied to Russian law, the investor can expect that even in international arbitration, the controlling substantive law will be Russian. Nevertheless, investors would most likely prefer international arbitration over the risks of partiality they could face in Russian courts.

Before submitting a dispute between a state and private party to international arbitration, the state must waive its sovereign immunity. Without a waiver, sovereign states such as Russia will often resist limitations on their autonomy, making it difficult for private parties to compel arbitration and enforce awards. Recognizing this concern, the drafters of the PSA law included Article 23, which authorizes Russia to waive its sovereign immunity in PSA contracts with foreign investors. The effect of this provision should not be overstated, however, because Article 23 continues to say that any limiting of sovereign immunity must be done in connection with existing Russian law. However, no such law exists. A law enabling Russia to waive its sovereign immunity is currently being reviewed in Parliament, but until it is passed, Article 23 of the PSA law is useless to investors.

V. RECOMMENDATIONS

A sophisticated and well-drafted PSA law would remove significant barriers to foreign investment in Russian oil. For the PSA law to work, however, at least three steps must be taken. First, the PSA

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91. See Lelewer, supra note 90, at 386.

92. See Moss, supra note 68, at 17.

93. While a PSA law would eliminate or at least reduce barriers resulting from the legal environment, other significant barriers to investment remain. Investors are reluctant to rely on the Russian pipeline network, which is not only in desperate need of repair, but also runs through former Soviet republics, such as Azerbaijan, which are now independent and often hostile to Russia's interests. A nother constant barrier is the threat of political turmoil. One need only recall, for example, that Russian tanks faced each other in front of the "White House" in a stand-off for political control less than four years ago. See Sonni Efron, Yeltsin Calls in Troops After His Foes Rampage in Moscow and Rout Police, L.A. TIMES, Oct. 4, 1993, at A1.
law must allow the state and foreign investors to conclude self-contained agreements. This could be accomplished by (1) redacting vague references to the “laws of the Russian Federation” in the provisions of the PSA law, and (2) adding a supremacy clause stating that any PSA contract is subject only to the PSA law and the terms of the PSA contract. Once PSA contracts are disengaged from existing laws, Russian authorities and foreign investors will be empowered to establish taxes, export duties, mechanisms for dispute resolution, and other specifics relating to a given project within the terms of the PSA contract.

Second, Russia’s PSA law should borrow provisions from successful PSA laws enacted in other countries and adapt them to the Russian context. Most PSA laws designate a specific percentage (ranging from thirty to fifty percent) of the total oil produced that the investor may recoup as cost oil. Russia’s PSA law should do the same because it gives the investor a powerful incentive to use the most cost-effective means of recovering the maximum amount of oil. If only thirty percent of the total oil produced may be allocated to cover costs, the investor will only pursue projects which will yield more oil with lower costs. The downside is that investors may refrain from the high-risk exploratory drilling which often result in discoveries of major reserves. However, with a sliding scale for cost oil, the investor could receive an increased allocation, up to fifty percent, depending on the relative difficulty of the project.

Other PSA laws also include a mechanism for calculating which costs may be reimbursable by the cost oil. Indonesia includes express provisions indicating how to determine overhead, capital and financing costs and how they are to be offset by the cost oil allocation. Capital costs must be amortized, and then offset against the cost oil by not more than 20 percent per year. This prevents the investor from applying all the cost oil to recoup capital costs in the short term.

94. However, for practical reasons, the PSA law should refer to the applicability of existing tort, environmental and criminal law to any contract concluded in Russia. Conceivably, an increase in environmental regulations detrimental to the profitability of an oil project could be offset by the stability provision found in Article 17.2.

95. See Smith, supra note 73, at 531.

96. This is an acute concern considering that much of Russia’s oil may be located in Siberia, the Russian Far East and under the Caspian Sea. Each of these regions presents unique challenges to exploration efforts and will most likely require significant capital costs to begin oil extraction.

97. See Smith, supra note 73, at 531.

98. See id.
and insures that the remaining 80 percent will be available for wages and taxes. Russia’s PSA law does not designate a specific method of calculating costs, but merely requires that whatever method is chosen must not “contravene the laws of the Russian Federation.” The drafters of Russia’s PSA law could afford the investor more certainty by designating a sliding scale for the allocation of cost oil and a system for calculating which costs are applicable.

Similarly, the drafters should designate a sliding scale for the allocation of profit oil between the state and investor. In both Kenya and Nigeria, the host state receives a progressively larger government take from the profit oil as the amount of daily production increases. For example, the government take from a project producing 20,000 barrels a day may start at 65 percent with the take increasing to 75 percent if production exceeds 50,000 barrels a day. The theory behind this sliding-scale mechanism is to reward the state and not the investor for an unexpectedly large discovery. A sliding scale may also diminish the state’s temptation to seek modification of the PSA contract due to changed circumstances. This benefits the investor by increasing certainty. At least the investor can anticipate the amount of increased government take resulting from a massive oil strike instead of being in fear of unilateral modification or expropriation.

Third, the Russian government should pass legislation enabling it to waive its sovereign immunity. As stated above, the PSA law has a provision allowing the state and the investor to choose international arbitration as their means of dispute resolution. This provision is moot, however, unless Russia is able to waive its sovereign immunity and be subject to the jurisdiction of a third party.

Following these three steps would improve the Russian PSA law. While not removing all the barriers to investment, a PSA law which allows the state and investors to conclude self-contained contracts, borrows from other PSA laws, and facilitates the use of international arbitration could make investment in Russia’s oil significantly more attractive to foreign investors. Furthermore, completing these steps would bring Russia’s investment environment closer to those existing in other oil producing countries, thereby making Russia a more viable competitor for international oil investment funds.

99. Law on Production-Sharing Agreements, supra note 12, art. 8.
100. See Smith, supra note 73, at 532.
101. See id.
102. See id. at 533. Left unresolved is the fact that a sliding scale could provide the investor with an incentive to under-produce, thereby avoiding an increased government take.
VI. CONCLUSION

Russia needs foreign investment to boost sagging oil production and attract desperately needed hard currency. Foreign investors want to invest but are hindered by Russia’s legal environment. A sophisticated PSA law would allow investors to obviate the existing legal morass and protect them from the threat of future governmental intrusion. Unfortunately, Russia’s PSA law does neither. In fact, the PSA law expressly refers back to existing legislation and opens the door for unilateral modification by future legislation. While no law can insure investment success, Russia’s PSA law, as currently drafted, insures that investors will wait for a more secure investment environment before committing a significant amount of resources. If Russia neglects to repair the PSA law or overhaul its legal environment, it may squander its potential to be a major oil producing nation and threaten its progress toward a democratic future.

Mark A. Stoleson

103. The promise of a PSA law led several American oil companies including Amoco, Exxon, Mobil and Texaco to begin negotiations with Russia. The disappointing substance of the law as passed, however, has caused several of the negotiations to stall, possibly indefinitely. See The Americans Are Backtracking On Their Offers, BUSINESS MN, Jan. 17, 1996, at 5, available in LEXIS, News Library.

104. See id.