

# Proposed Changes for Subsoil Law

*LeBoeuf, Lamb, Greene & MacRae*

This will provide a first summary of the nature and status of current proposals by the RF Ministry of Natural Resources ("MNR"), apparently in cooperation with other parts of the Government, to amend the Subsoil Law in two important respects: (i) introduction of substantial restrictions against foreign investors (or, apparently, Russian companies having substantial foreign/"offshore" ownership) obtaining licenses to develop hydrocarbon or other mineral resource deposits in Russia; and (ii) curtailment of what has long been the regional governments' joint role in decisions on and issuance of subsoil licenses, per the established "one-lock, two-key" approach considered to be based in RF Constitution dictate, by essentially now making this an exclusive federal government domain (collectively, the "Amendments").

We offer a summary of the status of these proposed Amendments in Part I below, and summarize the substance in Parts II and III below, respectively. If adopted in present form, the Amendments (particularly the foreign restriction part – with its introduction of a sweeping "group of persons" litmus test borrowed from the Antimonopoly Law) could have a substantial negative impact on the aspirations of some international oil companies in Russia, and could well also impact some of the Russian majors in their current offshore ownership vehicle configurations.

## I. Procedural Status; Documentation

The current status of the proposed Amendments appears to be as follows, per our own best available information gathered to date from various sources in Moscow.

The regional government curtailment provisions seem to have been adopted at first reading by the Duma in early July – as part of a much larger packet of amendments to several laws relating to the role of regional and local governments. This overall packet of amendments is apparently scheduled for second reading in the Duma on August 2. (To become a law in Russia, a draft law must be passed by the Duma at three readings – the sec-

ond and the third ones sometimes occur simultaneously; then be passed by the Federation Council (upper house), and then signed by the President.)

It appears that the foreign restriction provisions were presented by MNR to the Duma separately, more recently in July, and that they have not yet been formally considered/passed at first reading. It further appears that the MNR/Government and their Duma supporters intend to append these provisions onto the regional government curtailment provisions that were already passed at first reading, for further Duma consideration of both sets of provisions all together at second reading on August 2. (It would seem that this "short-cut" to passage of the foreign restriction provisions would comprise a violation of established legislative procedures, because law drafts are not supposed to be substantively amended like this between Duma readings. However, it would not be the first time such a thing has happened in modern Russian legislative practice.)

Our best current understanding regarding possible adoption is that these amendments could conceivably be passed by the Duma within a few weeks and then directed through the necessary further steps for enactment into law. The Amendments (both parts) are being pressed by MNR and some other parts of the Government. At the same time there is resistance at the regional government level (at least, to the "two-key" part of the Amendments). Presumably some resistance is developing to the foreign restriction part as well – although other than the Petroleum Advisory Forum ("PAF") there is not such an effective natural counter-lobbying force in this area. There is speculation that the MNR is anxious to have the Amendments in place before a new round of planned major license auction is held later this year – including on Barents Sea and Sakhalin 3 fields. It is also possible that the Amendments will be adopted following some clarifying/"softening" adjustments – or perhaps not adopted yet at all.

*Bottom line:* Neither we nor other informed observers in town can be confident right now of what may or may not happen in this area. It is true, of

course, that the Putin Administration essentially controls enough votes in both houses of Parliament to obtain passage of almost any legislation it strongly wants. We will continue to follow the developments closely and report as appropriate.

## II. Restrictions on Foreign Participation

We take this part of the Amendments first and devote the most attention to it, given the direct importance for the foreign investment community. (We have the current text of these proposed Amendments in Russian and English. It has evolved over the past few weeks and may change further.) There are some real uncertainties as to correct interpretation and intended application of these provisions as they now stand, which we try to point out below.

### A. Scope/Application of Restrictions

1. Under the Amendments, the Restricted Users (essentially meaning foreign persons/companies, as well as Russian companies having over 50% direct or indirect ownership or control – see Section II.B. below) would no longer be eligible subsoil users under Subsoil Law (“SL”) art. 9.
2. This new prohibition would be subject to certain limitations of application (i.e., it appears intended to have prospective force only) and exceptions as follows:
  - a. Restricted Users would continue to enjoy their subsoil rights (licenses) obtained prior to August 1, 2004. (This date might be further adjusted forward to accord with the eventual date of enactment of the Amendments.) But see the related points of restriction/uncertainty noted below.
  - b. It is stated that “[i]n exceptional cases, subsoil use rights may be granted to [Restricted Users] by decision of the RF Government.” No criteria for identifying such a particular exceptional case are stated or even indicated. Perhaps an accompanying legislative “Explanatory Note”, if/when such is presented in the Duma, will offer some guidance here. One supposes that the sponsors of these amendments have in mind fields – perhaps mostly offshore/shelf – requiring extraordinarily large investment and/or sophisticated technology, that only foreign participants may have available. (One is reminded here of the former article 6 of the PSA Law, with its stated exception from the general tender-requirement rule for cases dictated by national security, etc. – which, as applied, came to mean “economic importance” in the eyes of the Government and Duma.
- c. The restriction would not apply to subsoil use on the basis of a PSA. But, as is well known, this exception is of limited help because of the 2003 amendments to the PSA Law (and to the Tax Code and the already-adopted so-called PSA List Law approvals), which rendered this regime all but unusable for future projects. In any event the three existing “grandfathered” PSA projects should be safe from any effect of these Amendments, by virtue of the above- noted intended forward-looking August 1, 2004 trigger date as well as their PSA status.
3. Consistent with the general prohibition (point 1 above), Restricted Users would be barred from participation in auctions or tenders for the right to use subsoil plots, per proposed additions to what would now be SL art. 13 and to art. 14. (No exception is stated for “exceptional cases” by RF Government decision, to mirror the above-noted intended provision in SL art. 9. But such an exception is presumably intended here as well.)
4. The transfer/re-issuance of subsoil use rights (license) to a Restricted User would also now be barred – per a proposed addition to SL art. 17-1. Note the following in this connection:
  - a. License transfers from Russian company licensees to new joint venture Russian SPVs that have at least 50% Russian ownership at the time of transfer have been commonplace under the relevant existing SL art. 17-1 provision. The existing practice and licenses – and such structure for new E&P JV projects involving foreign oil companies – should not be affected by the Amendments, subject to some caveats discussed below.
  - b. Nor should past license transfers to companies that may since have become Restricted Users (i.e., have more than 50% direct or indirect foreign ownership) by gradual share purchases/transfers over the passage of time be affected by the Amendments, because of the noted August 1, 2004 trigger date – but again subject to caveats noted below.
  - c. Here again, there is no provision proposed for permitting transfers to Restricted Users by approval of the Government, but perhaps such possibility is intended.

5. The Amendments would also add/clarify grounds for termination of subsoil use rights (license) in connection with the new Restricted Users prohibition and related matters, as follows:
  - a. Termination in the event that "a subsoil user comprises with [foreign individuals and/or companies] a group of persons, with the exception of cases where it obtained the subsoil use right prior to August 1, 2004." (This new termination rule would seem most clearly to cover cases where the future user/licensee fits this characterization (see Section II.B. below) at the time it obtained the rights/licensee. Intended application to future users that subsequently become so "infected" through post-licensing share acquisition/transfer is not as clear, per this Amendment's present wording.)
  - b. Termination "in the event of violation of the conditions of subsoil use rights transfer, as well as in the event of re-issuance of a license with violation of the conditions provided by article 17-1 of this Law." (This new provision seems to be aimed both at further fortifying the new Restricted User rules and at plugging a perceived general gap in the existing SL article 20.)
- b. As most likely relevant here, a "group of persons" is considered established if a person or several associated persons (legal or physical) have direct or indirect control over more than 50% of the voting shares in another legal entity (here the user/licensee). Control is understood very broadly, namely by agreement (or coordinated action), including an acquisition agreement, trust management, joint activity agreement, appointment, "or other transactions or on other bases." A "group of persons" is also found if the same individual(s) and/or their close relatives have over 50% control of management bodies of two or more companies, and in various other circumstances. Again, the applicable full AML definition of "group of persons" is rather dense and requires close study to determine the whole range of its possible application to various corporate ownership structures. (Final note here: Significant amendments to the AML itself are said to be in preparation. It is not now clear whether these will include alteration of the "group of persons" definition.)
- c. Bottom lines for now, per the proposed amended SL art. 9 language: Restricted Users, to be barred from obtaining new subsoil use rights (license), apparently would include at least: (i) a Russian company licensee that is more than 50% owned/controlled, directly or indirectly, by one or more associated foreign companies/persons (i.e., "real foreign interests"); and (ii) perhaps also a Russian company licensee that is more than 50% owned/controlled, directly or indirectly, by an offshore holding company(ies) structure, even if the offshore company structure is ultimately owned in whole or part by one or more Russian citizens (i.e., "formal foreign interests"). See immediately below for further reflections on this.

**B. Restricted Category of Subsoil Users**

1. As noted above, the Amendments would impose restriction (or rather, prohibition) most significantly on the following potential subsoil users: foreign individuals, foreign-incorporated companies, and Russian-incorporated companies that form a *group of persons* with non-Russian individuals and/or companies ("Restricted Users").
2. The key Amendment, to SL art. 9, further states: "A group of persons for purposes of the present article shall be understood as a group of legal entities and/or physical persons that are recognized as a group of persons in accordance with the anti-monopoly legislation." This refers to the extensive definition of "group of persons" given at the RF Antimonopoly Law ("AML") article 4, and has the following real meaning and probably significance:
  - a. This AML definition is most commonly used, in conjunction with related terms such as "affiliate", in the context of required approvals or notices for share, asset and similar acquisitions per the AML itself, of certain requirements (such as notice or tender offer or for interested-party transactions) under the Stock Company Law, and related matters under securities law and rules.
  3. The following more specific preliminary reflections on possible application of this new intended Restricted Users rule and its "group of persons" core element may be of interest (although, again, more confident interpretation would have to await enactment and actual practice):
    - a. On the foreign oil company (and other foreign investor) side: As noted above, maximum 50% ownership (direct or indirect) in a Russian E&P project company/license should continue to be lawful if the Amendments are enacted as is, as under current law and practice. (Such ownership acquisition could be either by joint establishment of a new SPV licensee company or by

subsequent acquisition of shareholding in the Russian licensee.) The same should apply to 50% ownership of a Russian company that holds several licenses. As also noted, there is some uncertainty as to intended treatment of a Russian licensee company that is initially maximum 50% foreign owned but the foreign ownership share subsequently grows. (Under current law and practice there appears to be no bar against this. And this sort of “creeping foreignization” may be one of the “evils” the Amendments are seeking to cure.)

b. On the Russian oil company (and other Russian investor) side we see two potential problem scenarios given the apparent breadth of the “group of persons with foreign person or entity” rule:

! *First*, any Russian licensee company that has an offshore/foreign holding company structure with any percentage shareholding and/or management control at all could, if another 50% foreign oil company shareholding is injected, thus pass the 50% foreign threshold for group of persons and barred “Restricted User” status. (TNK-BP might be an example of this, as may any proposed “50/50” E&P JV where the Russian side also has offshore structuring.)

! *Second*, some Russian licensee companies – large and small – might encounter a problem with group-of-persons Restricted User Status, given their current offshore/foreign holding company structure – even without “real foreign investment.” Yukos and Sibneft might be examples of this – as might many smaller Russian-owned, offshore-structured licensees.

! *Third*, we suppose (contrary to some early press speculation we have seen) that Russian companies (such as Lukoil, Gazprom, etc.), in which foreigners have large aggregate shareholdings but not exceeding 50% in the hands of inter-related persons, would not per se run afoul of the Restricted User rules.

c. Final note: If the Amendments are enacted in or near present form, we suppose that creative Russian companies (and their foreign partners) will come up with new investment structures to attain their goals while complying with the letter of the law.

**C. Possible Arguments against Legality of These Amendments**

1. Arguments against the foreign restriction part of the Amendments could possibly be made on

the basis of the RF Law on Foreign Investment of 1999, and perhaps some others Russian laws, regarding violation of the requirement of equal treatment, etc. But there would be countervailing arguments of national need.

2. There could be similar equal-treatment arguments under certain bilateral investment treaties (“BITs”) entered into by Western nations with Russia. Note that the US-Russia BIT was signed in 1992, but never ratified and so not in force. The Energy Charter Treaty might also have some helpful provisions, but is not ratified and in force for Russia. The ICSID Treaty might also provide ammunition for foreign companies’ claims against Russia if these Amendments were somehow interpreted by the authorities to apply retroactively so as to effect a confiscation of existing investments. (We have yet not sought to analyze any of these treaties for present purposes.)

**III. Curtailment of Regional Government Role**

Under the other part of the Amendments, which has already passed first reading in the Duma, the long-standing “two-key” system of subsoil licensing would be scrapped. Federal government representatives under President Putin have been pressing this idea for a few years. The two-key system has been considered as based on a constitutional mandate of dual jurisdiction over subsoil resources, and so if enacted these Amendments could well be challenged in the RF Constitutional Court. Without going into detail here, the Amendments would take from the regional governments shared powers they have had to date with respect to:

! Most importantly, the granting of rights to use specific plots of subsoil except for common/widespread minerals (i.e., regional government co-approval will no longer be necessary for the issuance of subsoil licenses; representatives of regional authorities will be limited to mere representation on tender commissions, except for tenders of offshore fields).

! Receiving a share of some subsoil-use-related payments.

! Planning subsoil allocation.

! Certain other aspects of subsoil use management and control. □