

# 2004 Changes in Russian Oil and Gas Legislation

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Russia has embarked on a fundamental rewrite of its laws governing investment in the oil and gas sector. In 2003, the Russian State Duma adopted significant amendments to Russia's laws governing production sharing agreements (PSAs) and the mineral licensing regime.<sup>1</sup> Continuing the trend of a tightening of the central government's control over natural resources in 2004, President Putin signed into law new amendments to the Subsoil Law,<sup>2</sup> the Gas Supply Law<sup>3</sup> and the PSA Law<sup>4</sup> (the "2004 Amendments"), and at the end of 2004, Russia's Ministry of Natural Resources ("MNR") proposed to the Russian government a wholly new Subsoil Law (the "Draft Law").

The 2004 Amendments, along with the Draft Law, would fundamentally change the rules of the game for investing in Russia's oil and gas sector. The 2004 Amendments fully centralize the authority for regulating mineral rights in the federal government, while the Draft Law substitutes a wholly new contractual system for Russia's administrative licensing of mineral resources.

These changes take on even greater significance now because the restrictions recently incorporated into Russia's PSA regime render PSAs a virtual impossibility for most investments in this sector. Investment in the petroleum sector will therefore be primarily through the traditional subsoil regime that the 2004 Amendments and the Draft Law have targeted for overhaul. Although we are cautiously optimistic about these changes, as we explain, it remains to be seen whether they will ultimately be to the advantage of investors in Russia's oil and gas sector.

## The 2004 Amendments

The principal importance of the 2004 Amendments is to centralize regulation of mineral resources in the federal government. This marks a fundamental shift in inter-governmental relations between central and regional authorities. The 2004

Amendments do this by eliminating the requirement that regional and federal authorities jointly grant mineral rights. The 2004 Amendments authorize the MNR, without regional government consent, to grant subsoil use rights (either through tender or auction) with respect to all onshore fields.<sup>5</sup> The Russian central government, as has always been the case, is authorized to independently grant such rights in offshore fields (those on inland waterways, territorial seas and on the continental shelf) and to represent the Russian Federation in all PSAs.

The 2004 Amendments therefore appear to jettison the Russian Constitution's grant, in Article 72, of joint federal-regional authority on "possession, use and management of ... mineral resources." Article 72 traditionally has been read to impose a "two key" rule; requiring the consent of both regional and federal authorities as a prerequisite to the grant of subsoil rights. Although the "two key" rule frequently has been an impediment to investment in the Russian oil and gas sector, power sharing with respect to mineral resources is, arguably, a cornerstone of the Russian Federation.

One may query whether it is possible to streamline the "two key" approach to granting subsoil rights without running afoul of the Russian Constitution. The 2004 Amendments address this problem by including regional government representation on the MNR commissions<sup>6</sup> that conduct the tenders and auctions for mineral rights. The question nonetheless re-

<sup>1</sup> See discussion of those amendments in the article by Pavel Bakoulev and Charles Keefe, "New Developments in Russian PSA and Subsoil Legislation," *International Oil and Gas Finance Review*, 2004, pp. 108-111.

<sup>2</sup> Russian Law "On Subsoil," as restated by Federal Law No. 27-FZ of March 3, 1995 and amended through August 22, 2004 (the "Subsoil Law").

<sup>3</sup> Federal Law No. 69-FZ "On Gas Supply" dated March 31, 1999 and amended through August 22, 2004 (the "Gas Supply Law").

<sup>4</sup> Federal Law No. 225-FZ "On Production Sharing Agreements" dated December 30, 1995 as amended through December 29, 2004 (the "PSA Law").

<sup>5</sup> Commonly occurring minerals (for instance, sand, gravel, etc.), by contrast, will remain within the regional authorities' competence.

<sup>6</sup> In the PSA context, this is a special interdepartmental commission made up of representatives of federal executive bodies and regional governments (see Article 6(3) of the PSA Law).

mains unanswered as to whether regional representation on the federal commissions is sufficient to meet Russia's constitutional requirement of power sharing.

This modest nod to regional participation amounts to a significant reduction in regional authority. Regional authorities no longer nominate mineral deposits as eligible for development under production sharing agreements, participate in designating mineral deposits as federally significant, establish royalty rates and procedures for development of subsoil resources, or hold auctions and tenders or otherwise make decisions on the issuing of licenses.<sup>7</sup> In addition, payments related to the use of the subsoil (payment for geological information, tender/auction fees, and licensing fees) have been redirected from the regional budgets to the federal government.<sup>8</sup>

For investors this probably is welcome news. The "two key" rule had obliged them to serve two masters. Investors frequently had to meet competing obligations, some significant for the MNR and others for the regional authorities. If there was a conflict between these requirements (and this was common), the investor had a dilemma. Indeed, once rights were granted, regional and central government authorities regularly sought to exact additional concessions or benefits in conflict with one another. Centralization is therefore a welcome change, if, in fact, it does not conflict with Constitutional requirements.

A second feature of the 2004 Amendments establishes a centralized program for tendering rights to fields.<sup>9</sup> Under the new system, the MNR will identify fields eligible to be auctioned or ten-

dered as part of a licensing "program." Regional authorities are entitled to make proposals to the program, but the MNR retains final program authority. This approach is in stark contrast to the previous system in which licenses were granted on a case-by-case basis. The 2004 Amendments envision the federal government playing a central organizing role in formulating a program

for the development of Russia's mineral resources.

The 2004 Amendments also clarify the conditions under which a mineral license term will be extended. Prior to the 2004 Amendments, the question was whether a subsoil user was entitled to an extension upon meeting the Subsoil Law's statutory requirements. Article 10 of the Subsoil Law now reads that a license "shall" be extended at the subsoil user's request upon meeting the statutory criteria.

### The New Draft Subsoil Law

In November of 2004 the MNR announced that it had submitted to the government the draft of a new subsoil law (the "Draft Law"). The Draft Law would replace the existing Subsoil Law and establish both a general legal framework and detailed legal requirements for exploration and development of hydrocarbon resources, hard minerals, and underground waters. The draft that we have reviewed is comprehensive legislation and its substance cannot be fully addressed in an article of this scope. Readers are welcome to contact the authors for further information about these proposed changes.

The law, according to the MNR, is intended to transform Russia's entire approach to the use of mineral resources, including hydrocarbon reserves. A central feature of the new legal regime would be to replace the existing licensing regime with a contract-based model for granting subsoil rights. Thus, under the Draft Law, investors would enter into a subsoil use contract rather than being the recipient of a license. Although investors have urged this change for some time, the Draft Law lacks a number of provisions that are critical to protecting investor rights, including the right to international arbitration, express stabilization of contract terms, and equal access to subsoil resources. These features represent deficiencies and we would hope that a new statute would favorably address these omissions.

Although the Russian government did not review the Draft Law at the end of 2004,<sup>10</sup> it is expected to do so in the first quarter of 2005 and then, upon its approval, present it to the State Duma. Public accounts suggest that the Draft Law, although meeting with initial approval of the Government, may nevertheless be further revised.

<sup>7</sup> See generally, Articles 2.1, 4, 16, 17, 29 and 36 of the Subsoil Law.

<sup>8</sup> Articles 41-42 of the Subsoil Law.

<sup>9</sup> The time between initial public announcement and holding an auction has been reduced to 45 days; previously the period was 3 months for small fields and 6 months for large fields. The announcement period for tenders was reduced from 6 months to 90 days. In an auction the winner is the participant submitting the highest bid while in a tender there may be additional requirements and the winner is determined by an expert commission evaluating the proposed technical solutions and additional commitments proposed by the investor. See Article 13.1 of the Subsoil Law.

<sup>10</sup> Press reports say that, in December of 2004, certain state officials and industry commentators criticized the Draft Law and the MNR withdrew the draft from governmental review to address their comments and submit an improved Draft Law.

## **Centralization Of Authority Continues**

The Draft Law continues the concentration of authority in the federal government previously noted in respect to the 2004 Amendments. It unequivocally provides that resources in the subsoil, such as oil and gas, are exclusively federal property.<sup>11</sup> The only concession made to the regions' constitutional jurisdiction is to afford the respective regional authorities representation on federal auction commissions awarding mineral rights, as was the case in the 2004 Amendments.<sup>12</sup>

## **Restrictions On Foreign Investment**

In contrast with the Subsoil Law currently in effect, the Draft Law would prohibit foreign legal entities from directly holding mineral rights in Russia. Consequently, only companies established in Russia (i.e., Russian legal entities) would be entitled to hold subsoil use rights. Because the Draft Law does not prohibit foreign shareholdings in Russian companies holding mineral rights in Russia, this type of restriction probably will not significantly restrict foreign investment in Russia's oil and gas sector. The Draft Law, however, also authorizes the imposition of special restrictions in auctions and in other areas (for "national security" reasons and otherwise) which can materially limit foreign investment. For instance, Russian companies can be excluded from auctions if they are members of a "group of entities" containing (i.e., affiliated with) foreigners, persons without citizenship, and/or foreign legal entities. This type of restriction affords the government open-ended discretion to limit investment in the sector, particularly with respect to Russian companies having foreign investment, and therefore should be carefully monitored.

## **Contract-Based Subsoil Use Regime**

Investors have frequently expressed a desire for a contract-based system of subsoil rights as a way of achieving greater transparency, transferability, and protection of their rights. The current version of the Draft Law provides for such a system but it limits the flexibility of the system and ultimately may disadvantage investors.

While indicating that contract terms will be negotiated, the Draft Law anticipates that the subsoil contract's essential terms will have been included in the auction package prepared by

the auction's organizer, and that within three days following the auction, the auction's organizer will forward the winner a draft subsoil use contract. Within ten days from receipt of the draft, the winner must sign the final agreement and send it for state registration – or otherwise be subject to a claim for damages. The short time-frame, combined with government authorship of the agreement, would militate against significant negotiation. This "take-it-or-leave-it" approach may substantially undermine many of the advantages of a contract-based system.

A key to whether the new system is investor-friendly will be the reasonableness of the actual terms proposed in the respective auction package. The Draft Law contemplates that the authorized state agency (most likely the MNR and its successors) will prepare model agreements. These agreements must contain the statutorily required terms for a subsoil use contract as set forth in the Draft Law. The Draft Law tells us the *types of terms* that will be required *but not what those terms must be*. Therefore, critical to the new regime will be the terms actually adopted in the model agreements and then proposed in the respective auctions.

It is worth noting that the Draft Law does not alter the status of grandfathered PSA's nor does it contemplate compulsory conversion of existing mineral licenses to subsoil use contracts. Rather, the Draft Law grandfathers the licenses of existing mineral rights holders, who may continue to rely upon their respective licenses until their expiration. However, the Draft Law would permit a license holder, at its election, to exchange its license for a subsoil use contract.

## **Grant of Mineral Rights**

The Draft Law grants mineral rights only: (i) through an auction or (ii) by resolution of the authorized state agency, depending on the particular type of subsoil use under consideration. Exploration and development rights in hydrocarbon fields would

<sup>11</sup> The status of underground resources as "state property" (as currently provided for in the Subsoil Law) is inextricably tied to the constitutional question of whether political subdivisions of the Russian Federation (i.e., regions) may assert rights to those mineral resources within their territory.

<sup>12</sup> The Draft Law eliminates tenders in favor of the exclusive use of auctions. Auctions typically require an evaluation of only a bid "price" to determine a winner whereas a tender typically involves an evaluation of a number of factors, such as financial terms, investment obligations, and technical approach. The elimination of tenders in the Draft Law has been roundly criticized by State Duma deputies and tenders are therefore likely to be preserved in a final law.

be granted exclusively through auction.<sup>13</sup> Unlike the Subsoil Law currently in effect, the Draft Law provides detailed procedures for the auction of mineral rights. This level of detail arguably makes the issuance of implementing regulations unnecessary.

#### **Termination of Mineral Rights**

The Draft Law is also more specific than the existing Subsoil Law with respect to the termination of mineral rights. A subsoil use contract would be terminable only in court (unless terminated by mutual consent) for specified reasons: a subsoil user ceases to meet the requirements of the law, a breach by the investor of its obligation to put the field into operation by a certain date or a repeated breach of substantial terms of the contract.

<sup>13</sup> The authorized state agency may grant subsoil rights without an auction only for the conduct of regional geological studies, surveys for construction purposes, the construction and operation of underground commercial facilities, the underground storage of radioactive waste, short term exploration and production of minerals to replace an existing subsoil user whose rights have been terminated, the extraction of underground water, and mineralogical collection purposes.

In other instances an investor is subject to monetary damages. As far as a mineral license is concerned, the Draft Law provides an exhaustive list of grounds for revocation of the license.

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Seasoned observers of the Russian oil and gas scene will be able to trace the legislative changes being adopted to the myriad of reform efforts launched over the years. To see whether the coming changes provide investors with greater protection of their rights, we must await a final version of the Draft Law. However, an equally important perspective, as we have suggested, is that these legislative changes are part of the Russian state's broader struggle to consolidate its authority – to bind the regions to the center and to gain greater control the natural resources of the new state. And on a less inspirational note, they are emblematic of the struggle and shifting strategies among different elites within Russia for control of some of the most strategically significant hydrocarbon resources in the world today. When taken along with the highly publicized dismantling of Yukos, the attempt to create a Russian national oil company, the anticipated merger between Gazprom and Rosneft, and the high profile acquisitions made by international majors over the previous two years, these legislative changes amount to a new chapter in the fast-paced story of the Russian oil and gas industry. □