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Attraction of foreign capital, investment projects and mechanism of production sharing agreements

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Abstract

One of the most important factors of economic growth is foreign capital attraction. World practice shows that most countries use concessional economic principles in the form of production sharing agreements that establish a legal form of relations between the state and a private investor. Production Sharing Agreements imply large-scale long-term investment into oil-producing and oil-refining industries. It sets legal frameworks, contains conditions developed in a precise and detailed way that define rights and obligations of a foreign or a national investor and also rights and obligations of the state. First recognition of foreign capital and its advantages for dates back to 1982. Since then many legal enactments have been adopted and though being rather imperfect they represent a number of important steps in the development of Russian foreign capital attraction system. The most recent national law “About Production Sharing Agreements” was adopted in December 1995. Main advantage of this national law is that investments and loans related to Production Sharing Agreements are attracted on commercial basis and do not lead to the growth of the state debt.

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Introduction

A considerable number of countries in the world are developing successfully due to international capital inflow. The first recognition of advantages that it gives dates back to January 1987. At that time, small steps towards foreign capital formation were made in the USSR after a long period of unfavourable attitude to foreign investments. Despite imperfections and controversial nature of these legal enactments, they definitely play a historic role, having made foreign capital inflow possible for the soviet economy and having lifted a strict long-term ban on foreign investments.

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Many legal enactments on investment have been adopted since the soviet period. National law “About foreign investments” of 4 July 1991 remains a fundamental law in this sphere in the Russian Federation. It is also far from being perfect; a lot of presidential edicts and regulations have been issued in order to develop this law. Among them, the following documents are of a particular interest:

Presidential Edict of 27 September 1993. “About improvements in the sphere of foreign investments” was aimed at improving investment climate. According to this edict, limitations regarding activities of foreign investors on the Russian territory can be imposed only by means of legislation of the Russian Federation or by Presidential Edicts.

Presidential Edict of 22 may 1994 ensured a 5-year period of tax holidays for companies with foreign capital registered after 1 January 1994, but it did not contribute to the improvement of the investment climate. The Presidential Edict of 25 January 1995 “About additional measures to attract foreign investments for large-scale projects in the sphere of production” introduced a 5-year preferential duty on import of finished commodities for investing companies. However, to get these preferences a foreign investor had to contribute no less than \$10 mill. into the project with minimal cost of no less than \$100 mill.

According to the data of the State Statistics Committee, accumulated investment of foreign capital reached \$6 bill. by the beginning of the year 1996. That was too little, as the economy needed at least \$50 bill. foreign investments each year.

World practice shows that most countries use concessional economic principles in the form of production sharing agreements that establish a legal form of relations between the state and a private investor. Production sharing agreements are mostly made in the sphere of investments in the oil-and-gas industry and are used mostly by oil-and-gas producing countries and companies.

Production Sharing Agreement is a contract between a foreign (oil or gas) company (contractor) and a state-owned company (representing state) which empowers the contractor to perform geological-and-exploration routine and production activities within the specified area (contract territory) according to the terms of a contract. Production Sharing Agreement can be considered a special type of contract on joint venture establishment. (Nauro C., 2003)

Deposit development contract establishes contractual relations between a foreign oil company (usually specified as contractor) and a state-owned oil company (usually specified as state representative). Contractor is responsible for financing exploratory and operational activities. However, the contract envisages an alternative for the state, whether to participate in financing of development of commercial deposits or not. All actions are to be made in accordance with the yearly work plans and budget, which are approved by an oversight body, which is in most cases the state itself.

If the deposit is declared commercial, the contractor has to prepare a field development plan and submit it to the state for approval. Field development and mining operations are to be done according to this plan. Oil and gas production in the specified area and in approved quantities is divided (as agreed in the contract) between state that owns the deposit and the contractor.

A full part the contractor has right for consists of two elements. The first element is a percent the contractor can get as a compensation for fulfillment of obligations costs. In some countries they include a paragraph according to which income tax that the state and the contractor are liable to is also paid. The output that remains after oil royalty payment, recovery of expenses and sometimes oil tax (strictly in this order) is divided between the state and the contractor in a simple proportion or more frequently in complex proportion. Complex proportions of output division provide the state with more favorable conditions when dividing production on higher levels of oil pool output in comparison with the share measured in terms of overall output or in terms of daily production.

Production Sharing Agreement has a dual nature. On the one hand, it provides the right to extract oil as it empowers the contractor to perform exploratory and operational activities within the limits of the contract On the other hand it implements contractual relations between the contractor and the state. This form of cooperation

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