

Yet another new oil and gas regime for Russia ?

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There has recently been considerable activity relating to the subsoil legislation in Russia, with the aim of both improving the current oil and gas regime and introducing a new one.

Different governmental authorities have been working simultaneously on different sets of amendments to various legislative acts, including the Law On Subsoil, the Law On Production Sharing Agreements ("the PSA Law") and the Tax Code. In addition, a draft Law On Concession Agreements Entered into with Russian and Foreign Investors ("the Concessions Law") is being prepared by the Ministry of Economic Development and Trade, and the Ministry of Natural Resources is working on a draft Subsoil Code.

Problems with the existing regimes

By way of background, we would note that:

- (I) it is now over eleven years since work on the draft Concessions Law started, and the Concessions Law still has not been adopted;
- (II) almost seven years ago the PSA Law was adopted and since then not a single new PSA has been realised under this law, although three of the four PSAs that were grandfathered have been progressing with substantial foreign participation and investment;
- (III) currently, approximately 90 per cent of all Russian oil production volumes are produced by 10 vertically integrated Russian companies;
- (IV) Russian gas production, transportation and marketing remains dominated by Gazprom – although gas industry restructuring is currently under consideration at Governmental level, there is no imminent prospect of progress in this regard.

Presently, there are two alternative regimes for oil and gas exploration and production in Russia:

! production sharing; and

! what is commonly called the "tax and royalty" regime, although the fiscal aspect is only one of the significant features of this regime.

In effect, the two regimes co-exist and compete with each other. The main difference is that under the PSA regime, the PSA itself is intended to provide a self-contained set of rules for the development of the project that is the subject of the PSA, whereas the "tax and royalty" regime is subject to general Russian law, which is constantly evolving.

Production sharing

The main advantages of the production sharing regime over the "tax and royalty" regime are:

- (I) the contractual nature of the PSAs entered into (under the "tax and royalty" regime the key documents are the licence and attached licensing agreement, which are subject to administrative law rather than the law of contract – although there is a contractual element in the licensing agreement)¹;
- (II) the possibility of providing a comprehensive set of rules under each PSA to govern the exploration and production activities covered by it; and
- (III) the long-term stability – particularly as regards fiscal terms - that such an arrangement can provide (although the effectiveness of "stabilisation" clauses in PSAs may be open to doubt, one of the key purposes of the PSA legislation was to exclude the fiscal terms from Russian general legislation concerning tax and royalty – hence the common description of the alternative regime as "tax and royalty").

PSA regimes were common through much of the world, outside Europe and North America, when the PSA law was adopted in 1995. However, in practice the regime adopted under the 1995 law represented a unique Russian concept which

¹ Although technically a licence is required under the PSA regime, the primary set of rules applicable are those under the PSA law and the relevant production sharing agreement itself.

borrowed from international practice but turned out to work in quite a different way. Unlike most other countries which adopted PSA regimes, Russia did not have a national oil corporation with exclusive rights to exploit the subsoil which could make its privileges available to PSA contractors. Because a concurrent regime (i.e. the "tax and royalty" regime) governed most oil and gas production in Russia, to give effect to the PSA regime required piecemeal exceptions to be made to many aspects of Russian law.

In a country, which was simultaneously reforming its economic system and democratising itself, this proved to be a complex, time-consuming and imperfect exercise. Before long, it became clear that the initial PSA law was flawed, that extensive secondary legislation would be required to implement it and that substantial revisions to the tax regime were required to make it compatible with the PSA terms. It has taken almost seven years to reach the point where the PSA law has been revised, the relevant secondary legislation has been put in place at federal level (although some regional and local implementation is still required) and a position has been reached where the formal adoption of the PSA chapter to the Tax Code is expected to complete the protracted process of full establishment of the production sharing regime during 2003. How well the "improved" regime will work in practice remains to be seen.

"Tax and royalty" regime

Meanwhile, since the passage of the Law On Subsoil in 1992 the vast bulk of Russian oil and gas fields have been developed on the basis of the "tax and royalty" regime. This regime now has just over ten years of history and has been tested at virtually all levels of the Russian bureaucracy and judicial system. This gives it a degree of predictability, which, for those familiar with it, helps to alleviate its disadvantages. Some Russian oil companies have also expressed preference for the fiscal terms on the "tax and royalty" regime over those available for PSAs.

Nonetheless, the "tax and royalty" regime has a number of drawbacks:

- (I) although the Law On Subsoil (the basic law regulating licensing) contains an exclusive list of grounds for the licence to be suspended or terminated, it does not define each ground in detail and therefore allows the Government to interpret the grounds in its favour;
- (II) there is a general prohibition on assignment of subsoil licences, and, although there are ex-

ceptions, these do not readily allow transfer of licences, even with Government consent. This is a problem, not only for oil companies, but also for potential financiers of their activities;

- (III) there is a general absence of clear, detailed secondary legislation covering, for example, rules on the procedure for holding tenders for licence applications, for approving and amending production plans, for procurement; and
- (IV) it is more readily subject to legislative change than the PSA regime.

Can the years of application of the licensing regime in practice mitigate such risks? Perhaps the answer is "yes", for an investor familiar with the regime (or who has an experienced and reliable partner with such familiarity). It is probably easier to accept such risks in relation to small to medium size opportunities or where the investor expects to have a portfolio of operations so that exposure to the risks may be more balanced than in a single big investment. Clearly Russian oil companies have accepted the risks, but foreign investors (apart from portfolio investors in the Russian companies) have been reluctant to do so on any substantial scale.

As mentioned above, the Government and the legislators are currently working on a number of amendments to various legislative acts to try to remedy the problems. We set out what we believe to be the most interesting below.

The Draft PSA Chapter of the Tax Code

The Ministry of Economic Development and Trade has prepared the PSA chapter to the Tax Code. It is planned that the PSA chapter will be heard by the State Duma, the lower chamber of the Russian Parliament, in 2003.

While some of the secondary legislation is still necessary to implement the production sharing regime at regional or local level, the adoption of this chapter is intended to complete the main regulatory framework for PSAs in Russia, as mentioned above.

The Draft Subsoil Code

The Ministry of Natural Resources and a group of parliamentarians each have prepared separate drafts of a Subsoil Code and submitted them for the expert opinion (in Russian, "expertiza", a form

of review) of the Parliamentary Commission on Natural Resources:

The main purpose of the draftsmen, as we understand it, was an attempt: (I) to codify existing oil and gas and other subsoil legislation; and (II) to improve the existing licensing system by eliminating all the above-listed drawbacks.

According to the expert opinion of the Commission, however, neither of the drafts meets the criteria of a code, i.e., a systematic collection of rules relating to one area of law. The Commission, therefore, suggested that both drafts should be considered as the new versions/drafts of the Law On Subsoil.

The Draft Amendments to the Law On Subsoil – Civil law or Administrative Law Approach ?

While the Ministry of Natural Resources was preparing the draft Subsoil Code, a number of Parliamentary Commissions have been working on amendments to the existing Law On Subsoil. All the amendments prepared by different Commissions are aimed at dealing with the following issues: (I) the “two keys” principle¹; (II) license assignment; (III) tender procedure and the other defects mentioned above.

Nevertheless, one of the proposed sets of amendments has already been called revolutionary by some analysts. The amendments have been prepared by the Commission of the President of Russia on the Delimitation of Powers between Federal and Regional Authorities headed by the Deputy Head of the President’s Administration, Dmitry Kozak (the Commission is called “Kozak’s Commission”). It contains a number of provisions intended to create a new system for the use of subsoil (including oil and gas exploration and production) in Russia. According to the Explanatory Notes some of these provisions relate to the following:

1. the subsoil in Russia is state owned, but (because Russia is a federal state) issues of ownership, use and disposal of the subsoil, the legislation relating to subsoil, as well as issues of delineation of state property are within the joint jurisdiction of the federal and regional authorities. In this regard, the intention is to eliminate the regional authorities’ jurisdiction and to categorise the subsoil (except for common minerals) as Federal State Property;
2. the elimination of the licensing regime and the introduction of a contractual regime based on concession contracts;

3. the separation of exploration from production, which in practical terms, will lead to two types of contract: (I) a contract governing exploration work; and (II) a concession contract governing production; and
4. the provision of the alternatives of paying contractors for exploration work, which is to be made from state budgetary funds or alternatively granting investors pre-emptive rights to produce oil/gas/metals discovered as an incentive for exploration.

The authors of the above-described concepts are effectively proposing to change completely the existing licensing regime for the oil and gas industry (and other subsoil related industries) and to replace it with a concessions-based regime. This would also transform the basic regime from one, which is subject to Russian administrative law to one that is based on civil law contracts.

PSA Regime: “Tax and Royalty” Regime – Will a Hierarchy Be Established ?

Another important issue, which turned into a dispute between the Ministry of Natural Resources and the Ministry of Economic Development and Trade should be mentioned separately. The Ministry of Natural Resources suggested to amend the existing Law On Subsoil so that the PSA regime may only be applied under “exceptional circumstances”. This means that any new licence should first be tendered or auctioned under the tax and royalty regime. In the event that no-one expresses an interest in the licence, it will be placed under the PSA regime.

It appears that the Ministry of Economic Development and Trade does not agree with the Ministry’s of Natural Resources approach and supports the approach of Kozak’s Commission described above. Consequently, the two ministries support completely different concepts of the national regime for the use of subsoil in Russia and it remains to be seen, whether the basic regime will continue to be based on the administrative law or whether it will be replaced with civil law contracts.

The Draft Concessions Law

This regime, which would require that the draft Concessions Law be passed, would at least have one of the most important recognised advantages of the production sharing regime, i.e., its contractual basis. It is expected that this new regime would, nonetheless, be subject

¹ Currently both federal and regional authorities are responsible for issuing a licence. The subject for discussion is whether such powers should be transferred to the exclusive jurisdiction of either federal or regional authorities.

to tax and royalty, with the implication of variable terms. Currently, it remains unclear whether, apart from this, the concessions-based regime would provide the comprehensiveness and stability which are also desired features of the production sharing regime. Nonetheless, having the main Russian oil and gas regime governed at root by a contractual system may help to clear the way towards greater foreign participation in Russian exploration and production.

It would be ironic, if the international industry having been forced in countries like Indonesia and much of the rest of the world to move away from concessions to production sharing, it should return to Russia under a concessions regime.

We set out in the schedule to this article, a brief summary of the most interesting provisions of the draft Concessions Law. In the summary we do not address the draft critically or seek to analyse any of the issues.

Effect of the BP-TNK Deal

There has been some speculation as to what general effect the BP-TNK deal will have on the Russian oil scene. One question must relate to the further progress of the PSA legislation.

Until recently, the international major oil companies were relatively consistent in arguing that they could not contemplate major investments into the Russian oil industry except on the basis of PSAs. There were some exceptions to this, but

it was possible to reconcile them with the main thrust of the argument. In doing their deal with TNK, which would pool the Russian assets of BP and TNK into a single vehicle in which BP would have a 50 per cent shareholding, BP clearly is moving into a position where the bulk of its oil producing interests in Russia are subject to the tax and royalty regime.

It is still possible for the other international majors to argue that, while this may suit BP, it does not suit them. In particular, the arguments in favour of PSAs are still valid in respect of large projects where investment is concentrated under a single legal instrument and therefore especially vulnerable if that instrument is unsatisfactory. In addition, for companies without refineries and retail outlets in Russia, there is a problem of what to do with production, which cannot be exported because of the constraints of the export pipeline system. Currently, capacity in the pipeline system is made available to Russian producers on a pro-rationing basis. Under a PSA, it is possible to agree to be excluded from the pro-rationing system and to have preferential export rights. However, failure to agree on this may be one of the reasons why progress on the PSA legislation has been so slow in progressing.

It is not clear how this will be resolved. However, the attempt to give priority to the "tax and royalty" regime and designate the PSA regime as "exceptional" gives an indication of thinking in at least some official quarters.

Schedule

The Draft Concessions Law

The Law would regulate concessions granted by the Russian State to both Russian and foreign companies.

Foreign and Russian concessionaires would have equal rights under the new law.

The Law is designed to implement state policy on attracting foreign investments into the country.

The Law governs all processes in relation to concessions – from negotiations to expiry, cancellation or termination of concession agreements.

In case of conflict with an international treaty to which Russia is a party, the provisions of the international treaty would take precedence.

"Concession agreement" is defined as an agreement whereby one party (the grantor) grants another party (the concessionaire) the following rights for a fixed term in return for the concessionaire making a payment and bearing the costs and the risks of operations under the agreement:

! the right to use state or municipal property;

! the right to build a concession facility;

! the right to operate the facility in accordance with the terms of the concession agreement, subject to the obligation to transfer the facility to the State at the end of the specified term.

The payment may take any form, including:

! a percentage of production or a lump sum;

! the concessionaire bearing the costs of improvement of assets transferred to the concessionaire by the State;

! the concessionaire providing services to the grantor;

! the concessionaire transferring assets to the grantor,

or a combination of these or other forms of payment.

State property subject to the concession agreement is not to be privatised before the concession agreement expires.

The State may bear part of concessionaire's risks and expenses under the agreement.

The new law is to apply to a wide range of concessions in various sectors ranging from exploration and extraction of natural resources to facilities for provision of public services and various infrastructure facilities.

The state entity granting the concession may vary according to circumstances, i.e., it could be the Government, the federal executive body, the regional executive body, or a municipality as the case may be.

Where the concessions are being granted to a consortium of companies, the concession agreement shall be signed by a legal entity representing all of the members of the consortium. The companies in the consortium shall be jointly and severally liable for the performance of the obligations under the concession agreement.

Restrictions on conclusion of concession agreements include a prohibition on entering into concession agreements:

- ! where this would conflict with: constitutional principles, public morals, protection of health, rights and legitimate interests of other persons or the needs of national defense and security; and
- ! with foreign investors where this is prohibited by the federal legislation.

Assets granted to the concessionaire by the grantor must be returned (in accordance with the terms of the concession) to the grantor at the end of the concession period or earlier termination of the agreement, although in some cases the concessionaire may be required to return the assets before the agreements expires.

The title to all data and information acquired by the concessionaire at its own cost in the course of constructing and operating the facility, including results of feasibility studies, laboratory tests as well as all other industrial, commercial or technical information relating to the facility or the activities carried out at the facility, shall be transferred to the State free of charge.

Assets built or acquired by the concessionaire for the purposes of complying with its undertakings under the concession agreement shall be considered as belonging to the concessionaire, unless the agreement stipulates otherwise. Where the concessionaire is obliged to transfer such assets to the grantor before the expiry of the concession agreement, the concessionaire shall be entitled to use the assets free of charge for the purposes of complying with its obligations under the agreement - in which case the concessionaire shall also be responsible for maintaining the assets and shall carry the risk of accidental loss or damage.

The concessionaire shall be entitled to the profits obtained by it as a result of its activities under the concession agreement, unless the agreement stipulates otherwise. Where Russian foreign trade legislation restricts export of products obtained by a foreign concessionaire under the concession agreement, and as a result it is obliged to sell the products in Russia, the grantor shall compensate the concessionaire in accordance with procedure laid down by the Russian Government.

Compulsory terms to be included in all concession agreements:

- ! a right for the concessionaire to use grantor's assets or the right to carry out activities specified in the Law;
- ! the consideration payable by the concessionaire for the concession and the terms and conditions of payment; and

- ! the amounts which the concessionaire is required to invest into main assets and the timing of such investments.

Optional terms:

- ! an obligation on the concessionaire to operate and maintain the facility at set levels for a stated period;
- ! the procedure for setting and changing prices/tariffs for work done, products produced or services rendered under the concession agreement;
- ! provisions allowing the grantor to participate in the concessionaire's activities;
- ! provisions dealing with the transfer of assets and personnel at the end of the concession period or earlier termination; and
- ! environmental obligations imposed on the concessionaire.

In exceptional cases, the State is entitled unilaterally to change the terms of the agreement, in which case it shall compensate the concessionaire for its additional costs and losses resulting from such changes, including loss of profit. The concession agreement shall contain an exhaustive list of situations entitling the grantor to change the terms of concession agreement unilaterally, as well as the procedure for determination of the amount of compensation.

A guarantee of compensation in the event of nationalisation or requisition of concessionaire's assets.

A guarantee of no adverse changes in Russian legislation.

The concessions shall generally be granted in accordance with a tender process. In exceptional circumstances the tender process may be dispensed with.

The parties may agree that activities regulated in the concession agreement may be carried out by a separate legal entity specifically created by the concessionaire (possibly together with the grantor and/or third parties) for these purposes.

The grantor's representatives shall have the right to visit the site and inspect the progress and inspect the relevant documentation, provided that they shall not intervene in concessionaire's activities and shall not disclose any confidential information acquired as a result.

Concession agreements are to be subject to the special tax regime established under the Tax Code of the Russian Federation.

The concessionaire is entitled to transfer the whole or part of its rights and liabilities under the concession agreement to any third party in accordance with Russian legislation, provided that such party possesses the necessary financial and technical resources and management expertise necessary to comply with its obligations under the concession agreement. The transfer of rights and liabilities is required to be in writing.

Dispute resolution procedures include both litigation and arbitration. Foreign investors have the choice of litigation or arbitration in the international courts/arbitration tribunals if the concession agreement so provides. Concession agreements are to be governed by Russian law.

The grantor may waive its sovereign immunity in concession agreements with foreign investors.