Update on Russian Subsoil Development Regime:

The Situation for Foreigners under the Present and the Draft New Law

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This summary report addresses the issue of how the current draft of the New Subsoil Law would limit the ability of foreigners to be a license holder or a shareholder in an existing license-holding company — building on how the existing Subsoil Law regulates this area.

We approach the subject in historical/chronological context, for better understanding. We take into account the most recent draft version of the New Subsoil Law — which was apparently approved by the RF Government in mid-March for submission to the Parliament for consideration and hoped-for enactment some time this year.

Needless to say, the subject is still very much a "moving target": the draft New Subsoil Law may well (indeed, is likely to) undergo further change before enactment; there are a number of uncertainties of intent and of probable application even as to the existing draft provisions; and relevant auction-restriction amendments may in fact be introduced into the existing Subsoil Law in the shorter term (if the Ministry of Natural Resources — "MNR" — has its way).

Summary explanation/analysis as follows:

1. **Basic Current Law Provisions.** Current law (the 1992 Subsoil Law as amended, the 1992 Licensing Regulations, and the 2002 Ministry Recommendations on Conducting Auctions and Tenders) does not restrict foreign ownership participation in license rights. Just note:

a. The law/rules do permit restrictions (including Russian/foreign distinction and restriction) to be imposed on a case-by-case auction/tender basis. (Some question may be raised as to whether such discrimination against foreigners by such individual auction/tender rule, not specifically authorized in the Subsoil Law, is lawful under current law.[1] See further discussion below.)

b. And there is the further special restriction (under current Subsoil Law art. 17.1) that a license transferee JV company must be a Russian company and must be 50% or more owned by the transferor license holder at the time of transfer.

2. **Restrictions Proposed Summer 2004.** There was a proposal last summer to introduce a blanket foreigner restriction into the existing Subsoil Law, at a time when other amendments were being adopted. That proposal would have stipulated that only Russian companies can hold licenses and (apparently, depending some on interpretation in quite a complex area — involving application of Russia's Antimonopoly Law "group of persons" definition) that no such Russian licensee company could in any circumstances be more than 50% owned/controlled by a foreign partner company (such as a Western major) or even by a Russian company's offshore holding structure (such as involving Sibneft, for example). This proposal was not enacted at the time — but some basic aspects of it, albeit in less categorical prohibitive form, are incorporated in the current draft New Subsoil Law (see immediately below).

3. **Restrictions Now Proposed for New Subsoil Law.** The most recent draft of the proposed New Subsoil Law ("NSL"), approved by the Government in March 2005, states (at art. 9) the basic intended foreigner participation restriction rules. These are, with certain annotations and explanations added by us, as follows:

a. Subsoil rights holders must be Russian individuals (except to the extent individuals are restricted by law from being license holders) or Russian companies.

[1] Namely, the 1992 Licensing Regulations art. 10.5 (also reflected in the 2002 Methodological Recommendation art. 3.6) authorizes only limitation to Russian companies – but not further limitation as to ownership of such Russian company participants – for particular tenders/auctions. The current Subsoil Law itself makes only a few references to limiting/selecting users based on "national security" (see arts. 8 and 13.1), but those references alone do not seem germane to the issue of (i.e., to provide sufficient support for) restricting participation in particular tenders/auctions.

NSL art. 9.1. (In other words, foreign companies may not be subsoil users.)[2]

b. But Russian companies "that comprise, with foreign individuals and/or ... foreign legal entities, a group of persons may be subsoil users as long as federal laws or the decision on conducting a [particular] auction adopted in accordance with [this law] do not provide otherwise. ... For purposes of this clause, a group of persons shall mean a group of legal entities or individuals categorized as a group of persons in accordance with the anti-monopoly legislation." NSL art. 9.1 (emphasis added).

4. **Group of Persons.** The "group of persons" reference is to the definition found at art. 4 of Russia's Anti-Monopoly Law ("AML"). This definition (an unofficial on-line translation of which is attached hereto) is rather long and dense. (It is most commonly used in Russian practice, in conjunction with related terms such as "affiliate", in the context of (i) required approvals or notices for share, asset and similar acquisitions per the AML itself, (ii) certain requirements, such as notice for tender offer or for interested-party transactions, under the Stock Company Law, and related matters under Russian securities law and rules.)

a. Basic meaning

! As is most likely relevant here, a "group of persons" with foreign interests (regardless whether those foreign interests are "real foreign" or "Russian offshore" foreign) would be considered established if a foreign person/entity, or several associated such persons/entities, have direct or indirect control more than 50% of the voting shares in the relevant Russian person/entity (i.e., the subsoil licensee/user). Under the definition and its interpretation in practice to date, "control" is understood very broadly, being effected by agreement (or coordinated action), including an acquisition agreement, trust management, joint activity agreement, appointment, "or other transactions or on other bases."[3]

! The most commonly seen "other bases of control" include: (i) various voting arrangements where the shareholders of the Russian company would agree that, with respect to certain matters, the shareholders would vote in accordance with the wishes of the foreign company 50% (or less) partner, or the foreign company would have the deciding vote over certain important decisions (on the shareholders, board of directors and/or management levels); (ii) more than 50% of the directors and/or members of the management board of the Russian company and/or the CEO of the Russian company is/are foreign company representative(s)/ employee(s) or were appointed pursuant to the initiative of the foreign company; and (iii) management agreements putting a Russian company under operational management of an outside person or entity that is under the control of the foreign company, and the like.[4]

b. Further general cautions regarding the group of persons test:

! The operative AML art. 4 "group of persons" definition certainly refers to "more than 50%" — rather than "50% or more". Nevertheless, in some other contexts (Antimonopoly or Securities Law filings, etc.) in which this same definition/test is used (indeed, most commonly used), a more conservative "50% or more" rule of thumb (that is, anything more than 49.9%) is sometimes applied by advisors and their clients who want to be "better safe than sorry". We do not now see any basis for applying such a lower threshold rule in the NSL foreigner-control-restriction context, because the law wording/intent as drafted (assuming enactment per the present wording) seems so clear on its face. But we just point this out as an additional "practical caution". (And see also the discussion at par. 5 below regarding a different test that may be applied for certain "strategic" fields in practice.)

! For the purposes of the above analysis/conclusion as to the legal viability of a 50/50 foreign/Russian venture under the "group of persons" test as applied, we assume hypothetically that the foreign/Russian partner companies (through their respective subsidiaries) will be 50/50 direct shareholders of the Russian JV subsoil-user company — i.e., that there will be no intermediate foreign/Russian-owned off-

[2] An earlier version of the draft NSL had also provided that unincorporated groups of companies under a joint activity (simple partnership) agreement could be subsoil users as well. (This is consistent with the current Subsoil Law, art. 9.) But the most recent March 2005 (art. 9.1) draft provides that only PSAs (to the extent still allowed under Russian law) may be entered into by this form of subsoil user — NSL art 9.2.

[3] Note the uncertainty under current law (i.e., the "group of persons" definition as worded and applied) regarding whether, for example, two completely independent foreign companies (say, two foreign majors), each holding 30% of a Russian licensee company, would make for a group of persons, so as to trigger the restriction. Reading the AML art. 4 definition literally, such a foreign participation configuration should not necessarily trigger the restriction. (The case of TNK-BP, a 50/50 Russian/foreign venture company, raises some further and different questions in this regard.) This is a delicate area, which would require close attention in each particular case — including the possible presence of additional factors (e.g., a shareholders' agreement) that could tip the interpretative balance toward finding a group of persons. See also the main text paragraphs just below for further related discussion.

[4] Note that the Petroleum Advisory Forum in Moscow ("PAF") has been attempting — unsuccessfully to date — to lobby the RF Government/Duma to move away from the "group of persons" trigger, and instead use a straightforward charter capital percentage test, for this Subsoil Law foreigner-restriction context.

shore JV vehicle owning 100% of the shares of the Russian company. For example, in the event the foreign/Russian partners do form such an intermediate 50/50 offshore JV company that in turn will control 100% of the Russian company, the Russian company would (according to the literal NSL art. 9.1 wording) run afoul of the "Russian company in a group of persons with foreign interests" test.

! Also note that substantial government-sponsored changes to the AML are in progress now and are likely to be enacted by the Parliament later this year. Although the draft amendments are being advertised as "liberalizing", the most recent draft we have seen does tinker with the "group of persons" definition — and such changes might, at least indirectly, further adversely affect permissible foreign beneficial ownership of Russian companies for NSL analysis purposes.

5. **Possible Further Restrictions — Under NSL and Perhaps Sooner.** Recall the above-quoted NSL art. 9.1 provision that Russian entity license holders may be in a group of persons with foreign interests (thus distinguishing this draft NSL version from the strictest summer 2004 proposal) — "as long as federal laws or the decision on conducting a [particular] auction adopted in accordance with [this law] do not provide otherwise."

a. In other words, it appears that the NSL (by this art. 9.1 clause, together with art. 60.5) would in certain cases permit the rules for a particular auction to prohibit the Russian licensee company from being in a group of persons with (e.g., being controlled more than 50% by) foreign interests. NSL art. 60.5 provides that such exceptional cases are to be established by the Government. Recent Russian press reports indicate a Government view that such special restriction is to be imposed upon determination that a particular field is "strategic" in nature (although no such "strategic field" trigger provision is yet contained in the draft Law itself.)[5] As noted above, this planned right to restrict/prohibit might be viewed as consistent with provisions in the current Subsoil Law and implementing rules (although, as also noted above, there is some issue regarding the legality of such at present — see footnote 1 text above).

b. Further, in this context and as widely publicized, Minister Trutnev announced some weeks ago that impending auctions (apparently to be conducted later this year, before the NSL could come into effect) on the most important new resource deposits — including Sakhalin 3, the Central Khoreivsky blocks in Timan Pechora, as well as the Sukhoi Log gold deposit and the Udokan copper deposit — will have a less-than-50% owned/controlled-by-foreigners restriction written into the auction rules. Note the potentially important shade of difference between this and the no-group-of-persons-with-foreigners (i.e., no foreign owner can hold more than 50%) restriction as contemplated in NSL arts. 9.1 and 60.5. Thus a question may well arise as to whether the MNR's intended less-than-50% restriction variant for "strategic fields" would be lawful, strictly speaking; there may be more focus and adjustment in this area as the draft Law moves forward. (See also footnote 5 text above.)[6]

6. **Application of These Rules to Particular Projects.** In general the discussion above summarizes the general NSL provisions for subsoil rights holdings/holders on a going-forward basis. But many foreign companies may in fact be interested in the foreigner-investment-restriction situation with regard to fields already licensed to Russian companies, where the foreign company has already invested or proposes to invest (i.e., become a shareholder) in the existing Russian company licensee/user. The following additional NSL points are relevant in this connection (per NSL arts. 122–123 "Transitional Provisions" in the newest draft version):

a. Basically (per arts. 122.1 through 4), the essential "transitional approach" of the NSL is that the new regime (civil-law contract based; no more new licenses) to be introduced will leave existing/outstanding licenses (and attached license agreements, etc.) in place in accordance with their terms (per NSL Chapter 6) —

[5] Note that the PAF has also been advocating (again unsuccessfully to date), on the basis of protective provisions in the Russian Constitution and Investment Law, for limiting the right of restriction/prohibition against foreigners to cases directly provided in law, rather than permitting such by mere Government-approved (or even just MNR-approved) rules promulgated for a particular auction. We understand that most recently the RF President's Administration has also expressed some opposition to allowing such discretion on foreigner restrictions to be vested in executive branch agencies — citing to the Constitution, treaties and laws. Such questions being raised at that level could well lead to further evolution of the draft Law language in this area.

[6] Most recently it has also been reported that MNR will try to force such specific auction-restriction rules immediately as new amendments into the current Subsoil Law, even before enactment of the NSL — apparently to enable auctions to go forward later this year with the desired foreign-participation restrictions already in place, rooted firmly in law. It remains to be seen whether such "fast track" legislation can be accomplished.

We note, on the other hand, Minister Trutnev's most recent statement (last week, and again in a Vedomosti newspaper interview today) that such 49% or 50% ownership restrictions would not necessarily apply to new offshore shelf development projects and perhaps also to new Eastern Siberia onshore fields — in connection with which he recognizes Russia's need for more substantial foreign company participation. (He and other Government officials are lately also hinting at a needed revival of PSA-form opportunities — through possible "reliberalizing" amendments to the PSA Law — for new shelf projects.)

subject to the licensee company's option to convert that "old regime" license into a "new regime" contract (per the NSL art. 123 conversion rules), whose contract would then be governed fully by the new regime, per NSL Chapter 5 and all other general NSL provisions.

b. Further, under NSL art. 122.4, foreign companies that obtained their subsoil use rights prior to the NSL's entry into force "are entitled to realize the subsoil user rights in accordance with the conditions of a license [or PSA] for the term of their effectiveness." This appears to be intended as a sort of "grandfathering clause" to protect foreign companies that have obtained subsoil rights pre-NSL arts. 9.1 and 60.5 restrictions (although this intent was stated more clearly in the prior November 2004 version draft NSL).

- ! In other words, this might mean that if a foreign oil company were to lawfully obtain, prior to enactment of the NSL, a greater-than-50% interest in a Russian licensee company, the lawfulness of that acquisition/holding could be seen as protected/grandfathered against any possible restriction regarding that particular field that could later be introduced under the NSL. (By extension of logic, the same protection would seem to apply if the foreign company were now to obtain a 50%-or-less share, in the event of a possible later NSL-based restriction against even such lesser share being in foreign hands.) But it is not fully clear from the wording whether such protection would actually extend to cover such cases of a foreign company whose subsoil license interest is only indirect, through part-ownership in a Russian licensee company.
- ! As can be seen from reading NSL art. 122.4 and art. 9.1 second paragraph together, this art. 122.4 grandfathering protection would at least (most clearly, per the wording) cover the few foreign companies that are a direct licensee (such as the Shell/Sibir venture company Salym N.V. — a Dutch company).
- ! Note further NSL art. 122.4 second paragraph, which would restrict "grandfathered foreigners" having subsoil rights, as to the circle of possible transferees — i.e., those meeting the new NSL art. 9 requirements. (And note that this is another area where the PAF has been trying to lobby for some softening/improvement in the NSL language.)

We hope this paper serves the oil and gas investment community's need for basic understanding of the foreign-participation restrictions under current and proposed future law. We realize that the presentation is of necessity somewhat complex — taking into account various real factors including the actual provisions of the draft NSL, related applicable laws, and current MNR intentions. And again, our readers must appreciate that this whole area is still quite fluid.☐

RSFSR Law No. 948-1 On Competition and the Restriction of Monopolistic Activity at Commodity Markets (as amended)
(unofficial translation — excerpts)

Article 4 Definition of Basic Concepts

The following concepts are used in this Law:

. . .

group of persons — a group of legal entities and (or) physical persons in relation to which one or more of the following conditions are met:

- ! a person or a number of persons jointly as a result of an agreement (coordinated actions) have the right to control, directly or indirectly (including on the basis of purchase-and-sale, fiduciary, joint activity or agency agreements or other transactions or on other grounds), more than 50 per cent of the total number of votes conferred by voting shares or by contributions and holdings constituting the charter or pooled capital in one legal entity. In this respect, indirect control of the votes of a legal entity shall be understood to mean the ability effectively to control them through third parties in relation to which the first person has a right or authority of the above-mentioned kind;
- ! the person or persons in question have acquired the ability, on the basis of an agreement or otherwise, to determine decisions adopted by another person or other persons, including the ability to determine the conditions according to which another person or other persons carry on business activities, or to exercise the powers of the executive body of another person or other persons on the basis of an agreement;
- ! the person in question has the right to appoint the individual executive body and (or) more than 50 per cent of the members of the collective executive body of a legal entity and (or) more than 50 per cent of the members of the Board of Directors (supervisory board) or other collective management body of the legal entity have been elected at the recommendation of that person;
- ! the physical person in question exercises the powers of an individual executive body of a legal entity;
- ! the same physical persons or their spouses, parents, children, brothers, sisters and (or) persons recommended by one and the same legal entity comprise more than 50 per cent of the members of the collective executive body and (or) Board of Directors (supervisory board) or other collective management body of two or more legal entities, or more than 50 per cent of the members of the Board of Directors (supervisory board) or other collective management body of two or more legal entities have been elected at the recommendation of the same legal entities;
- ! a physical person who performs employment duties at a legal entity or at legal entities within one group is at the same time the individual executive body of another legal entity, or physical persons who perform employment duties at a legal entity or at legal entities within one group make up more than 50 per cent of the members of the collective executive body and (or) the board of directors (supervisory board) or other collective management body of another legal entity;
- ! the same physical persons or their spouses, parents, children, brothers, sisters and (or) legal entities have the right, whether independently or through representatives (agents), to control more than 50 per cent of the votes conferred by voting shares or by contributions and holdings constituting the charter or pooled capital in each of two or more legal entities;
- ! the physical persons and (or) legal entities in question have the right to control, whether independently or through representatives (agents), a total of more than 50 per cent of the votes conferred by voting shares or by contributions and holdings constituting the charter or pooled capital in one legal entity, and at the same time those physical persons or their spouses, parents, children, brothers, sisters and (or) persons recommended by one and the same legal entity comprise more than 50 per cent of the members of the collective executive body and (or) Board of Directors (supervisory board) or other collective management body of another legal entity;
- ! the legal entities in question are members of one financial and industrial group;
- ! the physical persons in question are spouses, parents, children, brothers and (or) sisters;
- ! the provisions concerning a group of persons shall apply to each person within that group;

. . .