One step forward, two steps back

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?Everything changes so that everything can stay the same,? someone whispered this in my ear as I sat among delegates at a conference in Moscow. He was quoting from a book on Sicilian aristocracy in the nineteenth century. But the venue was a conference on Production Sharing Agreements (PSAs) in Russia and the CIS, organized by Euroforum, and a member of the Russian Duma was speaking.

The PSA legislation that was approved in February 1998 is a sign of Russia's willingness to encourage foreign investment in its cash-strapped oil sector. With a few reservations, it is also welcomed by project financiers interested in Russia's oil and gas and minerals sector. But in order to gain the approval of a communist-dominated Duma, the government had to draw a parallel between the draft law and the Bolshevik legislation on PSAs in the 1920s.

A communist-dominated Duma is certainly not the best incentive for foreign investors, and recent tension over the Kosovo conflict has put a serious question mark on the future of Russia's relations with US and western Europe.

Then there is the issue of regional relations. PSAs need a representative body at a federal level, because there is no legal certainty that regional parliaments will accept the PSA. But political, economic and fiscal relations between the central government and the 89 subjects of the federation have been a constant source of uncertainty and conflict during Russia's transition period.

While some regions have been successful in lobbying for autonomy and have used their special economic status to attract foreign investment, other regions have ended up erecting obstacles to foreign investors.

According to Valeri Iazev, chairman of the Duma's sub-committee on fuel in Moscow: ?Federal subjects are usually opposed to PSAs because after they are approved the local government has no control over it and they are left out of it.? Another point where the legislation is not clear is on tax issues. Under the new PSA legislation, only federal taxes are relieved, but it is not clear what kind of tax relief should be provided by the regions.

Problems also occur when different regional governments deal with the legislation inconsistently. Anatoli Averkin, deputy head of the PSA expert group, ministry of fuel and energy of Russian federation and counsel at PricewaterhouseCoopers in Moscow, points to the Khanti Mansiski region. In that region there are conflicting laws. Averkin believes the inconsistencies in law may occur in Tatarstan. ?We have to change the inconsistencies,? he says.

Victor Orlov, minister for natural resources of Russia says that, while preliminary agreements are being made, regulation needs to be extended from the federal to the local and regional level. The government is already looking at gold resources in Yakutia, which could be developed on a PSA basis.

Gail Buskye, senior banker at the European bank for Reconstruction and Development (EBRD) in Moscow adds that clarifying local tax issues and regional government issues will be essential for part of the reforms required for Russia's financial sector. This is among the reasons why the bank is working on the development of the regional banking sector.

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Don't blame the financial crisis

Says Doug Glass, head of law firm Vinson & Elkins in Moscow: ?The financial crisis per se has not had a material effect on project finance, because things were not great before. Western multinationals are still here, even though their timetables might have been strung out a bit.?

There are not many project finance deals in the pipeline in Russia, because investors are not willing to take Russian risk at the moment, but, according to Buskye, ?there is light at the end of the tunnel?.

In the power sector, a new regulation allows limited power trading and Russia's Unified Energy Systems (UES) is looking at how to deal with it and how to ship power abroad. It is a step forward that could create opportunities for the project finance market. For example, German energy companies Bayernwerk and Wiener Verbund are negotiating with UES to buy electricity from Russia at a rate of 600,000 kiloWatts each. But, according to Glass, some time will have to pass before upgrade greenfield power projects will be a reality in Russia.

The climate for infrastructure finance in Russia is even worse. Such projects generate revenues in roubles and it is hard to find financiers willing to take rouble risk. The projects that are going forward are mainly those that generate cashflow on offshore accounts ? such as oil and mining deals.

But restrictions that the government has made on currency conversion has made it hard for existing projects. A source says that among the projects negatively affected by this regulation is the $180 million Kubaka Gold Mine project, which signed in 1996. Financing is led by the EBRD, Chase and Opic with an equity participation from Rossiyski Kredit.

Light at the end of the tunnel

The EBRD's Buskye points out that ?people have always done business here and they will continue to?. Small and medium-sized enterprises are a good example. According to Buskye, these companies have continued to honour their debts with the EBRD throughout the crisis.

Richard Ranken of the International Finance Corporation (IFC) in Moscow says that ?in the long term Russia has a great potential?. Even though ?the whole investment environment has a lot of holes,? there are interesting long-term investment opportunities. Many foreign investors in Russia are prepared to provide a lot of balance-sheet financing and they want a high degree of recourse, but they are considering the possibility of taking more project risk when the project eventually demonstrates the capacity to repay its debt. Ranken stresses that there is also a potential for venture capital financing in Russia, where there are many good sponsors. ?The implication is that Russia will eventually muddle through,? says Ranken.

A financial outcast?

The real problem is the disastrous state of the banking sector. A cover story of The Economist in March 1999 called Russia a ?financial outcast?. But a walk around the streets of Moscow does not give the impression of a country undergoing a deep crisis and Muscovites do not seem to have a complete awareness of the bad reputation the country is gaining. The new western-style restaurants of the centre are probably not as full as they used to be up to August 1998 and the considerable crowd in the brand-new Ohotni Riad shopping mall under the Kremlin is possibly just window shopping and not spending much cash. Especially considering that with the collapse of the banking system, many Russians had their bank accounts frozen. Genya, a Russian friend, claims that the only way she can access her money is by accepting the vouchers the bank is issuing, valid only in a few selected restaurants in Moscow.

Finding a solution ? a new development bank emerges

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In an attempt to solve the banking crisis, the Primakov government has initiated the creation of a Russian Development Bank. A source defines this ? together with the new PSA legislation ? as the only concrete step the Primakov government has taken up to now for the financial and industrial sector.

The Japanese government is cooperating with Russia on the creation of this bank, which will resemble a similar institution created in Japan after the second world war. The bank will provide loans and investment guarantee facilities. ?The problem is that, after the GKO experience, why would anyone take them seriously? The initiative looks at the symptom of the problem, not the cause,? says a source. Besides, it is not clear how such a project will be funded, as officials at the EBRD and the IFC are known to be sceptical about it. And it is unlikely that the initiative will have any foreign financial assistance.

In march 1999 Credit Suisse First Boston, one of Russia's main creditors, came up with a proposal, which is interesting from a project finance point of view: the money frozen during the August 1998 debt moratorium, when the Russian government suspended payment on $40 billion in Treasury bonds and bills should be put into a fund, which would be used to finance infrastructure and oil and gas projects. The cash-flow created by revenues from the projects would then be used to repay foreign creditors. But as Project Finance goes to press a final decision on the debt restructuring has not been taken, and it seemed unlikely that Credit Suisse First Boston's plan will be accepted.

Muddling through

So is Russia, as a source puts it, ?muddling its way through the crisis??

Russia has an increasingly ?virtual? economy. Barter arrangements have become the norm ? more than 50% in the industrial sector ? and what is emerging is something that can hardly be defined as a capitalist economy. This could be a problem for the development of project finance, which relies on well-established cash-flow.

Nobody expects a miracle, and there is still a long way to go in improving tax collection and corporate governance, among other things. In addition, one of the highest levels of corruption in the world has created fears of Russia becoming a ?big Sicily?.

But the EBRD's Buskye is among those that expect some progress in the sector in the next few years. One of the hopes is that when the next generation of young entrepreneurial ?bi-cultural, bi-lingual? Russians take control of government and big business, attitudes will change. But, says Buskye, we are talking about a 10 to 20-year horizon. As the IFC's Ranken points out: ?Business in Russia is based on building long-term relationships.You can't simply jet in a project finance team.?

Advantages of Production Sharing Agreements (PSAs)

There are alternative ways of cutting the project revenue ?cake?. But joint ventures are more rigid that PSAs, as they require a formation of a joint stock company. In a PSA, the foreign party is ?contractor? to the government. Below is a list comparing the advantages of PSAs over existing joint-venture agreements.

- Companies are subject to raft of corporate/tax legislation. PSAs, instead, are only subject to the Petroleum Law.
- The host government receives no profit until the company as a whole makes a profit. PSAs give governments profit share from the first production.
- Profits are allocated on a shareholding basis. PSAs give the government increasing share of profits with project profitability ? or sometimes production.

(Source: Monument)

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