The State as a Contracting Party: the Delimitation of Regulatory Authority in Licensing and Product Sharing Agreements

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An Introduction to Reality

The year 2003 began with the news of the largest equity investment made by a foreign company in Russia. In June 2003 BP announced the completion of a deal where it invested 6.75 billion USD to purchase a 50% share of TNK, to create an oil producer valued at 18.1 billion USD. The actual structure of this deal seemed to illustrate the pace of change in Russia: a board structure has been established that gives both sides an equal number of seats and a veto power over major decisions. The deal embodied an undisputable declaration of confidence in both the domestic economy and legal framework. In addition, Russia received $6.5 billion in foreign direct investment in 2003, with nearly half of that total invested in both petroleum and gas projects in Sakhalin. The prognosis in the summer of 2003 was that Russia could continue to generate hard currency reserves, capitalizing on the high price of oil on the world market.

The optimism of foreign investors generated by this deal rapidly vanished, however, following the events that engulfed the other oil major, Yukos, barely six months later. The more recent decision to annul the result of a tender to negotiate a Product Sharing Agreement (hereinafter referred to as PSA) for the Sakhalin 3 field has done nothing to rejuvenate confidence. Yukos acquired a 92% stake of Sibneft on 3 October 2003 for 3 billion USD plus a share exchange. On October 30, however, upon the initiative of the Prosecutor General's Office 44%of the shares in Yukos / Sibneft were frozen, stating that they had no choice but to hold the shares 'as collateral against material damage' caused by the tax evasion of Khodorkovsky. Six months later, on 16 April 2004, a court ordered that Yukos be prohibited from selling or transferring any assets during the current investigation being undertaken by the tax authorities.

1. Insuring Against Reality: the Development of PSA Legislation

A similar contradiction can be noted in the development of both policy and legislation regulating the development of the petroleum industry, this development inextricably linked to the changing character of the relationship between foreign investment, the large domestic oil producers and both the federal and regional authorities. Expressed simplistically foreign investors have been confronted with a political climate that is split between progressive, market-oriented forces, and conservative, nationalistic ones. The former invites and welcomes foreign investment in the petroleum area, whereas the latter affirms the political and social importance of maintaining national control on the Russian mineral resources. This instability has been exacerbated by further uncertainty generated by the conflict between federal and regional authorities, article 72.1.b of the Constitution of the Russian Federation granting joint competence to federal and regional bodies in the ownership of subsoil and natural resources.

The law On Production Sharing Agreements (herein after PSA law), introduced in January 1996,

embodied an attempt to establish a special legal regime that insulated investors from these risks, of changes in the direction of fiscal policy and the provisions of legislation.[1] It provided a fundamentally different legal basis for companies to explore for and develop mineral resources than the license issued for a 'joint venture' under the law On Subsoil of 1992.[2] The divisions within the lower house of the Russian Parliament (hereinafter the Duma), and between the interests of federal and regional governments, had led to an impasse in passing this legislation and the enactment of contradictory regulations. Yet, when the Duma finally did pass a PSA law in December 1995, internal power conflicts resulted in a legislative act that introduced a contractual system for investment, but within the context of a regulatory framework that to a large extent reiterated the provisions of the licence regime.

In theory, the fundamental difference in the regulatory schemes envisioned by the license agreement system and the PSA regime hinges on the distinction between an administrative grant of rights versus a civil law grant of rights (article 11 of the law 'On Subsoil'). Crucially, an investor, operating under the licensing regime, would expose himself to the risk that crucial conditions, such as the tax rate, could be modified in such a way that he is deprived of any economic benefit. In contrast, under the PSA Law, the investor's rights arise directly from the PSA itself, which is a negotiated contract between the investor and the state. Although a license is issued to the investor under a PSA, it is intended to serve simply as a confirmation of the contract rights: not as an independent source of rights and obligations. The PSA law contains a number of mandatory terms and conditions, but otherwise gives the parties considerable flexibility in negotiating and structuring their deal.

In practice, however, PSA regime combines both civil and administrative law. This juxtaposition seems to be contradictory. The parties may determine their civil law relationship in any agreement. Therefore, amendments to civil legislation do not automatically entail amendments to corresponding conditions in the agreement. On the contrary, changes in administrative regulations automatically apply from the moment of their adoption. Furthermore, in terms of the everyday functioning of the agreement, the state appears in such an agreement as a party to a civil law contract, yet fulfils regulatory functions that affect the workings of the agreement.

Indeed, the conflict about the extent to which a PSA should be located within the jurisdiction of administrative or civil law has characterized the development of both PSA and subsoil legislation. In February 2001 a government resolution was issued delegating authority to the Ministry of Economic Development and Trade to develop PSA legislation in a way that would better guarantee its effective implementation. The government approved a plan of 16 urgent legislative initiatives that would improve co-ordination between state bodies responsible for PSA issues resolve tax issues, and established a compensation mechanism. Finally, the Duma established a special commission on PSA problems that was to review proposed amendments to the basic law, the culmination of this work being the enactment of a new version of the PSA law on 6 June 2003.[3] The amendments to the PSA law, however, have only served to limit the circumstances under which the PSA regime can be used to produce those mineral deposits for which there are no available investors under the normal license regime. Finally, in addition, the majority of the projects that had been previously approved for PSA development were removed from the list law.

The seeming inability of foreign investors to operate in Russia under the PSA regime has encouraged investors to consider operating under the license regime. Although 30 projects have been approved for PSA development only three projects are being developed. All three of these projects were agreed upon before the actual implementation of the PSA law, the agreements that had been concluded grandfathered in the PSA law. The recent decision of the European Bank of Redevelopment (hereinafter EBRD) to provide project financing on the Prirazlomnoe field was based on a subsoil license.[4] The EBRD as an investor provides for an essential mitigation of country and currency transfer risks. As will be discussed in part 4 of the article with an analysis of the regulation of activity under the licensing regime,

[1] The process began with the issuing on 24 December 1993 a Presidential Edict on 'Questions of Product Sharing Agreements When Using Subsoil Resources' It established a scheme for foreign investment not mentioned in the 1991 Law on Foreign Investments. Both Russian and foreign investors under the Edict were at liberty to conclude production sharing agreements. The Edict offered formal recognition to the 'consortium' under Russian law as an association of investors without the formation of a judicial person, although there were remaining certain questions about the relationship between the consortium and the simple partnership under Russian civil law.

Then on 30 December 1995 federal law No. 225 f3 'On Product Sharing Agreements' was signed by the President of the Russian Federation, coming into force on 11 January 1996. The law has since been subject to numerous amendments the nature of which are analyzed in this article.

[2] Law No. 2395-1 'On Subsoil' was passed on 21 February 1992. The law has since been subject to numerous amendments, the nature of which are analysed in this article.

[3] Federal law No. 65-f3 'On Amending the Tax Code and Amending Certain Other Laws of the Russian Federation and Nullifying Certain Other Laws of the Russian Federation' of 6 June 2003.

[4] The license to the Prirazlomnoe field, held by Sevmorneftegaz, an operating company established last year as a joint venture between Rosneft and Gazprom, has an expected total production of 74.6 million tons over 22 years.

the mitigation of risk remains of critical importance. Although the rating agency Moody's have awarded Russia Investment Grade in November 2003, Standard and Poors have reiterated concerns about the power of major monopolies, the concentrated ownership of productive assets, and the deficient protection of property rights. For investments in the petroleum sector, the PSA was supposed to be a means to fence off many of these risks. As will be elaborated in the article, however, both legislation and practice have persistently failed to demarcate the role of the state as a contracting party in the agreement, and its role as a regulatory authority.

2. The Provisions of the PSA

The original law On PSA of 1995 appeared to offer many of the provisions that would be expected for any PSA regime, the law governing the legal relationships pertaining to the conclusion, implementation and termination of a PSA. Although the PSA Law contains a number of mandatory terms and conditions, it otherwise gives the parties considerable flexibility in negotiating and structuring their deal. Each individual PSA sets out specific terms between the parties relating to, *inter alia*, the exploration, development and production of minerals, and the sharing of production.[5]

The procedure for beginning work under the PSA regime is as follows. An auction is held to develop a subsoil area under the licensing regime. If the auction is declared void due to the absence of bidders, then the state can conclude a PSA with the successful bidder in a second auction, the agreement to be concluded within the timeframe agreed with the investor.[6] The subsoil area to be developed under PSA terms must have first been included in a list law by the Duma after the first auction was declared void (article 2.3 of the law On PSA). After concluding the PSA the state automatically grants the investor a subsoil license for the exclusive right for exploration, development and production of mineral resources on the subsoil area defined in the PSA (article 4.2 of same law). The agreement will include all the necessary terms and conditions relating to the use of the subsoil, including the terms, conditions and procedures for defining the value of, and sharing, the production between the parties.

The PSA provides for the terms, conditions and procedures for defining total volume of production and its value (article 8.1 of the law On PSA). Within a defined portion of production the investor is entitled to the recovery of costs incurred in conducting PSA operations i.e. the investor is entitled to 'cost recovery production.' The cost items that are subject to recovery by the investor from the cost recovery production should be specified in compliance with legislation. In addition, the investor is entitled to a portion of 'profit production,' the remainder of the profit production being given to the state. Id. The investor's share of this production may be exported from Russia under the terms and procedures specified in the PSA without quantitative restrictions on export (article 9.2 of the law On PSA).

In recognition of investors' concerns over the unpredictability of legal change in Russia, the drafters of the PSA law added a provision stating that the terms of a PSA remain in effect throughout the duration of the contract. Furthermore, the PSA law allows the state and the company to re negotiate the terms of the contract if the commercial returns from the investment get worse as a result of changes in legislation. The relationship between these provisions, articles 17.1 and 17.2 of the PSA law, insulating the investor against adverse legislative development will be discussed later. Finally, if either the investor or the state breaches the contract, the other party can enforce its contractual remedies in the manner set forth in the PSA, which can include international arbitration in a neutral third country (article 22 of the law On PSA).

With regards to taxation the law established that for the duration of a concluded PSA the tax charges to which the investor is liable is defined by the terms of the PSA between the investor and the state (article 13.2 of the law On PSA). Crucially, the effective rate of profit tax in a PSA, i.e. the value of profitable production minus the taxpayer's justified and confirmed expenses and mineral tax payment, is set on the date the agreement was signed and is applied for the whole term of the agreement (article 8.1 of the law On PSA). The investor is also exempt from payment of regional and local taxes upon the decision of the appropriate legislative body.

Regardless of the terms of the PSA, however, the following key taxes continue to be levied; VAT; Unified Social Tax; Customs Duties; and Mineral Extraction Tax. The projects operator, as well as the suppliers, and service pro-

[5] As an example of the mandatory terms article 7.2 of the law On PSA stipulates that the investor must grant Russian companies the priority right to take part in the conduct of the PSA operations as contractors, suppliers, carriers; investors must employ citizens of the Russian Federation so that they make up no less than 80% of all employed personnel.

[6] Article 6.1 of the law On PSA stipulates that the conditions for PSA development should be concluded no later than eighteen months from the date on which the special negotiation commission was established.

viders, are, however, in reality exempted from the payment of VAT on any goods and services imported for use in PSA works, and upon export of production by the investor according to the PSA terms. In addition, the following goods are exempt from import and export duties; goods being imported into Russia for the performance of work under the agreement according to project documents; the production manufactured under the agreement and being exported from Russia. Property tax is not levied on fixed assets, intangible assets, resources and expenses on the taxpayer's balance used exclusively for the purposes of the agreement. In addition, transport vehicles, which belong to the taxpayer and are used exclusively for the purposes of the agreement, are exempt from taxation. Finally, there is no tax on dividends paid to Russian and non-Russian investors.

Amendments were introduced to the 1995 law On PSA in January and February 1999, with the introduction of the law 'On Amendments to the Products Sharing Agreement Law,' and the law 'On the Introduction into Legislative Acts of the Russian Federation Amendments and Additions Arising from the Law on Production Sharing Agreements.'[7] The amended law clearly defined the criteria for fields to be eligible for production sharing agreements.[8] The law also asserted a 30% cap on reserves available for PSA development, stipulating that future auctions for the award of a PSA had as a required term the participation of Russian legal entities in the project, in shares determined by the Russian Federation and relevant regional government in each case. Finally, the amendments established a clear legal framework for the route from holding an exploration license to the start of production. Although they provided that the exploration license does not guarantee that its holder will automatically get production rights, a term was added elevating to priority position the company that has made the discovery.

Most importantly, however, the special stabilized regime of taxation for PSAs, established by article 13 of the PSA law, but subject to question since then as to its legal validity, was confirmed through the Enabling Law by specific amendments to the relevant tax laws.[9] Such amendments are crucial because of the basic provision of Russian law that taxes are to be established, and advantages or exemptions granted, only by tax legislation. This need is highlighted by article 18 of the Tax Code which requires that 'special tax regimes' be set forth in the Code.[10] The provisions of article 13 therefore did not provide the investor with a real stability, since article 14.1 of the PSA Law refers to Russian law as defining accounting rules. It follows that in spite of a fixed tax rate the amount of tax payable can be subsequently modified by the amendment of the accounting rules that calculate which part of the income the investor shall pay taxes on. Generating even more uncertainty, the original PSA law was thought by many to be a violation of the Constitution as it effectively usurped the power of tax legislation. Therefore a chapter on PSAs was drafted into the Tax Code.

These regulations as well as the system of taxation in general remained in dispute until the passage of the Tax Code that provided for a clearer and more understandable system, and better compliance between federal and regional taxes. On 5 January 2002 Part 2 of the Tax Code went into force, establishing fundamentally new rules for paying VAT, excise duties, and social taxes.[11] The provisions of the Code confirmed the existing exceptions from the general tax rules for a project based on a PSA, and they largely eradicated flaws in the previous tax laws that they replaced. Article 178 confirmed the right of investors and operators of PSA projects to pay the bills of their suppliers and contractors without including VAT and also to receive from the state a prompt refund of VAT outlays that nonetheless were paid under contracts. Article 206 exempted from excise duties the minerals and refined products that belong to investors under the terms of agreement.[12]

The legal mechanism providing investors with the opportunity to pay off bills to suppliers and contrac-

[7] Federal law No. 19 f3 of 7 January 1999 On PSA, and federal law No. 32 f3 of 10 February 1999 'On Introducing to Legislative Acts of the RF Amendments Following From the Federal Law On Production Sharing Agreements.'

[8] These conditions were stipulated in article 1.1 of the enacting law No. 19 f3 of 7 January 1999 as; the non profitability of the further production of the field for the producer and the state; significant production volume and large number of jobs involved; negative social consequences as a result of abandonment; lack of financial and technical assets for developing new large fields, construction of infrastructure and transportation facilities; priority of offshore and low explored areas; the importance for maintaining production levels in Russia and for social development and security of energy supplies; necessity for capital consuming technologies for recovery of reserves, residual reserves and avoidance of reserve losses; and the need for self supplies of fuel and energy in regions.

[9] Federal law No. 19 f3 of 7 January 1999 On PSA, and federal law No. 32 f3 of 10 February 1999 'On Introducing to Legislative Acts of the RF Amendments Following From the Federal Law On Production Sharing Agreements.'

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[11] Tax Code of the Russian Federation Part 2. Federal law No. 117 f3 of 5 August 2000.

[12] Article 178 and 206 became invalid with the adoption of federal law No. 65 of 6 June 2003 On Amending the Tax Code… which introduced chapter 26.4 establishing the PSA tax regime.

tors without VAT is extremely relevant to PSA projects as by 2001 the government had amassed several millions of dollars of debt to the investors based on the first three PSA agreements. In addition, a norm that following the start of the production of materials the state's debts to the investor for the reimbursement of input VAT will be covered at the expense of reducing the state-owned share of output has also had considerable practical effect. This suggests that investors and operators of PSAs will be able to compensate for losses on VAT with the non-payment of royalty fees.

The majority of the provisions of the Tax Code were already contained in the 1999 amendments to the PSA law. Its repetition was, however, of vital importance as the tax norms in the amended PSA law had often been perceived as a mere declaration of intent. They received their most recent, and most effective, affirmation with the introduction of a new chapter 26.4 to the Tax Code on 6 June 2003 that established a special tax regime for PSAs. Important changes relating to the determination of taxable income based on the volume of production and the price of overall production were introduced, a list being established, as well as limits, for reimbursable and deductible expenses for profit tax purposes. In addition, particularities regarding the calculation and payment by PSA investors of profit tax, VAT, and mineral extraction tax are specified. Yet, notwithstanding these favorable provisions, the legislative framework has been flawed by the continued failure to clarify the rights of investors in this and other legislation. More importantly, however, with regards to the implementation of the law, the exact scope of involvement of state agencies, regional administrations and local legislatures has neither been defined nor implemented.

3. The Problems of the PSA

The practical experience of investors operating under PSAs perhaps best illustrates the contradiction between the amendment of legislation and the retention of non-delimited behavior by the state both as a contracting party and a regulator. The Management Committee, composed of a representative of each party to the agreement, decides upon a work programme and project budget each year. The operator is not able to vary from this without a new approval from the Management Committee to establish what expenses are cost-recoverable. It is only when the external audit has been approved by the Joint Commission, as based upon the project's adherence to the work programme that the mineral production can be divided between cost and profit production. With regards to approving the annual audited budget, or the work programme, it has been established in practice that the decision of the Management Committee must be unanimous. It would thus appear that in reality the representatives of the regional and federal government on the Management Committee are entering the agreement as separate parties.[13]

A common dispute in the operation of a PSA project evolves around what expenses are recoverable as cost oil, a result of the fact that there are no guidelines in the PSA law as to the criteria that should be employed by the Management Committee. The recoverable expenses are merely linked to the approved work programme and budget. In the case of the Kharyagia PSA arbitration proceedings have been initiated by the project operator Total. The project did not receive approval from the Management Committee for the audited yearly account in 2001, as the representative of the regional government voted against them. In 2002 both the regional and federal government representatives on the Management Committee withheld their approval for the work programme and budget. As the audited accounts were not approved the operator received a tax demand as the total production is viewed by the Ministry of Taxation as profit production and therefore liable to taxation.[14]

The state appears in a PSA as a party to a civil law contract, yet fulfils regulatory functions that affect the workings of the agreement. As has already been noted, in accordance with article 7.7 the parties may agree to create a managing committee with equal representation for each side. The rights and duties of this body are defined by an agreement between the parties. This contractual mechanism allows the state to participate in the adoption of decisions on the operational issues surrounding the implementation of the PSA. This is supplemented, however, by the right of the state to issue guidelines in its role as a regulatory authority. Article 19 of the law On PSA provides federal executive bodies with the power to exercise supervisory functions such as tax, customs, and currency monitoring bodies. The bodies responsible for these activities have the right to de-

[13] This is despite the fact that the Russian Federation is named as a party to the agreement in article 3.1 of the law On PSA.

[14] Another practical issue identified as having the potential to escalate into a dispute is when the PSA does not limit the amount of production that can be used as cost oil, and the rental payment for subsoil use is defined as part of the profit production. Then no production would be used towards the rental payment and the state would be deprived of its share of the profit oil until costs are recovered.

mand documents from the investor, conduct inspections, and monitor the investor's activity. Thus, in reality, the investor, as a subject of administrative law, is compelled in the implementation of the project to deal with representatives of numerous state bodies. These bodies, in order to execute their supervisory functions effectively, must understand the content of the PSA and the particularities of its regulation. It is this contradiction, exposed by the practical example given above that is analyzed below.

As a general principle, the PSA Law states that PSA shall be primarily subject to the PSA Law (article 1.1 of the law On PSA). On the other hand, however, the PSA Law itself makes explicit reference to Russian administrative law for a long list of areas. This includes the use of land and other natural resources (article 1.2), the organisation and procedure of auctions for the award of licences (article 6.1), cost recovery (article 8.1), the calculation of profit tax (article 13.2), the transportation of raw materials (article 12), and until recently the export of the production (article 9.2). The agreement is also subject to civil legislation in general (article 1.3), and specifically with regards to the conclusion, modification and termination of agreements (articles 6.1, 17, and 21 of the law On PSA respectively).

Many of these areas, cost recovery, taxation, and the export of production, are essential to the investment. Referring to Russian legislation, as prevailing from time to time, in these areas, therefore, means that the main conditions of the investment are not only regulated by the PSA, but are regulated by the state. As an example, in accordance with article 9.2 of the PSA Law the investor has the right to take the raw materials that have become the property of the investor under the PSA, outside the territory of the Russian Federation in unrestricted quantities. Yet until recently article 15 of the law On the State Regulation of the Foreign Trade provided that the government has the right to introduce quantitative limitations on export in order to ensure state security, and protect the Russian domestic market.[15] Although, an additional paragraph 3 was added to article 15 of the law On the State Regulation of Foreign Trade in February 1999, providing that export limitations could only be imposed if the Russian Federation has fulfilled its obligations with regards to the export of the investor's production under the PSA, it is uncertain as to how this would work in practice in the event of a conflict of interest.

As the adoption of administrative legislation should impact upon the implementation of the PSA, article 17.2 of the PSA law elaborates upon the mechanism that will be deployed to ensure the stability of the agreement. It is not clear, however, as to; which categories of legislative acts these stabilisation rules apply; and how the mechanism applying the stabilisation rules works. Even if the PSA Law provides for the possibility to adjust the economic terms of each agreement, so that any subsequent modifications operated unilaterally by the state may be compensated, and even if it limits the possibility of the executive power to modify the conditions of the investment, it cannot be maintained that a contractual system has been implemented.

Firstly, it is not clear which legal acts entitle the investor to demand changes to the agreement, and which new legal acts are not applicable to the investor at all. Article 17.2 of the PSA law stipulates that the agreement should be revised when changes to federal, regional or local legislation, worsen the commercial results of an investor's activity. Secondly, with regards to the mechanisation of the stabilisation rules, in accordance with article 17.2, if business conditions are worsened by amendments to legislative acts the agreement must be revised. Yet the PSA law provides no criteria for identifying when conditions are worsening. Article 17.1 provides that the amendments agreed upon between the parties are to be introduced in accordance with the same procedure as the initial agreement. In practice, an agreement would have to be reached with the state on the fact that conditions had worsened, the degree to which they had worsened, and the duration of this worsening. Such criteria are therefore subject to other legal acts issued by either the federal or regional legislature.

With regards to the investor's access to a remedy for the breach of the agreement the PSA law contains provisions for the compensation of the investor in the case that the economic position of the investor is negatively effected by new rules introduced by federal, regional or local legislation (article 17.2 of the law On PSA). To the extent that it becomes applicable, therefore, a dispute arising in connection with such compensation may be considered as a dispute relating to a contractual obligation of the state, and therefore submitted to court or arbitration.

The PSA law fails, however, to provide a mechanism for the investor to terminate a PSA if an agreement cannot be made with the state with regards

[15] Federal law No. 157 f3 of 13 October 1995 'On the State Regulation of Foreign Trade Activity.' This provision is no longer in force as of 18 June 2004 following of the implementation of federal law No. 164 f3 of 8 December 2003 On the Fundamentals of the State Regulation of Foreign Trade Activity.

to the amendment of the agreement in the conditions described above. It should be clearly identified in the PSA law the bases for the amendment and rescission of the agreement. In accordance with the Civil Code, article 450.3[16], the investor should be granted the right of refusal to perform their obligations if such circumstances arise. Yet this provision of the Civil Code is not directly applicable to a PSA as a result of the PSA special regulatory status.

Selecting neutral bodies, not subject to or involved with the same interests of public and private nature pursued by the state/contractual party, for the interpretation of the contract and the resolution of disputes between the parties, is a well recognised need that has led to many contracts being subject to international arbitration. The PSA Law only partially adopted this principle. Firstly, article 23 envisages that the state may waive its sovereign immunity in each agreement, in case of legal proceedings being initiated and enforced against the state. The article, however, makes also reference to a specific law on sovereign immunity, not yet enacted, thus creating uncertainty as to the conditions and the extent of any waiver of immunity until such law is in place.

Secondly, with respect to the resolution of disputes, although article 22 expressly permits that disputes concerning the performance of the PSA can be submitted to arbitration, arbitration remains a method of dispute resolution that can only be applied to contractual and other civil law relationships. Operations regarding natural resources may be qualified, if we draw an analogy with chapter 17 of the Civil Code, as operations having a private law character. As has already been stated, however, the PSA law makes reference to prevailing Russian law in a series of instances that have an administrative law character. Furthermore, as article 1.3 of the PSA law states that 'those rights and obligations of the parties to a PSA, that have a private law character, are regulated by the PSA law and by Russian private law,' this could be argued as implying that some relationships are of an administrative law character and are regulated by Russian administrative law.

As long as essential conditions of the investment, such as cost recovery, taxation, and export rights are regulated both by contractual provisions and by state regulations, it remains disputed as to whether they should be considered as aspects of administrative law. Whilst the bulk of legal opinion views disputes relating to such matters as of a contractual law nature, the Russian government has suggested that such matters are not arbitrable, any arbitral award granted in such a matter likely to be declared invalid. The law On International Commercial Arbitration explicitly states that the performance of an arbitration decision may be refused if the court finds that the issue contested cannot be the subject of arbitral proceedings due to provisions of a law of the Russian Federation (article 36.1.2 of the Law No. 5338 – 1 dated July 7, 1993 'On International Commercial Arbitration'). Although amendments to article 50 of the law On Subsoil have provided that disputes with respect to issues of subsoil use are to be resolved in accordance with the terms and conditions of the respective PSA, and thus may be submitted for international arbitration, other types of administrative law disputes remain outside the scope of resolution by an international arbitration court.

This analysis of the efficacy of a PSA in protecting an investment would not be complete, however, without considering its availability. As was stated earlier in the article, the amendments to the PSA law of 6 June 2003 limit the circumstances under which the PSA regime can be used to produce those mineral deposits for which there are no available investors under the normal license regime. Article 2, as amended on 6 June 2003, establishes the requirements for the use of a PSA. A field may become available for PSA development only after; an auction for the development of such a field on the standard licence and tax terms has been held and declared void due to the lack of bidder; this field complies with at least one of certain additional conditions introduced in the law in accordance with article 2.4; and this field has been included in the list of fields eligible for PSA development.[17]

Thus, if there is a subsoil user holding a licence who wishes to enter a PSA with the state for the licensed field, under the amended article 2.4 the licence holder must first surrender his licence in order to permit the government to conduct an auction at which other investors would be entitled to bid. Only if there is no investor interest in a field tendered under the regular licence regime could the government then include the field in the list law, whereupon the government could hold an auction for a PSA.

The procedure by which the government awards a PSA has also changed as a result of the amendments. Article 6

[16] Federal law No. 51 f3 dated November 30, 1994 'The Civil Code of the Russian Federation Part 1.', Article 450.3, stipulates that 'in the event of a unilateral refusal to perform a contract wholly or partially when such refusal is permitted by a law or by agreement between the parties, the contract shall be considered to be dissolved or changed respectively,'

[17] The law did not establish how the government would proceed in case there were no investors to develop the field under the regular license regime, but other applicable criteria were not met.

of the amended law makes auction the only method for granting PSA rights to an investor. Article 6.2 which previously authorised direct negotiations under certain circumstances has been eliminated. After the conclusion of an auction the government of the Russian Federation, in coordination with the executive body of the federation subject in which the deposit is located, then creates a negotiation committee that shall conduct negotiations to conclude a PSA agreement.

The introduction of an auction system may bring greater transparency to the granting of PSAs. Previously, license holders who enjoyed administrative support converted their subsoil license into PSAs through a process of negotiation. Indeed, the general confusion that such non-transparency induced helps explain the division of opinion over Exxon's right to develop Sakhalin 3. In this case a tender was held for the field to be developed on PSA terms. The winning party attempted to negotiate a PSA agreement with the federal and regional government. Yet, as has been elaborated upon, it is only once a PSA is concluded that a license is issued automatically. Exxon had not been able to conclude a PSA. Furthermore, if it were to be stipulated in the license that the subsoil was to be developed on a PSA basis then it cannot be developed under the normal license regime.[18] Indeed, many of the problems that have plagued the development of Sakhalin 3 are explicable by the failure to introduce any amendment to the PSA law to resolve longstanding problems. For a more comprehensive PSA regime what remains required is; a clear procedure for concluding PSAs; and the introduction of a practicable procedure for governing the holding of auctions for subsoil use rights for the exploration and production of mineral resources under PSA's.

The most recent legislative amendments appear to have the narrowed the possibility of investing under the PSA regime, encouraging the question as to whether the ordinary license scheme provides a better alternative. This consideration has been encouraged by the fact that several recent judicial decisions have provided grounds for believing that non-PSA projects can secure an investor's rights. Furthermore, in terms of the improvement of the legislative framework, the new law On Bankruptcy has improved the potential for financing as secured creditors are guaranteed first priority with regards to assets secured by a pledge.[19] The new law On Currency Control[20] has liberalized the regulation of hard currency transfers, and the amendment of the law On Joint Stock Societies has improved the protection of shareholder rights.[21]

Yet the piecemeal development of subsoil legislation has led to licenses being flawed, the flaw either deriving from its original issuance, a transfer and re-issuance, or non-compliance with license obligations as will be discussed below.

4. Problems Specific to Licensing

The law On Subsoil contains provisions regulating; the issuing of a license authorizing the use a subsoil area (*article 10.1 of the law On Subsoil);* the guidelines for determining the maximum term of license validity (*article 10*); and guidelines for the organization of tenders and auctions for the use of sub soil (*article 13.1*). Although article 10.1 of the law On Subsoil expressly states that a license should be awarded following an auction, often companies have acquired licenses without auctions, and the deposits for which this license held have not been explored. Furthermore, article 13.1 fails to detail a clear procedure for the convention of an auction or tender, especially the criteria for considering an application. As a consequence, there are continuing uncertainties as to the agencies that are authorised to rule on tenders and auctions.

Establishing the procedures and terms for tenders and auctions is a shared authority of the bodies that have the right to issue subsoil use licenses. In reality, however, local departments of the Ministry of Natural Resources appear to have usurped certain powers, the most prominent example of which is the approval of the list of tendered subsoil properties. The attachment of additional conditions to the auction or tender is also widespread, both actions inconsistent with article 13.1 of the law On Subsoil. Although article 13.1, by its reference to article 10.1, gives the regional executive body and the local departments of the Ministry of Natural Resources the right to determine procedures for tender or auctions, this power must be exercised within the provisions stipulated in the law On Subsoil.

Significant issues have arisen in practice in relation to licence issuance including the improper execution of the licence by the issuing authorities, a failure to include all the terms required by law in the licence, a failure to register the licence with the relevant fund, or a failure to obtain appropriate land and mining allotments. Of concern is the reality that in terms of providing legal protection

[18] If a field is included on a list law for PSA development then it can only be removed if the Duma passes a subsequent law that the field be removed from the list.

[19] Federal law No. 127 f3 of 26 October 2002 'On Bankruptcy.'

[20] Federal law No. 173 f3 of 10 December 2003 'On Currency Regulation and Currency Control.'

[21] Federal law No. 208 f3 of 26 December 1995 'On Joint Stock Companies' and as subsequently amended.

against licence flaws identified in a due diligence the investor only has the option of attempting to mitigate his risk by obtaining a formal comfort from the issuing authority of its compliance with the issuing procedure or from the registering authority on the consequences of improper registration.

Indeed, in reality, even after proceeding through the many stages of the tender and auction process the winning bidder can be blocked from proceeding under the terms of the subsoil license. Auction organisers have often exploited gaps in the law that have permitted them to deny the endorsement of the results of tenders and auctions. Court procedures do not provide a clear answer as to whether the Ministry and regional executive authorities are required to unconditionally endorse the results of properly conducted tenders and auctions and to issue a sub soil licence to the winner.

An integral part of the subsoil licensing procedure is the licence holder's right to the relevant surface land plot. In accordance with the provisions of the law On Subsoil the preliminary boundaries of the subsoil mining allotment are defined upon the issuance of the licence and are specified in it. The final land allotment to the licence holder is made after the programme of work on the licensed field is approved, and must be obtained prior to commencing subsoil use (article 11 of the law On Subsoil). The formulation of this lease agreement is, however, subject to the provisions of the Land Code.[22] In practice the local authorities deliberately postpone the conclusion of the lease agreement due to the absence of an integrated approach in legislation to the issuing of both subsoil and other necessary use rights. It is the absence of any guarantee that the requisite permissions will automatically follow the award of a subsoil use licence that perpetuate the instability of the licensing regime.

Another one of the main problems confronting an investor is that of securing that the use rights under the licence are not vulnerable to termination by the state. As the state has a unilateral right to terminate the licence it is imperative that the investor does not become liable for the previous non-fulfilment of the obligations under the licence. Under the licence regime the obligations of the subsoil user are established in the licence agreement. The provisions of article 17.1 of the law On Subsoil states that legal entities acquiring a licence are responsible for all the obligations of former holders of the licence to the extent that they were not fulfilled. In contrast, under a PSA the investor has civil law obligations under the agreement. The investor does not answer to the issuer of the licence as the right to subsoil use is not transferred but arises automatically.

In practice there are always problems for a licence holder fulfilling their obligations, licence, agreements imposing numerous obligations on the licence holder. Under Russian law the licence holder, in addition to paying the applicable taxes and fees, must also submit to the federal and regional authorities certain geological annual reports on the work and financial activity of the licence holder, and submit data on the mineral resources within the licence area to the system of state monitoring. More onerously, commitments under the licence agreement will typically include the obligation to follow development plan provisions and to prevent environmental damage (article 22 of the law On Subsoil). Failure to comply can lead to fees, the suspension of production, and in the case of a breach of the essential terms of the licence, the list of which is established in article 12 of the law On Subsoil and whose nature is defined in article 432.1 of the Civil Code, the licence may be revoked (article 20 of the law On Subsoil). The threat of license revocation is frequently deployed by the Ministry of Natural Resources.

The legal form of participation in a project is of primary importance with regards to its financing. Under a PSA foreign companies can participate as a party to the agreement of joint activity. In the framework of the licensing regime participation in the project is restricted by there being only the possibility of assigning the subsoil use right to a Russian daughter company.[23]

Article 17.1 of the law On Subsoil stipulates the general rule that subsoil use rights are not transferable, including by way of security. There are, however, exceptions to this rule, the fact that these exceptions to the general rule on assignment have changed over time inducing contradictory interpretations as to whether the rights under a licence may be assigned to third parties. The 1992 law On Subsoil did not permit the re-issuance of licenses. The 1995 law On Subsoil permitted the re-issuance of licenses only when the license holder underwent a corporate reorganization, merged with another company, or if the license holder went bankrupt. Assignments to third party, however, were not permitted. However, in 1995, the Committee on Geology and Sub Soil Use issued Order No. 65 of 18 May 1995; its Instructions purported to create an exception to this rule. Section 17 of Instruction No. 65 stipulated that in case a company user of subsoil founded a new company, including a joint venture with foreign investments, with the special purpose to continue subsoil use in compliance with the terms of the licen-

[22] Federal law No. 136 f3 of 25 October 2001 'The Land Code of the Russian Federation.'

[23] The establishment of a joint enterprise is the most typical way of achieving the participation of a foreign investor in the project.

se at a land plot belonging to the company's founder, and the company founder held at least a 50% interest of the new company, the license could be assigned to the new company.

It became common practice for Russian oil companies to assign subsoil use rights as a capital contribution to joint ventures, although the validity of such assignments of subsoil rights as capital contributions was questionable, the rights based on the underlying subsoil use licences i.e. administrative instruments. When the validity of the licenses, that were assigned and reissued in reliance on Clause 17 of Instruction No. 65, were challenged by interested parties in the Russian courts, the courts usually invalidated the re-issuance on the grounds that Clause 17 was contrary to the 1995 Subsoil Law.[24] Clause 17 of Instruction No. 65 was finally abrogated on 22 April 1999 by Order No. 89 of the Ministry of Natural Resources. The amendments to article 17.1 of the law on Sub Soil that went into force in January 2001 resolved much of the confusion surrounding this issue by legitimizing the transfer of subsoil use rights from the holder of a subsoil use license to another new entity to the extent that the old license holder has acted as the founder of such an entity and holds at least 50% interest in such an entity at the time of the transfer of rights.

The primary issue associated with the license transfer regime is therefore that a licence transfer and re-issuance might be found not to have complied with the transfer rules in effect at that time. This is a real risk as many licences were the subject of transfers and re-issuances during the four-year life of Clause 17 of Instruction 65. Although it is not clear as a matter of law what should happen when a reissued licence is invalidated as a matter of practice in most cases the licence reverted to its original holder i.e. the original licence issued to the transferring licence holder was reinstated.

Indeed, the inadequacy of the existing subsoil use legislation, which today embodies an unsystematic collection of statutory and administrative acts, has prompted the Russian government to initiate on numerous occasions the preparation of new subsoil legislation. The most recent draft law On Subsoil, that was released by the Ministry of Natural Resources on 22 August 2003, along with a draft proposed by the Ministry of Economic Development, was submitted to the Duma Committee on Natural Resources. This draft has not yet been submitted for its first reading due to the changes of the structure in the government. In addition, two drafts of a Subsoil Code have been proposed, the first by the Ministry of Natural Resources and the second by a group of Duma deputies. The contradictions between the drafts are representative of the divisions that have plagued the development of the licensing regime. The draft law On Subsoil proposed by the Ministry of Economic Development was based on the principles of civil law, in contrast to the draft proposed by the Ministry of Natural Resources. Perhaps most significantly it removes the right of unilateral termination from the authority issuing the licence, and proposes that the subsoil use right can be pledged, providing an important mechanism for the raising of project financing.

Although, following the reorganization of the federal executive bodies, the Ministry of Natural Resources was authorized to prepare a new draft law On Subsoil it remains interesting to highlight some of the provisions of the draft law of 23 August 2003. Perhaps most importantly, it stipulates at article 45 that if a company has used its own resources to explore a field and a discovery is established 'it *shall* have the right to produce minerals from this field.' In the current law On Subsoil it is assumed that the exclusive right to production license in the event of discovery *may* be granted. By 'own funds' from which the geological survey was made the draft law means; own funds of the subsoil user; credit sources; borrowed funds; and funds received by the subsoil user into his property for free and irreversibly. If the state's contribution exceeds 50% of the costs related to the discovery the discovery will not be considered as being made from the subsoil user's own funds.[25]

In a similar vein, in the current law it is stated that a license for mineral production *may* be extended if there is a need to complete extraction. The provisions of article 18 of the draft law states that the period *shall* be extended by application of the subsoil user provided that he complies with the stipulated terms and conditions of subsoil use, in the case of a geological survey for up to 3 years, and in the case of mineral production for the period needed to complete development of the field.[26]

In the draft it is stated that subsoil parcels cannot be the subject of civil transactions, including sale and purchase agreements, and pledge agreements (article 8.4 of the draft law On Subsoil of 22 August 2003.). In contrast to the provisions of the current law, however, the rights to use the subsoil parcels may be alienated from one entity to another (article 20 of the law On Subsoil).

[24] This was the reason given by the Tyumen Arbitration Court in its ruling in favour of OJSC Tyumenneftegaz in 1997.

[25] But the fact of the discovery should be registered in accordance with the special procedure approved by the Ministry of Natural Resources. (Resolution No. 93 of 10 April 2000).

[26] The extension procedure for subsoil use for PSAs shall be determined by these agreements.

As has been outlined, article 17.1 of the current law allows for the assignment of a license only in cases of legal succession: a reorganisation, the termination of the legal entity, and the formation of a new company by the subsoil user.

Yet, it is the continued lack of clearly defined regulatory authority, and not the imperfections of legislative acts, that can be identified as the main impediment to the erection of a framework that facilitates investment activity. Both in the current and proposed law On Subsoil there is a possibility that the license may be prematurely terminated, suspended or restricted by the bodies, which granted the license. In the proposed draft the number of such cases is reduced, removing the right to terminate the licence on the grounds of: the systematic breach of the subsoil user of the subsoil use rules, and, the non-reporting by the subsoil user of bookkeeping in accordance with the subsoil legislation (article 29 of the draft law On Subsoil of 22 August 2003). The grounds for the withdrawal of a license have been narrowed yet the scope still remains for arbitrary administrative action.

The most important changes proposed, however, attempt to address the issue of the overlapping and ill-defined competences of federal and regional governments, an issue identified as being a source of many of the problems of legislative implementation identified in this article. Under the current law in the majority of instances the decisions of both federal and regional authorities are required to grant subsoil licenses (article 10.1 of the law On Subsoil). In the draft law the main role in the issuance of licenses is located with the federal authorities. Instead of a joint decision of the federal and regional authorities, the draft law states that when granting a license, the decision of the federal executive body shall be merely co-ordinated with the regional executive authority (article 23 of the draft law On Subsoil of 22 August 2003).

It is very important that the draft law identifies the level of state ownership of subsoil in general as being federal.[27] In the current law On Subsoil it is stated that subsoil shall be state property, a notion including both federal and regional ownership. This removes subsoil ownership rights from regions of the federation. This provision attempts to negate the principle of joint jurisdiction established in article 72 of the Constitution. Pursuant of article 72 the federal government and the relevant regional government jointly grant mineral rights. It is unclear how this departure from the Constitution could be justified, and whether or not, if it was given legal force, such a provision could be implemented effectively in practice.

Similarly, the proposed move towards a contractual subsoil use system in the Draft Subsoil Code is unlikely to have any impact in reality. The Draft Subsoil Code proposes that mineral licences be replaced by a contractual framework for subsoil use in which mineral rights would be granted pursuant to a special subsoil use contract executed between the state and the investor.[28] These contracts would be governed by civil law principles, setting forth the rights and obligations of the investor and the state in respect of the relevant field for the term of the contract. The issuance of a licence as an administrative act provides the responsible official with almost unbridled power to award or revoke. It would be unrealistically optimistic to hope, however, that a contractual system would in itself eliminate corruption. The same government officials that are responsible for the issuance of a licence would participate in the drafting of the subsoil use contract. The advantage of the move away from licensing as an administrative act is that under the contractual system an investor would in theory have access to more remedies against the state for breach of the contract. A contract, however, may also be vulnerable to bureaucratic extortion, and the level of protection it provides will primarily depend upon the terms of the contract and the practical limitations on enforceability.

Until these provisions become law, and more importantly, are effectively implemented, in reality the license regime will continue to be rendered inoperable by the contradictory interests of federal and regional government. These contradictory interests are, in turn, fuelled and exacerbated by the changing juxtaposition of government and business both in Moscow and in the regions. To illustrate this point, the allocation of subsoil areas, and the development of subsoil use terms in a PSA usually come from the regional administration. Yet it is regional branches of federal agencies that are involved when subsoil licenses are issued to projects and when rentals for a given PSA are calculated. As has been evidenced by the Yukos affair, however, the role of large companies within the sector, their ability to influence regional authorities, has rendered the operation of such arrangements, dependent on a host of institutions and individuals carrying competing interests, impracticable. It is for these reasons, and for those elaborated upon in the conclusion, that we are witnessing a movement away from PSAs, towards the conclusion of strategic alliances with established operators in a specific region.

[27] Article 8.2 of the draft law On Subsoil of 22 August 2003. Article 8.3 limits regional ownership to subsoil in land subsoil areas of local significance.

[28] See chapter 5 of the Federal Legislative Project 'The Subsoil Code of the Russian Federation' No. 218732-2.

Conclusion

Upon its election to office the Putin administration appeared to be making a concerted effort to address many of the fears of Western investors, the President at the Sakhalin conference on Product Sharing Agreements in September 2000, emphasizing the need for an increased input of foreign investment to increase oil and gas extraction. The creation of a more coherent and operational legal framework, providing better security and profitability for foreign investment in the petroleum sector was presented by the Minister of Economic Development and Trade as a part of a new national 'grand strategy'. But the provision of an effective legislative environment has remained, as will be detailed, inextricably connected to the crystallization of personal, corporate and institutional relationships.

In February 2003, a meeting between prime-minister Kasyanov and domestic oil executives produced proposals to restrict the tax and regulatory guarantees used to attract foreign investments to the oil industry. The group proposed that future guarantees should only be offered to the largest and most capital-intensive development projects. This proposal was evidence not only of a clear shift in opinion towards the idea that the domestic oil industry was capable of developing its own reserves, but of the pervasive influence of the large scale producers on both policy and legislation. A year ago, in conjunction the BP TNK deal, it had become clear that foreign investment should take the form of equity stakes in Russian oil companies. A year later it is not clear who will ultimately control shares in these Russian oil companies, the focus of attention moving away from competition amongst foreign suitors to the outcome of a criminal trial.

To understand the debate surrounding the development of PSA legislation it is necessary to understand how this regime is perceived as well as analysing its substance. In January 2003 the CEO of United Machinery Plants addressed a hearing of the Duma devoted to the issue. He equated the Russian tax regime with that of Norway and Canada; if a barrel sells for 12.50 USD the producer pays 27.3% tax; above 22.50 USD they pay 40.4%; above 30 USD they pay 60%. He suggested that the taxation set for PSAs is only between 12.5 to 25% of these levels, explicitly equating PSAs with the infamous offshore havens that do not bring investments into the national economy.

In reality, however, foreign investors in Sakhalin, as parties to a PSA, pay royalties equivalent to 6% or 8% of each ton of produced oil. They also have to pay corporate profits tax on their share of the profit oil production at between 32 to 35%. In comparison domestic companies are charged 24% as their corporate profit tax. Crucially, PSA investors pay taxes for specific projects at the place of their operations. In contrast, domestic oil companies operating under the regular fiscal regime and paying taxes where they are registered have been able to reshuffle their taxes by switching venues, and registering subsidiaries in quasi-offshore havens in Russia or Kazakhstan.

The new departure in policy is that neither group, neither domestic producers nor potential foreign investors, are perceived to serve the interests of the state. Precisely because the interests of the state are subject to the same individual, corporate and institutional struggles as those that are evident between the state and the privately owned producers. The Audit Chamber announced in December 2003 that it would examine the sell off of state assets as well as evaluate the taxes levied on oil majors Yukos and LUKoil and Sibneft. Following Putin's suggestion that new taxes on oil profits would be introduced, both the Ministers of Economics and Finance, both declared free market reformers, joined campaign against tax avoidance. This includes legal schemes for tax avoidance – what are phrased as optimization schemes.

It is therefore not difficult to comprehend why that although foreign companies in Russia hold stakes of different sizes in around 40 oil producers very few oil producers develop their oilfields on the basis of PSAs. As the BP purchase deal with TNK shows, the future of investment in the petroleum sector lies in formation of strategic partnerships and the acquisition of ownership in Russian companies. This activity has begun, despite of the fact that the country's legal and business institutional environment has been characterised by a lack of transparency and reliability in contract law and property rights, and a lack of regulatory predictability.

In this context, the scope and impact of amendments to company and tax legislation, along with the development of a consistent judicial practice, are of undoubted importance in securing an investment. More importantly, however, is the receipt of a guarantee, provided by the state and not the provisions of legislation. For oil and gas projects the ability to export is the key for project performance. This ability is subject to a non-transparent regulation of the access to transport infrastructure. Pipeline construction projects are subject to regulatory and political risks as the structure of such projects largely depend upon political consensus between private oil companies and the state. Yet ultimately control over the country's pipeline system gives the government considerable influence over the industry. It was one man's attempt to subordinate the state's interests to his own that has ensured that the perceived security of investing in Russia, be it under a PSA or the ordinary licensing regime, will largely be determined by the outcome of his criminal trial. □