

The View of Foreign Investors on the Subsoil Licensing Regime and Related Risks in Russia

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Our experience with foreign investors, primarily international oil companies, shows the following:

Subsoil-use projects are, as a rule, long-term and require substantial investment, including outside financing, for their implementation. Thus a general conclusion: for the subsoil use regime to be attractive to foreign investors, the following legislative components must be in place:

- ! (1) stability: rules and regulations concerning investors' activities should not to be modified unpredictably during the course of project implementation;
- ! (2) transparency: rules and regulations concerning investors' activities should be clear and concise;
- ! (3) rules and regulations are binding: adopted rules and regulations should be adhered to and disputes should be resolved effectively; and
- ! (4) effective investor protection is in place.

It is well known that there are two distinct procedures [in Russia] for granting and exercising rights in the area of subsoil use:

1. The administrative (licensing) system, whereby authorized governmental agencies issue special permits, or licenses, for subsoil use (this system is wholly regulated by the Russian Federation Law on Subsoil and related licensing regulations). Of the two systems used, the licensing system is predominant.
2. The contractual system, whereby the government and investors enter into a Product Sharing Agreement (PSA) (regulated under the Russian Federation Law on Product Sharing Agreements); this system, however, does not yet have any underlying law enforcement practice (the effective PSAs were entered into before the PSA Law came into force).

The licensing system is less attractive to investors (especially with regard to large projects), because

it entails administrative control and treats government agencies and investors unequally. Generally, investors refer to the following pitfalls of the licensing system:

1. Lack of stability or transparency. Under applicable legislation, the state at its own discretion may revoke the rights of subsoil users. For example, rights may be revoked on the grounds that material terms and conditions of subsoil use are not met. Such terms and conditions, however, are not defined in legislation and may be construed by the state to its advantage.
2. Lack of a "stability clause" (which is included in PSAs) and, as a result, no available protection to investors from adverse changes in legislation;
3. The procedures and provisions relating to licensing, tenders, involvement of third parties in subsoil use, annulment of subsoil rights, and status of a simple partnership (i.e., not a legal entity) as a subsoil user, etc., are ambiguous.
4. A general prohibition on the transfer of rights and licenses. A license is transferable in only a limited number of cases (reorganization or assignment to a subsidiary) and exclusively subject to the state's consent. Rights under a license may not be pledged;
5. The right to dispute resolution in an international arbitration in connection with licenses or licensing agreements is not a provided right.

Presently, the PSA regime is the most attractive to foreign investors, especially for larger projects.

Among PSA advantages are:

1. Relations between the government and investors are governed by civil law (licenses are mere formalities);
2. "Stability Clause" – protection of investors from adverse legislative changes;
3. Taxation predictability as a stability factor;

4. The right of the government to terminate a PSA is restricted, unlike under the licensing regime;
5. The possibility to transfer (assign or pledge) an investor's rights under a PSA subject to government consent; and
6. The [an expressly stated] possibility to refer disputes to international commercial arbitration and possible waiver of sovereign immunity by the government.

At the same time, there are certain disadvantages associated with PSAs:

1. Inadequate regulation of a number of provisions, in particular, cost recovery by investors, taxation (in all likelihood, the above matters will be addressed in a special chapter of the Tax Code of the Russian Federation related to PSA tax imposition).
2. Overcomplicated (legislative) procedure for approval of the subsoil formation to be developed under a PSA. In some cases, a PSA itself is subject to approval by a separate law (e.g., PSAs dealing with continental shelf deposits).

Generally, a significant growth in foreign investor' interest in subsoil projects in Russia should be

noted, which may be a result of the improvement in economic and political stability in Russia. Several years ago, foreign investors often declared their readiness to engage in subsoil projects in Russia under PSA terms only. Today, foreign investors are perceived to be interested in licensed subsoil projects as well.

As we know, there is an on-going discussion on possible revision of the subsoil use system. There are proposals to replace the license system with concession agreements under the Law On Concessions or to codify the licensing system based on the Subsoil Code. Investors are focused on stability and predictability of legislation. Therefore, any proposal to drastically alter the legal treatment of subsoil should be assessed from that angle.

Amending the respective statutory regulations may rectify the disadvantages of the existing systems. It seems practical to adopt the method of amendments with a view to improve the existing licensing and PSA regimes and to supplement these with new schemes and opportunities. One way to achieve this is to codify and improve existing laws, which has been attempted in the draft Subsoil Code and the PSA Chapter of the Tax Code. □