

Russia's Subsoil Licensing Regime: New and Improved?

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In tandem with Russia's steadily vanishing PSA regime, Russia's Subsoil Resources Law (the "SRL") has been the focus of increasing attention and criticism because it is the primary vehicle for upstream projects in Russia. In particular, both Russian and foreign oil companies and investors have complained that the SRL is vague (and therefore subjectively interpreted by bureaucrats), and does not require sufficient transparency at auctions for natural resources (and especially hydrocarbons) licenses. These complaints have prompted promises from various high-ranking officials including Minister of Industry and Energy Khristenko and Minister of Natural Resources Trutnev that the SRL would be revised and these problems addressed.

At last, on March 17, 2005, the Russian government approved a new draft SRL (the "Draft SRL"), and sent it to the Duma for approval. The Draft SRL does address several of the widely acknowledged faults of the existing SRL, but it also institutionalizes some equally negative aspects from the perspective of foreign investors. On balance, we view the Draft SRL as an improvement, but the Draft SRL is by no means positive for all present or potential investors in Russia's upstream sector.

Foreign Investors

Most prominent among the complaints about the existing SRL and the commentary on the Draft SRL is the status of foreign investors. The existing SRL does not formally restrict foreign participation, while the Draft SRL does, but that situation is not as simple as it appears. Other laws (most notably the Law "On the Continental Shelf of the Russian Federation," or the "Shelf Law") already expressly restrict foreign participation in certain projects, on national security grounds and/or to develop domestic industry, and as

a practical matter the system of tenders and auctions frequently operated de facto to exclude foreigners.

By contrast, the Draft SRL explicitly provides that the exploration and development of newly licensed Subsoil resources is restricted to Russian legal entities (or, in very rare cases, to individual Russian entrepreneurs). Article 122 of the Draft SRL provides that foreign legal entities and foreign individuals which have already been issued licenses or entered into production sharing agreements ("PSAs") may continue to explore or develop their deposits until the expiration of the term of their licenses or PSAs. Another important change proposed by the Draft SRL is found in Articles 9 and 60, which provide that in certain cases, either as provided by Russian law or by a decision of the governmental authorities organizing an auction, Russian companies forming a "group of persons" together with foreign persons (entities or individuals) may be restricted from particular deposits.

However, foreign investors may generally participate as minority (up to 49%) shareholders in Russian entities bidding for licenses. In fact, this restriction may be said to codify the informal situation in respect of Russian E&P licenses in that many foreign investors teamed up with Russian companies as majority partners to increase their chances of obtaining a license, or joined forces where the Russian company already had a license. What is different is that the Draft SRL itself now expressly provides conditions in which foreigners may be excluded (*i.e.* not simply under the Shelf Law).

Licensing

Under the Draft SRL, the right to explore or develop Subsoil resources may be granted either in the form of a license or an agreement on

the use of Subsoil resources (an "Agreement"), depending on the type of deposit and type of resource. For most purposes of foreign investors, licenses have effectively been replaced by Agreements.

An investor would enter into an Agreement upon the successful conclusion of an auction or in accordance with a decision of the appropriate governmental authority, and the Agreement then becomes effective upon registration in the state register of rights to real property and transactions therewith. The Draft SRL does not set a maximum term for Agreements, which may be concluded for an indefinite period. It also permits short-term Agreements (of up to one year) without the requirement of an auction.

The Draft SRL limits the issuance of licenses to two grounds only: (i) on the basis of a special decision of the Russian Government or an authorized agency, and (ii) to an investor which is a party to a PSA.

The move away from licensing to Agreements is significant in other respects as well. Where licenses are administrative instruments, Agreements will be treated as rights covered by civil law. In effect, the Draft SRL converts hydrocarbon licenses into leases of real property rights from the State. This makes transfers much simpler and allows for collateralization of the rights as described below.

Collateralizing Licenses

In a major improvement over the existing SRL, the Draft SRL permits Agreements to be used as collateral to secure debt. Moreover the secured party need not be engaged in the E&P industry as would be required to participate in an auction, so long as the pledge agreement only relates to proceeds and does not provide for the transfer of the right to perform the E&P activities by the secured party.

The Draft SRL specifies the different conditions for transferring under Agreements as contrasted with rights granted on the basis of license; the specific terms for transferring or encumbering rights under an Agreement are set forth in the Agreement itself, and require the consent of the government, while the transfer of licenses is limited to controlled affiliates.

Other Changes

In another key change, the Draft SRL provides that exploration and production rights will be awarded jointly, rather than separately as under the existing SRL, thus eliminating the necessity for a company to bid for a deposit after already having spent significant funds on exploration. Another beneficial change is the strengthening of the "one-key" system, whereby the investor/operator deals with a single governmental entity (the Ministry of Natural Resources) in negotiating the terms and entering into the Agreement. In an improvement in transparency, nearly all such Agreements will be granted on the basis of auctions, although the timing for bid packages has been significantly tightened.

Under the civil law governed Agreement regime, the liability of the operator (user) is broader, with exceptions limited to illegal acts of the government or events of force majeure. At the same time, it appears that disputes in respect of Agreements will be adjudicated exclusively in Russian courts rather than by administrative means. In our view, based on the experience of many investors in dealing with other governmental agencies in Russian courts, this could well be a positive development. Despite the reputation of Russian courts, it is a little-known fact that litigants against Russian governmental agencies (such as the tax inspectorate) frequently prevail and, in any event, judicial dispute resolution has the additional advantage of a measure of transparency and the right to appeal. □