

## New Developments in the Law on Subsurface in Russia

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It is common knowledge that the investment attractiveness of Russia to a considerable degree is dependent upon its vast reserves of minerals. The favorable conditions and procedures for obtaining and exercising the right to use its subsurface resources are established by the legislature and are undoubtedly a leading component of Russia's attractiveness to investors. Notwithstanding the fact that Russian projects that make use of natural resources with foreign capital are rife with

political undercurrents, like in any country where extraction of the raw material is a corner-

stone of the economy, the legal process governing subsurface use remains an important consideration for both Russian and foreign investors.

An analysis of the current circumstances and trends in the regulation of the subsurface rights that follows may be of interest to current and potential investors<sup>1</sup>.

### **The system of licensing of the subsurface use**

Russian mineral resources legislation has undergone many important changes over the last decade. After the break up of the USSR, Russia had

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<sup>1</sup> Legal aspects of the subsurface use on a production-sharing basis are not considered in this Article due to space considerations.

to devise a new legal system to fit within its evolving socio-political system. That required creation from the bottom up of a variety of institutions of law with no USSR analogues and without any available experience or precedent.

One of these new legal creations, which was non-existent in the USSR, was licensing by the state of the subsurface uses. The state licensing system was introduced in Russia by the Russian Federation Act No. 2395-1, On Subsurface Rights, of February 21, 1992 (hereinafter the RF Subsurface Rights Act). Under this Act, mineral resources were to be granted for use by a special state decision in the form of a license. The governments of the constituent parts of the Russian Federation and the federal agency managing the State Subsurface Stock<sup>1</sup> were designated to issue licenses.

The Statute of Licensing of the Subsurface Use that is currently in force was passed soon after the adoption of the RF Subsurface Rights Act, in July of 1992. In particular, the Statute outlined the method to issue and revoke licenses for various uses of the subsurface. Thus, RF Subsurface Rights Act and the Statute on Licensing of the Subsurface Use created a foundation for the new Russian mineral resource legislation.

Because licensed uses of subsurface rights were a new phenomenon in the Russian legal system, individual provisions of new legislation on subsurface to be considered below required development and refinement.

### Grounds for issuing licenses

Regulatory requirements are an important aspect of the subsurface uses licensing system. The first version of Article 13 of the RF Subsurface Rights Act contained a general provision calling for licenses to be issued through a competitive tender or an auction. This Article also delegated establishment of the procedures to grant licenses to state licensing authorities.

In general, the new Russian subsurface rights legislation mandated that all licenses for the right to subsurface use, irrespective of the type of deposits, their location and types of planned work, must be issued through a competitive tender or an auction exclusively. The Statute on Licensing of the Subsurface Use, however, granted to all functioning entities that had obtained the right to subsurface use prior to the introduction of the licensing system in Russia (i.e. before mid-1992) the right to

obtain a license on a competition-free basis (not through a competitive tender or an auction).

In 1995, the RF Subsurface Rights Act was amended by Article 10.1<sup>3</sup>, which established a limited set of circumstances when the license to use subsurface could be granted by the decision of authorized agencies<sup>4</sup> without holding a competitive tender or an auction in the following situations:

- ! for the purposes of burial of radioactive and toxic waste;
- ! for transferring valid licenses;
- ! for the use of mineral sites of local significance holding widely distributed minerals as well as for the purposes unrelated to mining;
- ! for the purposes of the geological study.

The list of cases granting a license without a competitive tender or auction was expanded in 2000 when the RF Subsurface Rights Act was significantly changed and, in particular, the new language of Article 10.1<sup>5</sup> was adopted. In addition to the above list, it was established that a license may also be granted without holding a competitive tender or auction by a decision of an authorized agency for the purposes of:

- ! exploration and mining of minerals of a deposit discovered by the subsurface user conducting at his own expense the geological study of a mineral site;
- ! the geological study and extraction of ground water to be used as a drinking water supply for the population or technological water supply for industrial facilities;
- ! construction and exploitation of underground facilities unrelated to mining;

<sup>1</sup> Currently the Ministry of Natural Resources of the Russian Federation, the former Committee on Geology and Mineral Resources Use (until 1992).

<sup>2</sup> Resolution of the RF Supreme Soviet, No. 3314-1, 07/15/1992 (Ru).

<sup>3</sup> Russian Federation Act On Amendments and Revisions of the Russian Federation Act On Subsurface Rights, No. 27-FZ (02/03/1995) (Ru)

<sup>4</sup> The "authorized agencies" are defined here as:

the RF Government (when licenses are transferred for mineral resource sites of the internal sea waters, territorial sea and continental shelf of the Russian Federation and with the agreement of the Federation subjects' executive agencies for the burial of radioactive, toxic and other hazardous water);

the RF Ministry of Natural Resources and a designated agency of the constituent part of the Federation in all other cases.

<sup>5</sup> RF Act On Amendments and Revisions of the Russian Federation Act On Subsurface Rights, No. 20-FZ, 01/02/2000. (Ru)

- ! construction and exploitation of the crude oil and gas storage facilities in rock beds and, and for storage of industrial and household waste;
- ! establishing specially protected geological sites;
- ! on the basis of the product sharing agreement that has come into force;
- ! serving as a temporary right to use a mineral resources site for conducting an activity within the site, when the right to use the site has been prematurely terminated.

In addition, the RF Subsurface Rights Act was amended by Article 13.1 to allow for issuing a license in the absence of a contest. Under this Article, the announced tender for the right to use the subsurface segment is recognized as if it had not taken place when only one bidder submits a bid. The license will be granted to the sole bidder under the terms and conditions of the tender.

Thus, there is a tendency of the development of the Russian subsurface legislation to balance a combination of granting licenses on the basis of either competition of bidders (through tenders or auctions) or through direct negotiations with authorized bodies. Despite the fact that year after year the list of circumstances when the subsurface use license may be issued without holding a tender or an auction grows, an auction or tender is still a mandatory condition for the granting of a new license for mining or a combined license for both exploration and mining

The mechanism of granting the right to subsurface use is expected to develop further after a new Federal Act on licensing replaces the outdated 1992 Regulations. However, that bill has not passed. It has not moved in any meaningful way since its first draft was adopted by the Duma in its first reading in 1997. Although in March of 2000, the draft was resubmitted to respective committees of the Duma, its prospects remain unclear. Despite the objective need for a new law, the timing and certainty of its passage is unknown.

In addition to the trend towards the gradual liberalization of the procedures for issuing licenses, an opposite trend is also emerging in Russia. It may be conventionally characterized as a bureau-

cratic tightening of that procedure and is likely the result of a change of leadership in the RF Ministry of Natural Resources in mid-2001<sup>1</sup>.

<sup>1</sup> Vitaly Artyukhov was appointed the new minister of natural resources by RF Presidential Decree No. 708, issued on June 16, 2001.

<sup>2</sup> Russian Federation Act On Amendments and Revisions of the Russian Federation Act On Subsurface Rights, No. 27-FZ (02/03/1995) (Ru).

For example, Order No. 475-r of June 22, 2001, suspended the issuance of licenses for the right to use mineral resources. It was among the first steps taken by the new Minister V. Artyukhov. The Order was in force for about two months and no license was issued during that period. Many investors expecting to obtain licenses based on the results of completed rounds of bidding reacted negatively to this order.

Another step worthy of mention here was Order No. 604 of August 24, 2001, which subjected all of the decisions on granting and transferring of licenses, and on bidding and auctions to preliminary consideration by an expert working group set up at the ministry.

The Order created a new entity called the expert examination commission, which had to give preliminary approval of the right to use subsurface rights. This complicated and delayed licensing and is not favorably viewed by investors.

### Legal aspects of transferring the right to use mineral resources

The potential to transfer the right to use mineral resources is also one of the key elements in the process of structuring a project associated with subsurface uses. Investors may only be willing to participate in mining ventures on the condition that the available license can be transferred to an investor's affiliate or subsidiary upon meeting certain conditions. Thus, the existence of this statutory right to transfer the license from one person to another with the corresponding obligation of the regulatory agencies to complete the necessary paperwork becomes a very important tool providing investors with flexibility and certainty in structuring their projects.

The original RF Subsurface Rights Act did not contemplate license transfers, and therefore the license could not be transferred legally.

Subsequently, it became obvious that in order to improve the attractiveness of investment in the development of mineral resources in the Russian Federation there had to be statutory provisions for the transfers of licenses for the right to subsurface use. As a result, in 1995, the RF Subsurface Rights Act was amended by Article 17.<sup>2</sup> which allowed transfer in the following situations:

- 1) change of the organizational and legal form of the entity using the subsurface rights;

2) mergers and acquisitions if the former licensee owns at least 50 percent of the charter capital of a newly formed entity;

3) spin-off when the newly established enterprise intends to continue activities at the site of the former user in accordance with the license.

It is worth noting that some provisions of Article 17.1 were, and continue to be, legally ambiguous and may be misinterpreted. For example, according to Article 17.1, the reorganization of an enterprise-subsurface user through merger or acquisition with another enterprise is one of the grounds for transferring the license. It is obvious that an enterprise acquired by a subsurface user should be liquidated and its rights and liabilities transferred in full to the enterprise-subsurface user. At the same time, the enterprise-subsurface user continues to function maintaining the same organizational and legal form, name and business functions. A question emerges whether it is necessary to transfer the license in this case. It is evident that there is no need to transfer the license in this situation. The first version of Article 17.1 did not allow for the opposite scenario, i.e., the potential to transfer a license where the enterprise-subsurface user ceased its activity as a result of acquisition by another entity.

Actual continuation of activities under the license at the site of the former user is one of the mandatory prerequisites of transferring the license to a newly formed entity-subsurface user when it is created via spin-off or splitting-up. If this norm is interpreted literally, one may conclude that it establishes the following sequence of events: first, a new enterprise starts its activity at the site of the former subsurface user and then the license is transferred to its name. At the same time, a newly established enterprise cannot continue its activity under the former user's license until the license is transferred, because under the RF Subsurface Rights Act, mineral resources are granted for the use only on a basis of the license. Consequently, resource users are caught in a catch 22 situation: the license cannot be transferred to a new enterprise until it starts activity at the site of the former user, and at the same time, this enterprise cannot start its activity at the given site until the license is transferred into its name. The situation lacks any legal logic. Fortunately the provision was changed later on.

The possibilities of transferring the right to use mineral resources stated in the RF Subsurface Rights Act were rarely used in practice. This is surprising given that the legal vagueness of indi-

vidual provisions of Article 17.1 and the long-term and specific character of the grounds for transferring licenses in the case of the reorganization of an enterprise-subsurface user, including through acquisition, merger, spin-off or split-off. Thus, despite the legal opportunity to transfer the right to use mineral resources that appeared in 1995, it should be recognized that this part of Article 17.1 was stillborn in fact.

It is of no small importance that the initial version of Article 17.1 of the RF Subsurface Rights Act did not contain the main ground most often used in practice, namely it allowed for no potential to transfer the license in the case where the subsurface user sets up its affiliate specifically for the development of a concrete mineral resource site and owns a share in the authorized capital.

To address this situation, soon after the adoption of the Article 17.1 of the RF Subsurface Rights Act, the RF Committee on Geology and Subsurface Use<sup>1</sup> issued order No. 65 of May 18, 1995, approving the Instruction On the Procedure of Transferring Licenses for the Subsurface Use (hereinafter Instruction No. 65). Item 17 of Instruction No. 65 provided that in the case when the subsurface user acts as a founder of a new legal entity set up specifically to continue an activity at the enterprise-subsurface user's site in accordance with the license terms and conditions, the license may be transferred to this legal entity under a condition that the former mineral resource user possesses not less than a half of the legal entity's authorized capital.

It is worth noting that Item 17 of Instruction No. 65 was a point at issue in the practice of the Russian arbitration courts more than once. One cannot help recognizing that item 17 of Instruction No. 65 allowed a broad interpretation of Article 17.1 of the RF Subsurface Rights Act and in fact introduced an extra ground for transferring licenses that was not provided for in the RF Subsurface Rights Act. This, however, was legally incorrect and the Committee on Geology obviously went beyond its authority.

Arbitration courts upon consideration of such disputes have not once concluded that the Committee overstepped its powers with regard to Item 17 of Instruction No. 65 and ventured an extended interpretation of the law. Consequently, when considering disputes of this kind it is necessary to be guided exclusively by the provisions of the RF Subsurface Rights Act because the law allows for no possibility of trans-

<sup>1</sup> The Ministry of Natural Resources of the Russian Federation at present.

ferring the license in this situation. For example, a decision of the Magadan regional arbitration court, of February 12, 1997, on case No. A-37-90/97-7 states that Instruction No. 65 contradicts the effective legislation and the RF Committee on Geology and Subsurface Use by issuing it acted beyond the powers granted to it under the Committee Charter of August 12, 1994. Due to this determination, the regional arbitration court suggests using the provisions of the RF Subsurface Rights Act exclusively.

Later, in April of 1999, Item 17 of Instruction No. 65 was nullified because of its apparent conflict with the RF Subsurface Rights Act.

After 1995, a great number of licenses were transferred in Russia based on Item 17 of Instruction No. 65. All these licenses, however, could have been disputed because of the rather dubious legal validity of Item 17. It was not until January 2000 that Article 17.1 of the RF Subsurface Rights Act was modified with a provision similar to the one provided for in Item 17 of Instruction No. 65.

Afterwards, Article 17.1 of the RF Subsurface Rights Act was amended more than once (for the last time in May of 2001)<sup>1</sup> and presently the full list of the grounds for transferring licenses for the right to subsurface use is as follows:

- 1) the reorganization of a legal entity—subsurface user by transforming/changing its organizational-legal form;
- 2) the reorganization of a legal entity-subsurface user by acquisition or merger with another legal entity;
- 3) the cessation of activity of a legal entity-subsurface user because of its acquisition by another legal entity in accordance with the legislation of the Russian Federation, provided that another legal entity meets the requirements to subsurface users, has qualified specialists, and the required financial and technical means to ensure safety of the work;
- 4) the reorganization of a legal entity-subsurface user by its splitting up or spin-off of a new enterprise from it, when a newly established enterprise intends to continue the activities at the site of the former user in accordance with the license for the use of a

subsurface site granted to the former subsurface user;

5) a legal entity-subsurface user acts as a founder of a new legal entity established to continue the activities at the granted subsurface site in accordance with the license for the use of the site provided that the new legal entity is established in accordance with the legislation of the Russian Federation and is given the property necessary to realize the activities specified in the license, including those related to the field surface facilities within the borders of the license site and provided there are necessary permits (licenses) for carrying out the types of activities associated with the subsurface use and the share of the former legal entity subsurface user in the authorized capital of the new legal entity is not less than 50 percent of the authorized capital of the new legal entity as of the date of the transfer of the right to use the subsurface site;

6) the acquisition of the property (property complex) of a bankrupt enterprise (subsurface user) by an entity engaged in the entrepreneurial activity according to the procedure established by the Federal Act On Insolvency (Bankruptcy), provided that the acquirer of the property is a legal entity established in accordance with the legislation of the Russian Federation and meets the requirements established by the subsurface use legislation of the Russian Federation for the subsurface user;

7) in the case subsurface sites are used under product sharing agreements, licenses are transferred in accordance with the Federal Act On Product Sharing Agreements.

Thus, the following conclusion may be drawn: one of the trends in the development of the Russian legislation on mineral resources and subsurface use is a steady increase in the number of grounds sufficient for transferring the right to use mineral resources from one entity to another.

It is worth noting, however, that certain language in Article 17.1 of the RF Subsurface Rights Act specifying the grounds and the procedures for transferring licenses needs improvement because the language is not always logical and accurate.

Below are a few examples as an illustration: First, Item 1 of Article 17.1 providing for the opportunity to transfer the license in the situation where the subsurface user acquires another legal entity is unlikely to change since it remains unchanged since 1995.

<sup>1</sup> RF Act On Amendments of the Legislation of the Russian Federation Stemming from the Federal Act On Production Sharing Agreements, No 32-FZ (2/10/1999) (Ru); RF Act On Amendments of the Russian Federation Act On Subsurface Rights, No. 20-FZ (02/0 2/2000) (Ru); and RF Act Amendments to the Article 17.1 of the Russian Federation Act On Subsurface Rights, No 52-FZ (Ru).

Second, Item 1 of Article 17.1 provides for the opportunity to transfer the license in the case the share of the former mineral resource user in the authorized capital of a new legal entity established for the purposes of performing work at the license site is not less than 50%. One should pay attention to the fact that in this case the demand to transfer the property required for conducting the activity specified in the license for the use of the subsurface site to the new legal entity is an extra criterion for transferring the license. It is impossible to understand what property is meant here. Could, for example, the situation when the property rights to all wells within the license site had been transferred to a new subsurface user but the property rights to the shift crews' housing had not, be considered a ground for the refusal to transfer the license. The RF Subsurface Rights Act contains no answer to this and other questions, and its text obviously needs further improvement.

Nevertheless, one should not underestimate the progressive importance of the current version of Article 17.1. Giving mineral resource users certain freedom to transfer the license to a third person or entity, undoubtedly, is a serious step towards liberalization of the state regulation of subsurface use. At the same time, one cannot help noting that certain provisions of the law suffer from the lack of legal technique and need development.

## The system of payments for the mineral resource use

The established system of payments for the use of mineral resources is another important component of the mineral resources use procedure.

On August 8, 2001, Federal Act No. 126-FZ was signed. It supplemented the RF Tax Code with Chapter 26 *Mineral Mining Tax* and adopted a new language of Section V *Payments for the Use of the Subsurface* of the RF Subsurface Rights Act. The law came into effect on January 1, 2002.

After the enactment of the Act, the system of payments for the use of mineral resources became more efficient. The main concept of the new Act is as follows: all tax payments levied on subsurface users are regulated by the Tax Code while all other non-tax payments and fees are regulated by the RF Subsurface Rights Act.

### Mineral mining tax

The mineral mining tax (hereinafter the Tax) is a new federal tax in Russia's fiscal system. On coming

into effect, allocations for the renewal of the subsurface base provided for in the RF Subsurface Rights Act were abolished.

Subsurface users are the payers of the tax, and the basis for the tax is determined for each mineral as the value of minerals mined.

The value of a unit of a mineral mined is as a rule, estimated from receipts determined with regard to the taxpayer's existing sales prices on a mineral, excluding VAT and less excise duties and transportation costs, including expenses on payment of customs duties and fees, obligatory insurance of cargo, discharge, filling, unloading, loading and reloading, payment of port and forwarding services.

### Rates of the Tax

Rates of the Tax vary from 0 to 16.5% depending on the type of a mineral mined. Below are the rates of the Tax on individual types of minerals, %:

petroleum gas .....	0
peat .....	4.0
coal .....	4.0
ores of ferrous metals.....	4.8
radioactive metals .....	5.5
precious metals (except gold) .....	6.5
gold.....	6.0
natural diamonds.....	8.0
mineral groundwater .....	7.5
rare metals .....	8.0
non-ferrous metals .....	8.0
natural gas and gas condensate .....	16.5
crude oil.....	16.5

### Temporary crude oil tax rates

The rate of tax on crude oil production comes to 340 rubles per ton during the period from January 1, 2002 to December 31, 2004. The rate is used with a quarterly adjusted coefficient characterizing dynamics of world crude oil prices (Cp) determined from the formula:

$$C_p = (P - 8) \quad R/252$$

where P = Average Urals price over the tax period, \$/bbl;

R = The RF Central Bank dollar to the ruble rate averaged over the tax period.

**Example.** With average Urals price of 20 \$/bbl and dollar to the ruble rate being 30:1, the coefficient (Cp) will be equal to:

$$C_p = (20-8) \times 30/252 = 1.43.$$

The Tax rate = 340 x 1.43 = 486 (rubles).

The calculation shows that with an average Urals price rising to 25 \$/bbl, the Tax rate will grow to 688 rubles.

### **Payments for the use of mineral resources**

A new version of Article 39 of the RF Subsurface Rights Act establishes the following system of payments for the use of mineral resources:

- 1) one-time payments for the use of subsurface paid upon occurrence of certain events stipulated in the license (hereinafter one-time payments);
- 2) regular payments for the use of mineral resources;
- 3) payment for geological information on mineral resources;
- 4) fees for participation in bidding (auction);
- 5) license fee.

### **One-time payments**

One-time payments should be paid by a subsurface user, when the events stipulated in the license begin. Minimal (initial) rates of one-time payments are established as equal to not less than 10% of the mining tax sum projected from the average annual design capacity of a mining enterprise.

The final rates of one-time payments are established on the basis of bidding or auction results and stated in the license for the right to use subsurface.

### **Fee for participation in bidding (auction) and license fee**

One of the conditions of registering the application is a payment of the fee for participation in bidding (auction). The amount of the fee is established based on costs of preparation, holding of bidding (auction) and determination of the results, including payments to the invited experts.

The license fee is paid when the license for the subsurface use is issued. The amount of the fee is determined by the cost of preparation, drafting and registration of the license.

### **Regular payments for the use of mineral resources**

Under Article 43 of the RF Subsurface Rights Act, regular payments for the use of subsurface are charged for granting the users the exclusive right to search and appraise mineral deposits, conduct

exploration, geological study, build and exploit underground structures not related to mineral mining. Regular payments for the use of mineral resources are levied on each type of work individually.

Amounts of regular payments for the subsurface use are determined subject to economic and geographical conditions, the size of the mineral resource site, type of mineral, duration of work, degree of the geological study of the territory and degree of risk.

The rate of the regular payment for the subsurface use is established per one square kilometer of the subsurface site. The RF Government sets the minimum and maximum rates of the regular payment for the subsurface use. State executive authorities of the respective constituent parts of the Federation are authorized to set a concrete rate of the regular payment for the subsurface use for each site after its presentation by the territorial agency of the Ministry of Natural Resources within the limits established by the RF Government.

The RF Government must establish the procedure and the terms of charging regular payments for the subsurface use and providing the user with geological information.

Thus, the RF Government has to adopt a whole series of regulations for the system of payments for the subsurface use to take its final shape.

### **Withdrawal of licenses**

Existence of the statutory procedure for the termination of the right to use subsurface, i.e., legal protection of investors against bureaucratic outrage is one of the main conditions of attracting investors to subsurface use projects in Russia. Recently, as is well known, the Ministry of Natural Resources has intensified its work related to the revelation and withdrawal of licenses for the right to subsurface use from those users that, in the opinion of the ministry, violate the terms and conditions of the subsurface use stipulated in the license.

In fact, there are a great many examples in Russia when the license is granted, but work is performed with serious violations of the license terms and conditions or is not performed at all. These licenses, no doubt, may be and should be withdrawn, but strictly following the procedure established by the law. The law, on the other hand, should provide for the unambiguous and clear grounds for withdrawing the license.

In accordance with Article 20 of the RF Subsurface Rights Act, the violation of the essential conditions of the license is one of the grounds for its withdrawal.

The Act, unfortunately, contains no direct indication of what license conditions are essential and what violation of such conditions may be a ground for its withdrawal. It follows from this that theoretically any, even relatively insignificant, violation of any license condition may serve as a ground for withdrawing the license.

The general approach of the Ministry of Natural Resources to the withdrawal of licenses may be understood from a recent interview of the Minister Vitaly Artyukhov. The Minister said that licenses would be withdrawn for a failure to fulfill the license requirements first of all, with environmental and fiscal concerns being most important<sup>1</sup>. This statement however does not bring much clarity to the issue.

The RF Subsurface Rights Act should clearly define what violations of the license are sufficient for its withdrawal.

### Conclusion

The above analysis of individual provisions of the Russian legislation on the subsurface use enables investors to conclude that the legal regulation of relations arising from the subsurface use has undergone serious changes over the last decade. All the changes introduced into the current subsurface use legislation are, as a rule, aimed to liberalize use and grant users more freedom within the law.

But note, that the development of the subsurface use legislation is closely associated with the political course of the country's leadership and often becomes an object of trade-off between various political forces, each of which is pursuing its own ends. □

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<sup>1</sup> Comersant-Daily, July 19, 2001.