M & A guide for the Russian oil and gas industry

Legal and tax issues of mergers, divestitures and acquisitions

By Asset Capital Partners and Nörr Stiefenhofer Lutz

Preface by RPI*

Since the start of 2005 the Russian M&A market in the oil and gas sector has undergone fundamental change and at the same time has been demonstrating strong growth. During this period the total amount of closed deals exceeded US$ 30 billion, accounting for every two dollars out of five paid in more than 700 M&A transactions made in Russia. The intensity of such activity can be explained by several reasons: massive growth of the government's role in the Russian oil and gas industry; availability, strategic importance and relatively low cost of reserves; the comeback of licensing as a method of accessing reserves; optimisation of asset portfolios by the Russian oil and gas players; the Russian energy companies' growing appetite for expanding and acquiring new assets internationally; the mounting importance of the Russian petroleum market against the backdrop of surging oil prices.

Tightened government control over the industry ensured the domination of the Russian players in the M&A market with state-controlled giants Gazprom and Rosneft leading the way as the biggest spenders. Thus, Rosneft paid US$ 9.35 billion to establish control over Yuganskneftegaz, the former key production unit of YUKOS, while Gazprom acquired Sibneft, Russia's fifth-largest oil producer, for a record US$ 13.7 billion. These mega deals were followed by several others of smaller, but still rather significant size: Gazprom acquired Sevmorneftegaz for US$ 1.34 billion, TNK-BP divested Udmurtneft to the Rosneft-Sinopec alliance for US$ 3.5 billion and Saratovneftegaz to Russneft for US$ 432 million. The list of last year's important deals also includes the sale of the Russian government's remaining 7.59% stake in LUKOIL for US$ 1.988 billion to ConocoPhillips, which staged the scene for the U.S. major's ensuing purchase of more LUKOIL stock.

Having reasserted its position as a dominant factor in the oil and gas industry, the Russian government practically reshaped the configuration of methods used by market players to access hydrocarbon reserves in Russia. Compared with the early 1990s, when the cash-strapped industry welcomed foreign investment, recent years saw that focus shift as domestic majors built muscle and used government support to put a lid on the foreign companies' bids to acquire Russia's upstream assets.

This change came to marginalise the previously used methods such as **joint ventures and production sharing agreements (PSAs)**. Joint ventures were popular in the early 1990s, but went out of practice by the late 1990s after the industry almost completely ended in private hands. PSAs were originally seen as a method of attracting foreign investment into major, capital-intensive projects, but in the late 1990s they fell out of favor with both the Russian government and domestic oil and gas companies. Currently, the outlook for PSAs is dim, but even if the concept of PSAs makes a comeback, its use will be limited to strategic, predominantly offshore projects with Russian players in the front seats.

In the last few years other methods such as **licensing** came to the foreground, giving bidders first-hand opportunity to acquire hydrocarbon assets through direct participation in licensing auctions. Until late 2004 licensing in Russia was dormant or irregular, but in 2004 the authorities awarded 32 licensing blocks, in 2005 the number rose to 129, and in 2006 the Ministry of Natural Resources plans to award several hundred blocks. Buying into Russian upstream through acquisition of companies that emerge as winners at licensing auctions is another option that is becoming increasingly popular.

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Today, would-be lessees practice both approaches. As a rule, licensing attracts small foreign firms who bid for small- and medium-size assets. The number of foreign majors bidding in this segment of the market is fairly negligible - they target larger assets, but at the same time exercise caution as the pending legislation on restricting access to reserves in Russia's strategic industries is likely to put most of the targeted fields out of their reach. Another source of assets is licenses revoked by the government regulator because of violations of licensing agreements.

Mergers & acquisitions remains to be a key instrument for gaining access to reserves, though it has undergone important developments in the last several years. Apart from the creation of TNK-BP, which was the last large M&A deal not directly engineered or closely coordinated by the Russian government, all other major purchases follow the new script that generally gives preference in acquisition opportunities to the state-owned companies.

The failed buy-in of Western energy majors into YUKOS and the successful LUKOIL-ConocoPhillips set of transactions were the landmark cases that set patterns for the government's involvement in planning and in effect regulating large-scale deals. The government assumed the role of the 'arbiter' among the large Russian oil and gas players, both state-controlled and private. Foreign strategic investment in projects with low geological risk will be limited to non-controlling stakes and wherever feasible, within a broader context of strategic alliances or asset swaps (see also asset swaps below), while also carefully tailored so to avoid serious competition with the incumbent players. For the large international players, the key development is the shift to opportunities with greater geological risk, as well as to other instruments for buying into assets and accessing reserves.

Opportunities associated with M&A are numerous and diverse. Companies operating greenfield projects present one such opportunity that has started to attract both Russian and international petroleum companies. A telling example is Rosneft, which has a number of consortia to develop exploration-stage offshore projects, with foreign companies (such as BP, Sinopec and KNOC) acting as minority partners. This kind of *modus operandi* is expected to be further used with companies from China, India, Japan and South Korea, considering limited opportunities offered to Russian companies in their markets. However, for Chinese and possibly Indian companies strategic considerations are likely to open managed access to mature assets as well.

On the medium- and small-company level, M&A activity is dynamic with lots of assets changing hands. Certain companies like Russneft and Urals Energy have been demonstrating impressive acquisition-driven growth and are approaching the reserves and production levels of the smaller Russian majors (vertically-integrated companies).

The ongoing restructuring and optimising of upstream portfolios by several Russian oil majors has already led to divestitures of a number of important assets, with LUKOIL and TNK-BP having been at the forefront of this process. Assets sold by these companies found new owners among different types of players, depending on the size of asset – both majors and independents, Russian and international.

Another strengthening trend has been the return of Russian money that had moved abroad during the notorious capital flight of the 1990s. Fronted by foreign investment outfits, these funds are now coming back home in increasing amounts.

Under the current circumstances **strategic alliances and asset swaps** have emerged as the key approaches for the large players. The multi-faceted deal between LUKOIL and ConocoPhillips has been the first prominent case where the agreements were structured with the government's consent and active participation. Recently, Gazprom's top management has declared publicly that negotiating asset swaps was the "definitely preferable" method of developing business with foreign partners – a method exemplified by the deals with BASF/Wintershall and E.ON/Ruhrgas, as well as by the negotiations agenda with a number of other international companies.

Such alliances are seen as a vehicle and part of the strategy of Russian oil and gas companies to penetrate and develop on international markets – most recent examples include Gazprom's buildup of stock in Wingas, its joint venture with Wintershall, as well as a swap with E.ON involving Gazprom's acquisition of stakes in two Hungarian gas companies and a power firm in exchange for a stake in the giant Yuzhno-Russkoye field controlled by Gazprom.

Though government regulation tends to reduce investment opportunities to foreign entities,

Russia's petroleum industry still has plenty of assets to offer. The key to success in entering (or expanding in) your upstream base is to weigh properly your options and clearly identify your target, as well as the most suitable method of entry. Current tendencies speak in favor of small- and medium-size foreign companies willing to operate smaller, older or more complex fields, while major projects requiring huge investments may involve international majors on a risk-sharing basis. The period when foreign capital was at the top of the investment agenda has come to an end as mountains of petrodollars helped build several of Russia's own oil company empires. However, it should not be overlooked that the Russian government recognises the need for foreign investments in the oil and gas industry. Only recently the Russian Minister of Natural Resources Yuri Trutnev estimated that US$ 55 billion were needed just to search for and develop new fields.

Well conscious of their financial might, Russian firms will not stop here and are actively seeking ways of entering markets abroad in Europe, Asia and the Americas, while at the same time tightening the grip on its own market. Such developments will open the door for asset swapping and test the foreign markets' readiness to accept new players from Russia. At the same time, it will provide opportunities to buy into Russian upstream assets at a time when the chances of direct large-size takeovers in the typical M&A fashion look increasingly slim.

Before emerging as a successful investor in an M&A market as complex as Russia's, one needs to come to grips with a multitude of issues stemming from its complexity. That effort may be facilitated by the use of a reliable source of information, which provides an in-depth insight into related issues.

The *M&A guide for the Russian oil and gas industry* sheds light on the whole range of market-related issues, including legislative, regulatory, fiscal and other aspects. We find the report unique in the way it provides readers with a comprehensive and meticulously structured framework for navigating through the field of Russian oil and gas M&A. We are confident that the *M&A guide* will be of important help to its readers in developing a better understanding of the current and future Russian M&A reality and will provide valuable guidelines for making successful business decisions.

1. Introduction

This Mergers & Acquisitions ('M&A') guide for the Russian oil and gas industry is written for companies and individual investors interested in acquiring or divesting Russian oil or gas assets with a focus on the upstream sector. It shall be a practical guide and thus provide practitioners with much needed guidance in this complex field.

The legal and tax framework of the Russian oil and gas industry is ever evolving. Despite the constant changes in the legal and tax environment, the regulatory framework of the oil and gas industry in the Russian Federation can now be considered as mature. It provides investors with certainty which is necessary in preparing investment decisions.

This guide is published at a time when a major change has been announced with the proposal to introduce a new Subsoil Law. On 17 June 2005 the Government submitted Draft Law No. 187513-4 "On Subsoil" to the State Duma (the lower house of the Russian parliament) ("Draft Subsoil Law"). According to the information publicly available as of the date of this guide,[1] the State Duma decided on 24 January 2006 to postpone the examination of the Draft Subsoil Law and no new date for the first reading of the draft has been set. There has been no further statement from the State Duma with regard to the draft law since. A revised draft has been published by the Ministry of Natural Resources in February 2006 ("Revised Draft Subsoil Law") but is still under discussion. It appears that the draft law is not likely to be adopted in its current form in the near future due to the opposition from major Russian oil and gas companies. Although no new subsoil law has been passed and no date for the enactment of such a law has been given, the existing drafts provide insight into current thinking and are reflected in this M&A guide.

The guide is divided in the following chapters:

- The second chapter provides a brief overview of the **Russian oil and gas market**.
- The guide explains in the third chapter the **assets** which can be acquired or divested in the oil and gas industry.
- The fourth chapter will deal with **investment structures** and show the most important structures used in practice.
- In the fifth chapter we will discuss the **legal due diligence process** and provide an overview of the aspects which have to be reviewed by the potential acquirer (and ideally well prepared by the party selling assets or shares).

[1] See the State Duma's official website http://www.duma.gov.ru/.

- The sixth chapter will provide an overview of the **documentation** involved in M&A transactions. It will discuss both the investment itself and its financing.
- The seventh chapter gives an overview of the **notification and approval requirements** under Russian law for acquisitions and divestitures.
- In chapter 8 we look at **legal issues of the target company**, in particular corporate governance aspects of Russian companies and the issue of shareholder rights under Russian company law (the latter is particularly important to minority shareholders).
- In the ninth chapter we discuss **taxes and other payments due to the State**. This is particularly important since tax payments have become a main aspect for the profitability of oil and gas companies in Russia. Tax rates and export duties reported in the guide are expected to be changed frequently from the time of the guide's publication. However, specific figures have been included in the text to provide readers with a starting point for further enquiries.
- Lastly, **currency law and export law issues** with respect to hydrocarbons are discussed in chapter ten.

We are grateful for the support provided by Statoil ASA and RPI. Both institutions have commented on the drafts prepared by Asset Capital Partners and Nörr Stiefenhofer Lutz. Furthermore we would like to thank Jon Hines, partner at LeBoeuf, Lamb, Greene & MacRae, for his valuable remarks on a draft version of the text. The responsibility for the content of the guide rests, however, with Asset Capital Partners and Nörr Stiefenhofer Lutz.

There is currently only little literature about the technicalities of M&A transactions in the Russian oil and gas industry. We would be grateful for comments from readers which may help further to improve future editions of this guide. You can address any comments you may have to Jan-Hendrik Röver (roever@assetcapitalpartners.com) or Dr. Peter Zier (peter.zier@noerr.com).

Needless to say that acquisitions and divestitures are extremely complex transactions which require careful preparation both from the selling and the buying party. Each transaction will provide its specific challenges. The teams of Asset Capital Partners and Nörr Stiefenhofer Lutz have many years of experience with completing complex M&A transactions in Russia and are at your disposal for assisting you in closing your transactions successfully.

2. Russian oil and gas market

Russia holds 6% of the world oil reserves and ca. 25% of the world gas reserves. It is the world's second largest producer of crude oil after Saudi Arabia. Although several oil and gas companies are fully or partially state-owned (most notably Gazprom and Rosneft) the Russian oil industry, like e.g. the US-American or Canadian oil industry, is characterised by a large private sector. Several of the major oil companies are privately-owned and there is a group of privately-held independent oil and gas companies. At present there are about 150 independent oil companies that account for ca. 7 percent of the country's oil production.[2] The group of independent gas companies with sizeable operations comprises less than 10 companies.[3] Refineries are mostly owned by the Russian oil majors.[4]

The Russian oil and gas industry is clearly of interest to local and international investors alike with many foreign oil companies already having made investments in the Russian oil and gas sector. Particularly prominent examples of foreign investors are ExxonMobil (with their involvement in the Sakhalin 1 project), E.ON Ruhrgas (with their investment in Gazprom), Wintershall (with their engagement in several of Gazprom's upstream activities), BP (with their joint venture with TNK), Shell (with their participation in the Sakhalin 2 liquefied natural gas offshore projects and their oil production in Western Siberia at the Salym field), ConocoPhillips (with their investment in LUKOIL and Polar Lights) as well as Total and Hydro (as the major investors under the Kharyaga production sharing agreement). Despite these examples the majority of transactions is still done by local investors.

The Russian oil and gas market is currently at a very dynamic stage. There are literally hundreds of assets whose development is to be funded. These assets are either auctioned by the state or offered by investors who already purchased the subsoil use rights. And even among major Russian oil and gas companies the consolidation process is far from being finished as the takeover of Sibneft by Gazprom has proven.

There is currently much talk about a nationalistic trend in the Russian oil and gas industry in the sense that the state wants to increase the share of

[2] For an overview see RPI (ed.), The Independent Oil Producers in Russia: Companies and Assets (August 2005).

[3] See RPI (ed.), The Independent Gas Producers in Russia (February 2006).

[4] RPI (ed.), The Future of Russian Refining and Exports of Oil Products (July 2005).

state ownership in the industry. Much of this talk seems to be exaggerated particularly since private investment is an important factor in the development of the Russian oil and gas industry. Although state driven consolidation may occur among major companies (and may also have an effect on large assets) it is to be expected that the need for investments as well as technological support will always keep a window open for the private sector.

3. Main assets of hydrocarbon companies

The first issue to consider is which assets are available for a divestiture or an acquisition.

3.1 Hydrocarbon reserves

Under Russian law currently in force ownership to hydrocarbon reserves in the ground is deemed to be State property under the joint jurisdiction of the Russian Federation and the respective region where the reserves are located. However, the Draft Subsoil Law states that the subsoil and minerals, energy and other resources contained therein are federal property only.

Although reserves are not legally owned by the company holding the subsoil use rights, in economic terms they still are assets of the person holding the respective subsoil use rights. This becomes clear in any financing situation which will i.a. rely on the reserves in the ground "held" by the oil and gas company. Financings such as reserve based lending, project financings,[5] export trade financings and even corporate financings will essentially rely on the amount of reserves available. Reserves are assessed by specialised state institutions (currently the State Reserves Commission [Gosudarsdvennaya Komissiya po Zapasam Poleznykh Iskopayemykh = 'GKZ'] and the Territorial Reserves Commissions [Territorialnaya Komissiya po Zapasam Poleznykh Iskopayemykh = 'TKZ']) appointed by the Federal Agency for Subsoil Use (Russian abbreviation: Rosnedra) upon discussion with the Ministry of Natural Resources of the Russian Federation. Once the assessment is completed, Rosnedra confirms the reserves.[6]

Practice note: Often it will not be sufficient that Rosnedra has confirmed the reserves. Particularly for the purpose of obtaining financing or in the context of an M&A transaction reserves will have to be confirmed by a reserves audit from an independent reserves auditor.[7] For senior debt financings banks will typically lend only against proven (P90) reserves of producing fields and will require a 'reserve tail'[8] of between 20-30% of the financing amount.

3.2 Exploration and production rights

Currently private companies are granted rights of use with regard to hydrocarbon reserves under two different subsoil use regimes, the licensing regime and the production sharing agreement regime.[9] Under the Draft Subsoil Law a regime of regulated contracts has been introduced; it is as yet unclear whether or not production sharing agreements will be signed in the future. The Draft Subsoil Law provides that the old licensing regime and the production sharing agreement regime which are applicable under the current Federal Law on Subsoil shall continue to apply to existing licences and production sharing agreements. We will, therefore, discuss both the existing and the draft rules.

3.2.1 Licensing regime

To date several thousand subsoil licences were issued. Licences are – due to their limited transferability – not freely disposable assets of a hydrocarbon company. There are three types of hydrocarbon licences, namely the exploration licence, the production licence and the combined licence.

3.2.1.1 Exploration licence (sometimes also referred to as "geological research licence")

- Issued for up to 5 years
- Only for certain exploration activities

3.2.1.2 Production licence (sometimes also referred to as "exploitation licence")

- Issued until the deposit is depleted; the depletion period is determined on the basis of the feasibility study; until 2000, the licenses were issued for 20 to 25 years
- Extensions may be granted if they are reasonably necessary to exploit the deposit or to abandon the operation
- Issued only through tender (auction or competition)[10] (ex-

[5] See Jan-Hendrik Röver, Öl und Gas (oil and gas) in Ulf R. Siebel (ed.), Handbuch Projekte und Projektfinanzierung (Munich 2001), pp. 49-54; Jan-Hendrik Röver, Projektfinanzierung in Ulf R. Siebel (ed.), Handbuch Projekte und Projektfinanzierung (Munich 2001), pp. 153-241.

[6] See procedure established by Regulation No. 69 of the Government of the Russian Federation dated 11 February 2005, clauses 11 and 14, and Ordinance of the Federal Agency for Subsoil Resources Management No. 1332 dated 22 December 2005.

[7] Reserves audits are offered e.g. by DeGolyer & McNaughton, Gaffney Cline & Associates, Miller and Lents and Ryder Scott.

[8] Net cash flow from operations calculated from the time of contractual repayment of the debt financing.

[9] See also Tatiana Pashchenko and Ilia Rachkov, Gaswirtschaft in Russland – Rechtliche Rahmenbedingungen, in: WiRO 2006, pp. 164-171.

[10] Auction: licence is granted to the highest bidder; competition: licence is granted to the applicant who is most suitable to comply with the required scientific and technical level of the geological research and use of the subsoil area; the completeness of extraction of minerals from the subsoil; the contribution to the social and economic development of the territory in which the subsoil area is located; deadlines for implementation of relevant programmes; the efficiency of subsoil and environment protection measures; and the national security of Russia. Of course, the criteria for awarding a licence in a competition procedure provide large discretion to the officials in charge of conducting a competition and the auction procedure, therefore, is a more transparent pro-

cept when issued to a company which made a commercial discovery under an exploration licence). Please note that the competition procedure has not been used since early 2000 due to bribery scandals associated with certain competitions. The most notorious case is the Gamburgtsev Swell. The licence was granted to the small oil company Severnaya Neft for a payment of only US$ 7 million to the State. In 2003 Rosneft acquired the oil company holding the licence for US$ 600 million.

3.2.1.3 Combined licence (exploration and production licence)

- A combined licence combines an exploration and a production licence
- Issued until the deposit is depleted, i.e. for the period required to develop a hydrocarbon field (based on a feasibility study)
- Issued only through tender (auction or competition)

3.2.1.4 Other types of licences and approvals

The development of and production from a hydrocarbon reserve requires not only hydrocarbon licences. A number of other approvals will also have to be obtained,[11] i.a.

- Approvals for the construction of any facilities on site
- Environmental approvals

Where midstream (i.e. transportation) or downstream (i.e. refining or marketing) activities are involved as, additional licences may have to be obtained.[12]

3.2.1.5 Legal characteristics of the licensing regime

- Rights to the produced oil or gas belong to the producer (i.e. the producer owns the produced hydrocarbons)
- The general tax regime applies
- Subsoil use rights under a licence can be **transferred** only in a limited number of cases:
  - **Transformation of the licencee** into another legal form (e.g. transformation of a Russian closed or open joint stock company into a Russian limited liability company and vice versa);
  - **Reorganisation of the licencee** through merger of another legal entity into the licencee or merger of the licencee with another legal entity in accordance with Russian law;
  - **Accession of the licencee** to another legal entity in accordance with Russian law provided that such other legal entity will comply with licensing requirements and possess necessary personnel, financial and technical resources;
  - **Reorganisation of the licencee by division or spin-off:** the reorganisation of the licencee where the licencee spins-off a new company established under Russian law to which the licence is transferred, provided that the new company continues operation of the licence in accordance with the terms and conditions of the licence;
  - **Joint venture:** a licencee may transfer its licence to a new **company** which is established with the participation of the licencee as a founder of the new company established under Russian law holding at least 50% of the new company's share capital as of the date of the transfer; in this case the licencee company must also transfer to the new company all property and property rights necessary to conduct operations in the licence area; in a joint venture with the licencee in the form of a **simple partnership** (referred to as "joint activity" under Russian law) the licencee would continue to hold the licence; however, the joint venture partner would benefit indirectly from the licence. The Russian simple partnership agreement rules are imprecise with the result that this type of arrangement is rarely used in practice for large-scale oil and gas project investments.
  - **Bankruptcy:** a third party may acquire a subsoil licence by purchasing the insolvent company's (licencee's) **assets** (including the rights to the licence) in the course of bankruptcy proceedings, provided that the third party purchaser is a Russian legal entity and has the financial and technical capability to operate and comply with the terms and conditions of the licence being purchased. The subsoil licence will also be indirectly acquired if a third party purchases the **shares** of an insolvent company.

[11] See in particular Federal Laws No. 80-FZ dated 2 July 2005 and No. 200-FZ dated 31 December 2005 amending the Federal Law "On Licensing Certain Types of Activity".

[12] The need to licence the exploitation of trunk pipelines was abolished by Federal Law No. 80-FZ dated 23 July 2005. However, trunk pipeline construction, ownership and operation remains strictly controlled by law and practice in Russia. To date only Transneft and the Caspian Pipeline Consortium (CPC) can operate crude oil pipelines, Transneftеproduct oil product pipelines and Gazprom natural gas pipelines. – Equally removed was the requirement for licences for the transportation, storage and refining of oil, gas and related products.

- **Note:** in any other situation a transfer of rights under a subsoil use licence will require a renewal / reissue of the licence. In other words, the licencee may not transfer its subsoil licence to any third party for temporary or permanent use; **licences cannot be transferred freely**.
- However, subsoil use rights under a licence can be acquired indirectly by the acquisition of shares in a company holding a subsoil use licence. Note, however, the restrictions on foreign investors (see 4.10).

- Subsoil use rights cannot be taken as **security** (e.g. pledged) since they are not freely transferable
- Subsoil use rights can be **terminated** unilaterally by the State in the situations listed in the Federal Law on Subsoil (including material breach of licence terms or repeated breach of subsoil use terms) (see 3.2.1.9 in more detail).

3.2.1.6 Procedure for granting a licence

The proper procedure for granting a licence requires the following steps:

- Inclusion of a hydrocarbon field into the licensing programme by the Ministry of Natural Resources of the Russian Federation
- Decision to conduct a tender (as mentioned above, since 2000 no competitions have been conducted)
  - By the Russian Government for offshore fields

  or
  - By the Federal Agency for Subsoil Resources Management or its territorial branches for all other fields[13]

Practice note: Auction participants can obtain information about an auction from announcements in Russian-wide and regional mass media.[14] In addition, information about subsoil mineral deposits put up for auction is generally published in the newsletter "Economic and Legal Aspects of Subsoil Use in Russia" (which was renamed "Subsoil Use in Russia" on 1 January 2005) of the Ministry of Natural Resources of the Russian Federation.

- Organisation of a tender procedure[15]
  - In most cases the Federal Agency for Subsoil Use will organise the tender procedure under the auspices of the Ministry of Natural Resources of the Russian Federation
  - In case a subsoil field is situated within Russian territorial waters, internal sea waters or on the continental shelf, the organiser of the tender will be the Government of the Russian Federation
  - The regional governments may be the organisers of subsoil tenders only with respect to local subsoil resources; local subsoil resources include widespread subsoil resources; the lists of widespread resources are approved by the Ministry of Natural Resources of the Russian Federation jointly with the government of the relevant Russian member state; for instance, in the Moscow region, even minerals used for the production of construction materials are not qualified as widespread resources.
- Conducting a bid
  - Auction: licence is granted to the highest bidder

  or
  - Competition: licence is granted to the applicant with the best proposal for subsoil use. Since early 2000 competitions have not been conducted because competition procedures were prone to bribery.
- Decision to grant the licence
  - By the Russian Government for **offshore fields**

  or
  - By the tender commission for **all other fields**[16] (formerly the so-called two-key principle applied pursuant to which the licence was executed by the Ministry of Natural Resources of the Russian Federation and the competent governmental body of the relevant Russian member state; this two-key principle was, however, abolished in August 2004

[13] Article 13.1 Subsoil Law.

[14] Article 13.1 Subsoil Law.

[15] The procedural rules for tenders are laid down in detail in the Subsoil Law and the following legal acts:

(i) Regulations "On the Procedure for Issuance of Subsoil Use Licenses" as approved by Decision of the Supreme Court of the Russian Federation No. 3314-1 dated 15 July 1992 ("1992 Licensing Regulations"),

(ii) Methodological Guidelines for the Preparation of Terms of and on the Procedure for Holding Tenders and Auctions for the Rights to Use Subsoil Areas as approved by Order of the Ministry of Natural Resources No. 457-p dated 14 November 2002 ("2002 Ministry of Natural Resources Recommendations on Conducting Auctions and Tenders"),

(iii) Procedure for Transferring a Licence for Subsoil Use Rights approved by Order of the Ministry of Natural Resources No. 1026 dated 19 November 2003 and (iv) Procedures for the Review of Applications for the Rights to Use Subsoil for Geological Studies approved by Order of the Ministry of Natural Resources No. 61 dated 15 March 2005.

[16] Article 10.1.5 Subsoil Law.

when the Subsoil Law was amended). Currently, the tender commission comprises both federal and regional officials, whereas the licence itself is executed by the Ministry only.

Practice note: Although licences should be issued based on a decision of the tender commission, in practice a subsoil licence is generally issued by the Federal Agency for Subsoil Use or its territorial branches on the basis of the powers contained in the Regulation on the Federal Agency for Subsoil Use which provides that the Agency is in charge of issuance, execution and registration of subsoil use licences.[17] In practice the tender commission merely records the auction results while the actual approval of the results is conducted by the Agency.

- Licence issuance
  - Formerly so-called two-key principle: by the Ministry of Natural Resources of the Russian Federation and the governmental bodies of the relevant Russian member state
  - After an amendment to the current Subsoil Law in August 2004: Federal Agency for Subsoil Use
  - The Subsoil Law provides that subsoil use licences shall be issued with the prior consent of the land resources management body or the owner of the relevant land plot[18]
- Licence registration by the Federal Agency for Subsoil Use. Since 1 April 2005 the Regional Agency for Subsoil Use for the Central Federal District is in charge of the state registration of subsoil use licences, amendments to license agreements and completing and signing registration stamps.[19] After such state registration took place, the Regional Agency for Subsoil Use for the Central Federal District shall forward execution copies of the appropriate documents to each of: the licencee, the Russian Geological Fund Federal State Institution (to keep it in custody), the territorial branch of the Federal Agency for Subsoil Use and the appropriate territorial fund (for information purposes).
- When a production licence is issued, the preliminary and later the definitive boundaries of the mining allotment must be registered; currently, the Federal Service for Ecological, Technological and Nuclear Monitoring carries out the functions of the state mine inspectorate[20]

3.2.1.7 Minimum content of a subsoil use licence and a licence agreement

A subsoil use "licence" consists of (i) the actual licence and (ii) the licence agreement. The licence agreement is an attachment to the licence. In most cases, the licence is accompanied by a licence agreement entered into between the licence holder and the licencing authority. The licence holder may insist on concluding a written licence agreement.

The licence and the licence agreement should have the following minimum content:

- Details of the subsoil user (licencee)
- Grounds upon which the licence is awarded
- (Ideally) 3-D boundaries of the subsoil area
- Boundaries of exploration or production mining allotment and land plot
- Term of the licence and date of commencement of operations (including time schedule for attaining proposed production capacity)
- Environmental protection and safety requirements
- Abandonment or conservation programmes and plans for land reclamation
- Agreed level of production (Article 12 of the Subsoil Law)
- Operation milestones (drilling, production etc.)

Practice note: The milestones should be negotiated carefully and should allow for modifying operational expectations as required by reasonable industry standards and practices. If milestones are set too tightly there is a danger of loosing the licence or at least of having to enter into cumbersome and lengthy renegotiations of the licence.

- Clear provision that terms of licence and licence agreement cannot be changed without the licencee's express written agreement

3.2.1.8 Compliance with hydrocarbon and other licences

The compliance with hydrocarbon licences will constantly be reviewed by the Ministry of Natural Resources of the Russian Federation. During the exploration stage the Ministry will have to approve design

[17] See Paragraph 5.3.8 of the Regulation on the Federal Agency for Subsoil Use, approved by Regulation No. 293 of the Government of the Russian Federation dated 17 June 2004.

[18] Article 11 Subsoil Law.

[19] Ordinance No. 363 dated 4 April 2005 of the Federal Agency for Subsoil Use.

[20] Regulation "On the Federal Service for Ecological, Technological and Nuclear Monitoring" approved by Regulation of the Russian Federation Government No. 401 dated 30 July 2004, as amended on 21 January 2006 and 29 May 2006.

and feasibility studies, pilot projects and development plans.[21] In addition, state control of the geological study, efficient use and protection of subsoil resources will be carried out by the Federal Supervisory Service in the Sphere of Nature Use in co-operation with certain other controlling authorities.[22]

Practice note: Licence compliance is a major issue in the Russian oil and gas industry since companies often do not comply fully with the requirements of the licence agreement. The standard procedure of dealing with a deviation from the terms of the licence agreement or a termination of the licence in the near future is to apply for a confirmation of changed licence terms or an extension of the licence. Although in principle it is well possible to receive such confirmations and extensions it is in practice often a cumbersome and time-consuming process. However, without a clear situation with respect to the hydrocarbon licence it would not be advisable to invest in an oil and gas asset at market prices.

Non-compliance with licence requirements can in practice not only lead to issues with governmental authorities (such as the Ministry of Natural Resources of the Russian Federation) but opens up opportunities for (mainly Russian) companies seeking control over competitors via a hostile takeover.

Similar to the situation of hydrocarbon licences, the compliance of the company with any other licences required to developing and producing from hydrocarbon reserves will be monitored by governmental institutions.

3.2.1.9 Termination, suspension or restriction of a subsoil use licence

- A subsoil use licence terminates in the following cases without any grace period:
  - Upon expiration of the licence term as stipulated in the licence
  - Upon a waiver of the right to subsoil use by the licence holder
  - Upon occurrence of a condition (as stipulated in the licence) which results in an early licence termination
  - Upon transfer of the licence in violation of the law

Practice note: Exploration licences often expire when their time limit is reached without the licence holder having completed all necessary works. If the field is still economically interesting to the licence holder, he will typically apply for an extension of his licence. It is not unusual that such an application needs some time for examination by appropriate authorities.

- A subsoil use licence **may** be early terminated, suspended or restricted by the bodies which awarded the licence in the following limited number of cases:
  - Immediate danger to health or safety of the local population living in the area where the relevant mineral deposit is located
  - Material violation of the licence terms by the licence holder, e.g. failure to make timely payments of levies and taxes for subsoil use; in practice, a three months grace period may be granted during which the licensee shall cure the failure to pay the amount due
  - Failure of the licencee to commence operations in accordance with the terms of the licence; in certain situations, however, state authorities abstain from the subsoil license withdrawal even if the licencee substantially violates the timing to launch operations in the appropriate subsoil area
  - Liquidation of the legal entity holding the licence
  - Failure of licencee to provide required reports (e.g. geological information to controlling bodies)
  - Systematic violation of the subsoil use rules by the licence holder; state authorities often grant a grace period (e.g. three months) to allow the licencee to remedy such violations.
  - Occurrence of extraordinary situations (military operations, disasters etc.).
- A decision to terminate, suspend or restrict the right to use the subsoil can be **appealed** by the licencee through administrative or court proceedings.

3.2.2 Production sharing agreement (PSA) regime

The PSA regime in Russia first appeared in 1993 when President Yeltsin signed the Production Sha-

[21] The development plan in particular is confirmed by the Central Commission for Development (Centralnaya Komissiya po Razrabotke = TsKR). Detailed regulation on the development and approval of a field development plan is provided by: Rules for Developing Design Documentation for the Development of Oil and Gas Fields No. RD153-39-007-96 approved by the Ministry of Fuel and Energy of the Russian Federation on 23 September 1996 ("Development Plan Regulation") and the Ordinances of the Federal Agency for Subsoil Use: No. 531 'On the Central Commission for Development of Hydrocarbon Deposits' dated 26 November 2004, No. 877 'On Approval of an Interim Order on the Central Commission for Development of Mineral Deposits' dated 15 August 2005 and No. 1107 'On Local Subdivisions of the Central Commission for Development of Mineral Deposits' dated 28 October 2005.

[22] See Regulation "On State Control over Geological Study, Efficient Use and Protection of the Subsoil" approved by Russian Federation Government Resolution No. 293 on 12 May 2005.

ring Decree,[23] but a comprehensive legal framework for PSAs was established only in 1996 when the Russian Parliament approved the PSA Law.[24] From 1996 until today the PSA Law went through numerous revisions: initially the law was revised to restrict access to the PSA regime and then to ease it. From 1996 to 2003 ca. 30 oil and gas deposits were approved for production sharing agreements by the State Duma. Signed and operating are, however, only three: Sakhalin 1 and Sakhalin 2 as well as the Kharyaga field.[25] PSAs have, therefore, not been of real practical importance in the Russian Federation and we will, hence, only provide some highlights of this special regime.

The PSA Law provides for the establishment of a list of deposits eligible for development under a PSA. In order for a particular deposit to qualify for the list, it must be approved by the Russian Parliament in a special federal law – a so-called "List Law".[26]

3.2.2.1 Legal characteristics of the PSA regime

- Rights to the produced oil or gas are shared between the State and the investor (i.e. the investor owns only part of the production, see Article 9 [1] PSA Law)
- A special negotiated tax regime applies (tax exemptions and/or refund of certain taxes out of produced oil and/or gas before sharing)
- Subsoil use rights arising from a PSA can be transferred (subject to the State's approval)
- Upon consent of the State, the investor may pledge its proprietary rights and assets under the PSA in order to secure the investor's obligations in connection with the implementation of the PSA; the pledges shall be governed by Russian law (Article 16 paragraph 3 PSA Law); however, there is not really any practice with this to date
- Subsoil use rights terminate according to the PSA

3.2.2.2 Procedure for granting a PSA

- Sign-off by the relevant state bodies
  - Formerly the so-called two-key principle applied according to which the Ministry of Natural Resources of the Russian Federation and the governmental bodies of the member state(s) of the Russian Federation in which the deposit is located had to sign-off
  - After a change to the current Subsoil Law in August 2004 in most cases only the Ministry of Natural Resources of the Russian Federation must provide sign-off
- Tenders for subsoil use must be carried out according to the requirements of the PSA Law
  - PSAs are concluded after two tenders (auctions)[27] have been conducted between investors with respect to a specific deposit (see Articles 2 and 6 [1] PSA Law); there is a narrow exception for a few particular offshore fields.

Generally speaking, the procedure for receiving a PSA is extremely lengthy which has added to its unattractiveness in practice.

3.2.2.3 Requirements for PSAs

Under the PSA Law there are two special requirements for a PSA: the Russian content rules and special management requirements.

- Russian content rules
  - The participation of a Russian investor is now a must for any PSA project. Although the PSA Law does not establish what share is to be allocated to the Russian party, under the second paragraph of Article 6 (1) of the PSA Law Russian authorities are entitled to determine that share and this shall be an integral part of the terms of the PSA auction.
  - 80% of the employees must be Russian citizens; foreign specialists may only be retained at the initial stages of work under the PSA or in the absence of suitable Russian specialists.
  - The PSA Law requires a PSA investor to provide priority to Russian contractors, suppliers and carriers and unlike earlier there is no qualification that their goods or services must be of comparable quality.
  - To qualify for cost recovery, 70% of the total costs of all machinery, equipment and supplies required for geological studies, extraction and "initial processing of raw materials" must be purchased from Russian entities or foreign entities which are registered as Russian taxpayers.[28] Compliance with this domestic content requirement is measured not over the life of the project but continuously from day one. To qualify as Russian-made, goods must be manufactured by Russian

[23] Decree No. 2285 "On the Issues of Production Sharing Agreements" dated 24 December 1993.

[24] Federal Law No. 225-FZ "On Production Sharing Agreements" dated 30 December 1995.

[25] Interestingly, all these PSAs were signed before the PSA Law came into effect and, hence, are not fully governed by it.

[26] Article 2 (3) of the PSA Law.

[27] Article 6 of the PSA Law. Auction: licence is granted to the highest bidder.

[28] Article 7 (2) of the PSA Law.

companies on the territory of the Russian Federation from materials and components of which not less than 50% (in terms of value) were produced in Russia by Russian companies.

- In recognition of the protectionist nature of the above requirements Article 7 of the PSA Law stipulates that the PSA Law shall be amended to comply with WTO principles when Russia joins the WTO.[29]

- Management is done by management committee which must include both federal and local Government representatives.

3.2.2.4 Compliance with a PSA

Typically a PSA indicates details on field development. Development plans are discussed in a Production Sharing Agreement Joint Management Committee which comprises representatives of the Industry and Energy Ministry of the Russian Federation and the investors. The Joint Committee also approves past costs and budgets for future costs.

3.2.3 Regulated contracts under the Draft Subsoil Law

Under the Draft Subsoil Law the approach for subsoil use will change fundamentally: instead of subsoil licences (and hence administrative regulation) specially regulated contracts are concluded (and hence contractual regulation applies). The intention seems to be that subsoil licences will no longer be issued and will gradually be replaced by specially regulated contracts. The parties will be able to negotiate the terms of a subsoil use contract unless the terms are set by federal laws, legal acts other than laws or by the terms and conditions of the auction. It is currently unclear how these new types of contracts are to be categorised under the existing contract types of the Civil Code of the Russian Federation.

3.2.3.1 Procedure for granting subsoil use rights

The Draft Subsoil Law establishes basically the same procedure for granting subsoil use rights as the current regime (see 3.2.1.6). However, there is a major difference: Under the Draft Subsoil Law subsoil use rights should be tendered only through auctions where the subsoil use rights are granted to the highest bidder. The subsoil use rights are granted to the auction winner on the basis of a subsoil use contract signed with the executive body of the Federal Government or the executive body of the respective member state of the Russian Federation.[30] Although the draft submitted to the State Duma on 17 June 2005 limits the license granting process to auctions only it can currently not be concluded that the tender procedure of competition will not be introduced into the draft law again. In fact this issue is currently under discussion in the Government and the State Duma.[31]

The subsoil use rights can be obtained by a subsoil user without an auction only in case such subsoil user discovered a new deposit on the basis of an exploration permit. Subsoil use rights can also be granted without an auction on the basis of a decision of the Government of the Russian Federation, a state agency appointed by it or an executive body of the respective member state of the Russian Federation, as the case may be.[32] The Revised Draft Subsoil Law published by the Ministry of Natural Resources in February 2006 further enumerates those cases in which a subsoil licence can be granted without a tender, i.a. regional and federal exploration studies, "conversion" in case of a commercial discovery, temporary use rights, nuclear or other hazardous waste burial.[33] Depending on the subject-matter of the rights, these are granted by federal or regional authorities.

3.2.3.2 Transfer and pledging of subsoil use rights

The Draft Subsoil Law provides that subsoil use rights acquired on the basis of specially regulated contracts can be transferred, subject to a consent of the relevant State authorities. The draft law also allows the pledging subsoil use rights.

3.2.3.3 Amendment and termination of subsoil use rights

Article 80 of the Draft Subsoil Law provides that a regulated contract can be **amended** if there is a substantial change in circumstances. Such substantial changes include:

- Need for reduction of the initial subsoil plot area based on the results of exploration works
- Change in the amount of produced mineral

[29] The Russian Federation is currently negotiating membership in the World Trade Organization ('WTO') (see Jan-Hendrik Röver, Russia's accession to the WTO – how near is agreement with the US on financial services issues?, in: 2006 AmCham News, pp. 6-7). Please note that under the Agreement on Trade-Related Investment Measures ('ATRIM') which forms part of the WTO legal framework mandatory local content requirements which are placed on foreign direct investors or their local subsidiaries by member governments are prohibited.

[30] Article 36 Draft Subsoil Law.

[31] The revised version of the Draft Subsoil Law published by the Ministry of Natural Resources in February 2006 re-introduced the concept of competitive tenders for offshore fields; the re-introduced competitive tender approach may eventually be allowed in other cases as well.

[32] Article 37 Draft Subsoil Law; the application procedure for granting a subsoil use right without an auction process is regulated in Article 69 of the Draft Subsoil Law.

[33] Article 69 Revised Draft Subsoil Law.

due to circumstances which occur independently of the subsoil user

- Immediate danger to health or safety of the local population
- Need for limited use of the subsoil area by another subsoil user
- Extension of the term for subsoil use for the purpose of completion of exploration works or completion of abandonment but only if all conditions of the regulated contract are fulfilled; the extension period cannot be less than 1 year[34]

Pursuant to the Draft Subsoil Law a subsoil use right can be **terminated** in the following cases:[35]

- Upon failure of the licence holder to commence development
- Upon failure of the licence holder to make a one-time payment
- Upon failure of the licence holder to comply with subsoil use requirements
- Upon expiration of the term stipulated in the regulated contract
- Upon termination of a regulated contract:
  - based on a mutual agreement of the parties
  - in case that the subsoil use term is not defined in the regulated contract, the subsoil user has the right to withdraw from the contract at any time by notifying the other party (i.e the State) three months prior to the notified termination date
  - at the request of any party on the basis of a court decision, especially at the request of the State on the basis of a court decision[36]
- if the subsoil user does not comply with the requirements of the Draft Subsoil Law
- if the subsoil user fails to comply with the terms of the field development
- if the subsoil user fails to pay the one-time subsoil use payment

A termination of a subsoil use right prior to its stipulated term does not exempt a subsoil user from the fulfillment of its obligations on subsoil conservation and compensation for damages.

3.2.3.4 Position of existing licences

It should be noted that existing/outstanding licences (and licence agreements attached thereto) will remain in full force and effect in accordance with their terms under the

Draft Subsoil Law (i.e. they will be grandfathered), subject to the licencee company's option to convert a current regime licence into a new regime contract.

3.2.3.5 The future of PSAs

It is currently not clear what the future of the PSA regime will be once the Draft Subsoil Law comes into force. PSAs are currently under discussion as a tool e.g. for special projects, e.g. in the Artic offshore region.

3.2.4 Restrictions on participation in tender procedures by foreigners

3.2.4.1 Current Subsoil Law

The law currently in force (i.e. the 1992 Subsoil Law, 1992 Licensing Regulations and the 2002 Ministry Recommendations on Conducting Auctions and Tenders) does not restrict foreign ownership participation in licence rights. There is a provision in the 1992 Licensing Regulations[37] pursuant to which only Russian Federation entities can participate in tenders. However, the 1992 Regulations apply only to the extent that they do not contradict the Subsoil Law and this point is clearly contradictory to the Subsoil Law which contains only few limitations (the law permits restrictions to be imposed on the basis of federal law)[38]. In addition, the requirement of the 1992 Licensing Regulations may be met if a foreign investor establishes a Russian subsidiary instead of being engaged in exploration and production itself.

3.2.4.2 Draft Subsoil Law

The Draft Subsoil Law contains foreigner participation restriction rules (see Articles 9 and 19 Revised Draft Subsoil Law). According to these rules:

- Subsoil right holders must be held at least 50% by Russian individuals (unless the individuals are restricted by virtue of law from being licence holders) or Russian companies (Article 9.1 of the Draft Subsoil Law) and thus foreigners may not directly take part in subsoil use tenders on their own but should use Rus-

[34] Article 51 Draft Subsoil Law.

[35] Articles 40 and 79 Draft Subsoil Law.

[36] In Article 79 of the Revised Draft Subsoil Law the requirement of a court decision prior to a termination of subsoil use rights has been removed. This change is, however, still under consideration.

[37] Article 10.5.

[38] Article 9 Subsoil Law.

sian subsidiaries, to comply with this requirement.

- The draft law is expected also to contain criteria for "strategic fields" to which the restrictions apply. Only deposits the reserves of which exceed a certain size or which are of particular importance for Russian national security and defence are considered "strategic reserves" and limited for foreign investment. Discussions on the exact figures for the thresholds are still ongoing and it is premature to report on the possible outcome of these discussions.[39]
- However, Russian companies "that form, jointly with foreign individuals and/or […] foreign legal entities, a group of persons may be subsoil users and thus may take part in subsoil use tenders as long as federal laws or the tender terms 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 categorised as a group of persons in accordance with the anti-monopoly legislation". (Article 9.1 Draft Subsoil Law) Article 4 of the Law on Competition and Restriction of Monopolistic Activities No. 948-1 of 22 March 1991 defines a group of persons very broadly.[40]

Practice note: The 50% requirement may also impact Russian listed companies. Under the rules they would have to demonstrate that Russian citizens are the true beneficiaries of at least 50% of their outstanding shares. This is difficult to establish for companies with traded shares.

3.3 Produced hydrocarbons

The main assets of an oil and gas company are the produced hydrocarbons which are either fully owned by the company (under the licensing regime or in most cases under the regulated contracts regime proposed under the Draft Subsoil Law) or at least partly owned by the company (under the PSA regime).

3.4 Sales receivables and bank accounts

The produced hydrocarbons will eventually be sold. The company will receive sales proceeds (in the form of a money transfer into the company's bank accounts) and prior to that it will hold receivables against the purchasing party. An asset is also future receivables under offtake contracts which can be assigned to a third party. Particularly where the receivables are against foreign entities they (as well as the company's operating and deposit bank accounts) may offer excellent security for receiving export trade financing.

3.5 Land rights

An oil and gas company shall hold land rights (ownership or lease) to the land and any fixtures attached to the land it is working on. It should be noted that while Russian law does not prohibit the ownership of land plots **covering the subsoil area**, in practice, oil and gas producers typically lease such land plots.

3.6 Exploration and production equipment

Either the licence holding company itself or a separate operating company will own various exploration and production equipment (including drilling and extraction equipment, drilling and production rigs and offshore platforms).

3.7 Infrastructure

Furthermore, the company will own land and buildings, storage facilities, low pressure pipelines connecting the facilities of the company with trunk pipelines, refineries etc.

Practice note: Ownership of field infrastructure (as well as of field equipment, see 3.6) is an important and contentious issue both prior and after acquisitions. Sometimes infrastructure and infrastructure is only leased and if lease agreements are close to their termination dates there is a risk of production being stopped or slowed down.

3.8 Interest rate, currency and oil price hedging agreements

It is typical for western oil and gas companies to hedge against interest rate, currency and oil price change risks. Rights arising under the respective agreements are assets of the oil and gas company.

[39] See also Jon Hines, Status of Proposed Restrictions on Foreign Investment in Mineral Resource Development, in: 2005 AmCham News, pp. 8-9. According to most recent publicly available statements (Vedomosti, 3 July 2006), the deposits that have crude oil reserves in excess of 70 million tonnes, natural gas reserves in excess of 50 billion cubic meters, gold reserves in excess of 50 tonnes, copper reserves in excess of 500,000 tonnes shall be considered "strategic". Pursuant to these criteria, approximately 70 oil and gas deposits may be qualified as strategic ones.

[40] In general terms, a company or individual controlling another company, or a company controlled by another company or individual or a company being under the joint control from another company constitute a group of persons under Russian anti-monopoly legislation.

Practice note: Oil price hedging is still rare to find with Russian independent oil and gas companies. However, from 8 June 2006 Urals oil future contracts started trading on the RTS and there are plans to trade Urals contracts in New York (NYMEX), London and possibly Dubai. It is to be expected that the use of listed and over-the-counter (OTC) commodity derivatives will increase in future, in particular since legal and tax uncertainties under Russian legislation are in the process of being removed.

3.9 Carbon credits

On 17 February 2005 the Russian Federation acceded to the Kyoto Protocol, an international treaty.[41] The purpose of the Kyoto Protocol is to achieve a global reduction of CO_2 and methane gas emissions. The tool for achieving this is to allocate carbon credits to companies who contribute to such a reduction e.g. by realising gas-to-power plants or other emission reduction projects. Carbon credits are now freely tradable and are an asset of the company generating such a carbon credit. Carbon credits are a recent development and still an often overlooked issue. Recently, the Russian Government announced its plans to launch a platform for the trading in carbon credits by September 2006.

In Russia, the following bodies are in charge of the implementation the Kyoto Protocol: Rosgidromet (Federal Service for Hydrometeorology and Environment Monitoring), the Ministry of Economic Development and Trade, the Ministry of Foreign Affairs, the Ministry of Natural Resources, the Ministry of Industry and Energy, the Ministry of Nuclear Energy, the Ministry of Agriculture and the Federal Construction Agency.

By Ordinance of the Government of the Russian Federation No. 278-r dated 1 March 2006 the Government decided to establish the so-called 'Russian system of assessment of anthropogenic emissions from sources and absorption of greenhouse gases which are not regulated under the Montreal protocol by scrubbers'. Data from that system shall be annually submitted as a cadastre of anthropogenic emissions in accordance with the Kyoto Protocol. On the basis of this data, Russia shall prepare notices to be submitted in accordance with the Kyoto Protocol. Rosgidromet has been appointed as the federal agency in charge of administering that system. In particular, until 1 July 2006 Rosgidromet should enact a procedure (elaborated in cooperation with other federal agencies) for the establishment and management of the system. It seems that Rosgidromet did not yet enact such a procedure.

By Ordinance of the Government of the Russian Federation No. 215-r dated 20 February 2006 the Russian Register of Carbon Units has been introduced. The Ministry of Natural Resources of the Russian Federation is in charge of keeping the register in accordance with Kyoto Protocol. In particular, the Government instructed the Ministry to:

- propose by 1 May 2006 to the Government of the Russian Federation a body which shall be appointed as administrator of the register; and
- prepare by 1 June 2006 and approve a procedure for the establishment and keeping of the register.

Practice note: The market for carbon credits is still in its infancy. Realisations from carbon credits need proper structuring.

3.10 Shares in an oil and gas company

Since subsoil use licences under current law are not transferable a seller will transfer the shares he holds in an oil and gas company (or companies). In addition, an oil and gas company may hold shares in another company which could also be the subject of a sale.

4. Investment structures

4.1 Sale of hydrocarbon assets

There are typically two ways of acquiring a company: either by way of an asset deal (see this paragraph) or by way of a share deal (see 4.2). The most important asset held by an oil and gas company is its subsoil use rights. Whereas it is in principle possible to acquire the transferable assets owned by an oil and gas company (e.g. its equipment items) special rules apply to subsoil use rights.

The sale of hydrocarbon reserves contained in the subsoil by way of direct sales of subsoil use rights under a **licence** is in principle not possible under Russian law. Licences are issued to companies

[41] Under Russian law international treaties entering into force for the Russian Federation take priority over national law. Hence, there is in principle no need for implementing them into domestic legislation in Russia. However, additional legislation for the implementation of the Kyoto protocol has not yet been completely passed. Note, however, the text above.

and can only in exceptional cases be transferred to other companies. They would terminate upon transfer outside one of the permitted situations.

It would be possible to sell subsoil use rights under a **production sharing agreement** (subject to the State's approval).

Please note that the Draft Subsoil Law provides that subsoil use rights acquired on the basis of the specially **regulated contracts** can be transferred, subject to a consent of the relevant State authorities. The purchase of subsoil use rights under a regulated contract may be an attractive option to an investor who feels uneasy about the financial position of the company holding the rights.

4.2 Sale of shares

4.2.1 Companies under Russian law and types of shares

Russian law provides two forms of companies,[42] the limited liability company (LLC) and the joint stock company (JSC). Joint stock companies can be established as closed JSC (ZAO, limited to a maximum of 50 shareholders) or open JSC (OAO, permits an unlimited number of shareholders).

Complex share structures are often ill-advised in Russia and are limited by the simple fact that a JSC is only permitted by law to issue two types of shares: ordinary shares and preference shares, the respective rights of which are broadly defined by law. The main difference between the two is the voting rights. Preference shareholders may vote only in very limited cases, such as on a company's reorganisation or liquidation. Investors considering using preference shares as a mechanism for redistributing equity should be aware of their potential downside. In Russia, there is a risk in issuing preference shares to an incoming investor, because on failure to pay a dividend the preference shares automatically become voting shares which could upset the previously agreed balance of control. It should also be noted that the total nominal value of all issued preference shares may not exceed 25% of the company's total charter capital; all newly issued shares must be fully paid for at the time of acquisition (a foreign investor may not pay in foreign currency for the shares acquired).

4.2.2 Direct acquisition

4.2.2.1 Purchase of shares in a Russian company

A purchaser sometimes acquires directly the shares in a Russian company which holds the subsoil use rights to the exploration and production of the hydrocarbon resource. This Russian target company may itself be the operator of the exploration and exploitation activities. However, in many cases the operation is done by a separate company. The purchaser will have to decide whether or not he also wants to acquire shares in the operating company (which may sometimes be the case but not always) or will simply rely on an operations and maintenance (or service) agreement with the operating company.

The acquisition of shares in the target company may be preceded by a share capital increase in the target company if the seller only wants to divest part of its shares and its main goal is to pursue a joint investment strategy with a partner on the basis of increased equity.

4.2.2.2 Acquisition of shares in an offshore company

Many Russian companies holding hydrocarbon licences are held by separate holding companies (so-called special purpose vehicles). Often an acquirer just purchases shares in this holding company. In the past many holding companies used to be located in Cyprus. With Cyprus' accession to the European Union it is to be expected that in future holding companies will increasingly be found in other offshore jurisdiction (such as the British Virgin Islands).

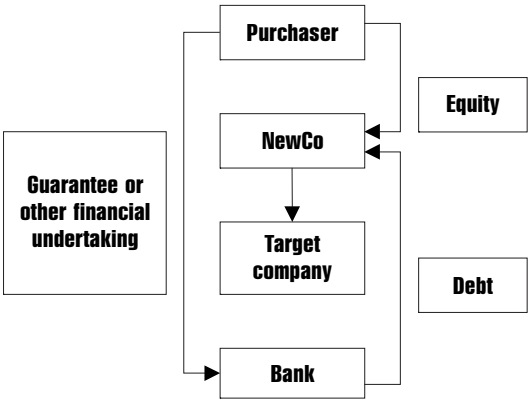
4.2.3 Indirect acquisition

The purchaser may not wish to be directly liable for the liabilities of either the target company or the holding company. In such cases he will establish a special purpose vehicle for the purposes of the acquisition, usually called "NewCo" in the context of acquisitions. NewCo will be domiciled either in the Russian Federation or an offshore jurisdiction (depending on the tax requirements of the parties) and become the holder of the shares in the target company. NewCo will thus become a holding company. The purchaser's equity contribution will be injected in this special purpose vehicle and potential acquisition debt will also be provided to the special purpose vehicle. In a so--called non-recourse financing the purchaser will not even provide direct guarantees or other financial undertakings

[42] The term „company" is more narrowly defined than the term „legal entity"; the latter comprises both partnerships and companies under Russian law.

for the benefit of the financing banks, in a limited recourse financing the banks will at least have some degree of recourse to the purchaser by way of guarantees or other financial undertakings.

The indirect acquisition route offers another structural advantage: it may allow using the interest payments on the acquisition debt for reducing the amount of taxes payable. This is a critical aspect in many acquisition financings since it may significantly increase the amount which can be debt financed. It is also a more tax efficient way of implementing an acquisition. However, careful structuring will be required to achieve the desired results.



4.2.4 Farm-in agreement

A farm-in agreement is a transfer of a part of the shares in an oil or gas company in consideration for an agreement by the transferee to meet certain expenditures that would otherwise have to be undertaken by the licencee. This is particularly common at the exploration stage. Essentially a farm-in agreement combines any of the above mentioned investment structures with an additional investment commitment. The advantage of a farm-in arrangement for the selling party is that it can keep some interest in the company although it has not sufficient funds for its further development.

4.3 Swap of shares

The purchaser may decide not to pay a purchase price (and the seller may equally decide not to receive a purchase price) but instead to sell shares in another company with a reserve base (or an assumed exploration potential) attractive to the seller.

In such cases the parties will not enter into a swap agreement (as is usual for financial derivates) but rather into two separate sale and purchase transactions (with related sale and purchase agreements) or a barter agreement, combined with a set-off of the respective obligations to pay a purchase price. Since the assets subject to such a "swap" will rarely have an exactly equal value, one party will have an additional obligation to pay some part of the purchase price in cash or shares.

A swap of assets is possible. However, under the current licensing regime due to the fact that licences may not be transferred under Russian law this is of little attraction. This may change under the new regulated contracts regime once the Draft Subsoil Law comes into force.

4.4 Greenfield projects

Greenfield projects (i.e. projects with no major prior exploration work) are typically pursued by setting up a separate company (i.e. a limited liability company [LLC] or a joint stock company [JSC]). This company will enter into a regulated contract with the State under the Draft Subsoil Law (or hold a licence under the current Subsoil Law).

4.5 Joint venture

Joint ventures are vehicles of several companies for pursuing jointly an economic goal which may either be an existing or a new project. A joint venture between several companies may either be established in the form (1) of a simple partnership under Russian law (i.e. a non-corporate entity), alternatively called "joint activity agreement" (JAA) (which does not create a legal entity but has the nature of a contractual pooling of assets), (2) of a company under Russian law (i.e. a limited liability company [LLC] or a joint stock company [JSC]) or (3) a consortium-form investment under a joint operating agreement (JOA) governed e.g. by English law.[44] Under a partnership structure, a joint activity structure and joint operating structure the subsoil use rights are held by one partner, the other partners do not have subsoil use rights; under a company structure the subsoil use right is held by the company.

4.6 Acquisition of a contractual right to incremental production

In principle an investor could purchase a **proprietary** (*in rem*) share in the production of a company (without becoming a shareholder of the company). This is a usual investment structure e.g. in Kazakhstan or the United States. However, under Russian law this structure is possible only in the context of **production sharing agreements** where the shareholders of the project company

[44] Sakhalin 1 is the only example to date in Russia.

hold interests in their respective share of the total hydrocarbons production.

Under **licences** or **regulated contracts** a proprietary share in the production can, however, not be agreed between the parties. In principle, a co-shareholder of an oil and gas company holding a licence or being a party to a regulated contract will have a right to receive dividends in cash. As far as possible payments of in-kind dividends from an oil and gas company are concerned, this is only theoretically possible in a joint stock company.[45] But even in a joint stock company there is a potential significant tax issue as follows. The Law on Joint Stock Companies allows dividends to be paid from net profit, meaning after-tax profit.[46] If hydrocarbons are distributed to shareholders, the tax authorities may claim that this is a scheme to reduce to tax base for profit taxes. There are various technical problems arising from the need for the directors of the company to determine the market value of the assets being distributed, which is constantly changing. Thus, in practice payments of dividends in-kind – in particular in the form of crude oil or other hydrocarbons – does not appear to be a viable option.

However, an investor may purchase a **contractual** right to incremental production (which will provide him a right to claim a transfer of ownership in the production). Such a right can be based e.g. on a service or operating agreement between an investor and an oil and gas company.

4.7 Acquisition of a contractual right to future sales proceeds or future profits

An investor may also decide to purchase future sales proceeds or a company's future profits against an upfront payment. Such rights can be based on a service or operating agreement. In addition, the right to receive profits may be based on a profit sharing agreement (if the company the profit of which shall be distributed is a Russian limited liability company or a foreign company since the profit in Russian joint stock companies is distributed in accordance with the shares held by the shareholders) or on a purchase of profit notes (provided foreign law applies to the latter since Russian securities law is not familiar with profit notes).

4.8 Corporate restructuring after acquisition

An acquirer may decide for many reasons to reorganise the corporate structure of a company after its acquisition.

- **Mergers and takeovers:** the reorganisation of an acquired company through merger (sometimes also referred to as takeover) where the company merged into another company ceases to exist as a legal entity and all of its rights and obligations are transferred to the successor (surviving) entity. The merger may be an "upstream" or a "downstream" merger, depending onto which entity the companies are merged.
- **Reorganisation of the acquired company by division or spin-off:** the reorganisation of the acquired company where the acquired company spins-off a new company to which the subsoil use licence or other subsoil use rights are transferred (which is possible under the current licensing regime), provided that the new company continues operation of the licence in accordance with the terms and conditions of the licence (which is the requirement under the current licensing regime).

4.9 Hostile takeovers

Investors may want to try to take over an oil and gas company without co-ordination with the target company's management board. This is referred to as a "hostile takeover". Companies will often try to protect against such a hostile takeover in a way which enables them to keep control of the business either in advance (preventive measures) or once the attempt of such a takeover is made (emergency measures). The field of protection against hostile takeovers is complex and we can give here only a few initial indications as to which measures can be taken.

Preventive measures of a company which could be subject of a hostile takeover include:

- Formation of a shareholding structure which prevents hostile takeovers (e.g. by introducing non-voting shares);
- Implementation of facilities to prevent uncontrolled purchase of shares in the target company (e.g. through option rights, pre-emptive rights, contractual penalties, tag along and drag along regulations, shooting-out procedures, Russian roulette);
- Design of a system to motivate the management for creating shareholder value and thus influencing shareholders not to sell shares in the target company;
- Implementation of methods considerably decreasing the

[45] The Law on Limited Liability Companies neither explicitly allows not explicitly prohibits payment of in-kind dividends.

[46] Article 42 Law on Joint Stock Companies.

attractiveness of the company subject to takeover (e.g. by limiting dividend payments).

Emergency measures of a company threatened by a hostile takeover include:

- Asset stripping;
- Litigation against the aggressor (e.g. on the grounds of competition law);
- Corporate restructuring;
- Blocking of the aggressor's equity stake;
- Arrangement of a white knight[47] who buys shares in the target company;
- Issuance of additional shares (i.e. dilution).

4.10 Restrictions on foreign investments

4.10.1 Current Subsoil Law

In principle, there are no restrictions under the current Subsoil Law for a purchase by foreign investors or Russian companies controlled by foreign investors of shares in Russian companies holding subsoil use licences (except previously for Gazprom shares, for whom, however, the restrictions for foreign ownership were abolished in December 2005). Unless a special federal law establishing such restrictions is adopted, neither the

Government of the Russian Federation nor the Ministry of Natural Resources of the Russian Federation may establish any restrictions on the purchase of shares in Russian subsoil users.

However, there is a special restriction (under the current Subsoil Law, Article 17.1) that a licence transferee joint venture company must be a Russian company and 50% or more of it are owned by the transferor licence holder at the time of transfer. Similarly there are Russian content rules for PSAs which allow on the one hand foreign ownership of oil and gas companies but require 80% employment of Russian citizens (see 3.2.2.3 above).

A further restriction was introduced with the State Secrets Law. Access to State secrets is granted to Russian citizens only (Section 5 State Secrets Law). Foreigners may have access to the information which is considered a State secret only with a permit of the appropriate State body and Federal Security Service. The State Secrets Law considers the quantity and volume of reserves and levels of extraction of Russia's strategic fossil-fuels to be State secrets. Government Decree No. 210 lists "strategic natural resources" and includes information on the balance of subsurface reserves of oil and gas dissolved in oil, also of non-ferrous and rare metals (such as nickel, cobalt, tantalum, niobium, beryllium). The State Secrets Law may create, and has actually created in the past, issues for foreign managers working in the oil and gas industry in Russia.

4.10.2 Draft Subsoil Law

Article 60 (5) of the Draft Subsoil Law contains the following restrictions with respect to the participation of foreigners in auctions for subsoil use rights:[48] to ensure the defence and security of the Russian State, in particular its economic security, a specially appointed federal executive body may prepare a motivated explanation to the effect that legal entities in which foreign citizens, stateless persons and/or foreign legal entities:

(i) are entitled to appoint the chief executive officer (CEO) and/or more than 50% of the management board and/or more than 50% of the supervisory board (also referred to as the board of directors) or any other collective managing body; or

(ii) hold more than 50% of the voting shares; or

(iii) are entitled to divest directly or indirectly more than 50% of the total number of votes represented by voting shares of such companies,

shall be prohibited from participating in an auction for subsoil use rights. Such restrictions may not, however, apply to restrict the freedom of the economic activity and to create unjustified preferences for certain companies; they also may not be applied on a discriminatory basis. An unjustified application of such restrictions may be appealed in court. Furthermore, the above restrictions do not apply to Russian legal entities, i.e. entities in which more than 50% of the total number of votes of each foreign company being a shareholder of such Russian company are controlled directly or indirectly by Russian individuals or legal entities.

If the auction winner meets the above criteria, the results of such auction may be cancelled and consequently the **subsoil use rights** granted to such subsoil user terminated early. The draft law is expected also to contain criteria for "strategic fields" to which the restrictions apply. Only deposits of a certain size or which have a particular im-

[47] I.e. friendly supporter of the target company.

[48] See also Jon Hines, Status of Proposed Restrictions on Foreign Investment in Mineral Resource Development, in: 2005 AmCham News, pp. 8-9.

portance for security and defence are considered "strategic reserves" and limited for foreign investment. Discussions on the exact numbers for the thresholds are still ongoing and it is premature to report on the possible outcome of these discussions.[49]

A **purchase of shares** in violation of the restrictions may be declared **invalid** by a competent court. However, the law does not provide for the automatic retransfer of shares the purchase of which was declared invalid. As a result, it will be crucial for foreign investors to pay special attention to the transaction structure pursuant to which foreign investors purchase shares in, or enter into a shareholders' or other agreements with, companies so as not to trigger revocation of the subsoil use licence as a result of such transaction.

Practice note: The 50% requirement may also impact Russian listed companies. Under the rules they would have to demonstrate that Russian citizens are the true beneficiaries of at least 50% of their outstanding shares. This is difficult to establish for companies with traded shares.

Hence, it is still possible for foreign investors to acquire shares in Russian oil and gas companies. However, the participation in tender procedures whilst still possible may require careful structuring in future. The State Secrets Law applies in parallel to the Subsoil Law and should also be considered (see 4.10.1 above).

5. Legal due diligence

Any investment will require a comprehensive due diligence process. Legal due diligence will be an important part of the overall due diligence process. We set out below the main issues which should be considered during the legal due diligence process.

5.1 Legal status of the target company and proper establishment

5.1.1 Privatisation

If shares were originally issued by way of a privatisation it is necessary to review carefully the privatisation documents for compliance with the tender requirements thus ensuring that the initial transaction conveyed valid ownership to the purchaser. Risks are substantially mitigated by the decrease of the statute of limitation for null and void transactions from previously 10 to now 3 years.

In this context it is also important to review carefully who legally obtained which precise assets of a former State enterprise in a privatisation process. Often there are questions as to the ownership of particular assets.

5.1.2 Incorporation

It should be ensured that the corporate documents comply with the requirements of the Law on Limited Liability Companies or the Law on Joint Stock Companies, as the case may be.

The corporate documents may contain certain limitations on foreign ownership or limitations on the transfer of shares in the company which have to be checked against the intended transaction.

The company must be properly registered in the company register.

5.2 Ownership of shares in the target company

5.2.1 Issuance and registration of new shares

Issuance of shares generally requires **approval** by the shareholders of the issuer and possibly of other corporate bodies. Special approvals may be necessary if the State owns a stake in the company.

Russian companies are not allowed by law to issue bearer shares. Shares issued by a Russian company are "uncertificated" (non-documentary) and ownership is recorded in book-entry form in the shareholders register administered by each company or – if the number of shareholders of the company exceeds 50 – an independent licenced registrar.

A **prospectus** must be prepared and registered with the local branch of the Federal Service for Financial Markets[50] for any open offering or for a closed offering of shares involving more than 500 purchasers.[51]

State registration of share issuances is typically done by the local branch of the Federal Service for Financial Markets.

[49] According to most recent publicly available statements (Vedomosti, 3 July 2006), the deposits that have crude oil reserves in excess of 70 million tonnes, natural gas reserves in excess of 50 billion cubic meters, gold reserves in excess of 50 tonnes, copper reserves in excess of 500,000 tonnes shall be considered "strategic". Pursuant to these criteria, approximately 70 oil and gas deposits may be qualified as strategic ones.

[50] Formerly called "Federal Commission on Securities Markets" ("FCSM", also called Federal Securities Commission).

[51] Once a prospectus is registered, the issuer is subject to various information disclosure requirements, such as quarterly issuer's reports and notification of material events.

5.2.2 Purchases made in the secondary market

5.2.2.1 Shareholders register

Since Russian shares are "uncertificated" a change of ownership in the shares is recorded at least in book-entry form in the company's shareholders register. For this new shareholders must open a "shareholder personal account" with the registrar. Ownership passes to the purchaser upon recording in the shareholders register. The registrar issues, upon request, an "excerpt" to the new shareholders confirming ownership.

5.2.2.2 Regulatory approvals

- Federal Anti-Monopoly Service ("FAS")[52] or its relevant territorial division
  - The acquisition of 20% or more of the shares of, or other interest in, a Russian company requires a prior written consent or notification of the FAS in most cases.

> **Practice note:** In some bidding situations involving 20% or more of the shares of a company it may occur that a bidder of a final (binding or non-binding) bid notifies the FAS of its intention to acquire the shares or the assets of a company. This can lead to the situation that several companies notify the FAS prior to the selection of the final bidder.

  - The approval must be issued by the FAS within 30 days; this term may be extended by up to 20 days.
- Federal Service for Financial Markets
  - No sale transaction may be completed until the issuance of shares is registered with the Federal Service for Financial Markets except for transactions with underwriters. Hence, the registration will be a condition precedent of the sales and purchase agreement.

5.2.2.3 Use of nominees and custodians

In many cases, the owners of Russian joint stock companies are investing via an offshore company (in the past often a Cyprus company), have cross-ownerships or are hiding behind nominal owners (nominees). Acquisitions through third parties (i.e. nominees and custodians) – who are required to be licenced – are possible but:

- Use of nominees can complicate the due diligence process
- Nominees are often used to hide the identity of the true owner. However, the registrar of the company's shareholders register has the right to demand a list of the actual owners. In addition, a shareholder holding at least 1% of the votes may request a list of shareholders entitled to participate in the general shareholders' meeting.

5.2.2.4 Rights of first refusal and pre-emptive rights

Rights of first refusal pursuant to which existing shareholders have the right to purchase shares in the first place have to be examined.

- In joint stock companies existing shareholders have the statutory right of first refusal in any open subscription (applicable to open stock company only), or if they voted against the decision on closed subscription or did not participate in such a vote, in a closed subscription (applicable equally to an open or closed joint stock company). A failure to comply with rights of first refusal procedures may lead to the invalidation of a transaction.
- Limited liability companies do not issue shares. A limited liability company may invite a new participant (somewhat similar to a closed subscription in favor of a third party in a joint stock company) in which case, subject to unanimous approval of the existing participants, such new participant receives a participatory interest. However, no pre-emptive rights apply.
- In other cases it has to be checked whether the issuer's corporate documents or shareholder agreements grant existing shareholders rights of first refusal to participate in the purchase. E.g. if the issuer is an open joint stock company such rights cannot be granted under its corporate documents (this is prohibited by law). Such rights can only be granted in shareholder agreements. A right of first refusal may also be granted to the company, if provided in the company's corporate documents.

5.3 Ownership and use of assets

Clearly the company (or the shareholder from whom an investor is purchasing shares in the company) must hold the assets or shares which are acquired.[53]

With respect to **land**, at least the following issues should be checked:

- Who is the owner of the land plot? Possible answers are: the Russian Federation, one of its

[52] In March 2004 the former Ministry of Anti-Monopoly Policy ("MAP") was reorganised into the FAS.

[53] See already practice note in 3.7 on ownership in infrastructure and equipment.

member states, a municipality, a legal entity or an individual.

- Does the company hold valid ownership to the land plot? Typically, the company will be leasing the land plot on the basis of a written lease agreement with the owner of the land plot.
- Did the previous owner(s) or user(s) of the land plot validly waive their rights to use the land plot? For state-owned companies, there is a special procedure to waive land use rights.
- What is the category of the land plot? In Russia, all land is categorised and a land plot may only be used in accordance with its category. Most land in Russia is either agricultural or forest land. Natural resources may only be extracted on land plots which are industrial, forest or settlement land plots. Extraction of natural resources on agricultural land plots is strictly prohibited and may be penalised by fines, sometimes with considerable amounts, and prohibitions to carry out a business activity.

As far as real estate is concerned purchase contracts, lease contracts and mortgages must be registered to be valid; prior to September 2004 mortgage agreements with respect to immovable property mandatorily had to be notarised which was expensive.[54] However, the need for notarisation has now largely been abolished, and notarisation may be done now on a voluntary basis.[55] The permitted use of real property must be verified, especially if land is involved: rights for the use of land plots are granted to oil and gas companies after the receipt of a relevant subsoil licence and determination of the area and depth of subsoil exploration. While Russian law does not prohibit the ownership of land plots over subsoil, in practice, oil and gas producers typically lease such land plots from the State.

5.4 Security rights

There is a need to ensure that there are no statutory or contractual security rights on the target's assets, in particular its equipment, and that equipment was paid for properly and in full.

5.5 Contracts entered into by the target company

5.5.1 Transportation and offtake issues

Oil and gas projects and companies rely not only on the efficient exploitation of the hydrocarbon reserves but equally on the transportation and refining of the production. Key points in a legal due diligence are therefore:

- the transportation contracts with various transporters (mainly Transneft and the Caspian Pipeline Consortium [for crude oil], Transnefteproduct [for oil products such as diesel], Russian Railways [for crude oil and oil products] or Gazprom [for gas]) and
- offtake contracts typically with oil traders buying the producer's hydrocarbons production or processing contracts with refineries.

5.5.2 Labor matters

The following issues will typically be the focus of the due diligence:

- Collective bargaining agreements
- Review of employment contracts, in particular termination problems
- Payroll issues (make sure no illegal schemes for payment exist)

5.6 Compliance with legal requirements

5.6.1 Requirements for licences, production sharing agreements and subsoil use rights under regulated contracts

- Has the company obtained all necessary licences or other subsoil use rights (for exploration and production of oil and gas)?
- Was the licensing authority authorised to issue the licences?
- Were the subsoil use rights granted in accordance with the established procedure?
- Do the subsoil use right documents contain all details required by applicable law?
- What is the term of the licence (exploration licence generally is 5 years, production licence until depletion of the deposit)?

5.6.2 Other types of licences and approvals

The development of and production from a hydrocarbon reserve requires not only hydrocarbon subsoil use rights. A number of

[54] Prior to September 2004 notary fees for mandatory notarisation were 1.5% of the value under the mortgage agreement.

[55] Fees are 0.15% of the value under the mortgage agreement. Voluntary notarisation is in practice often advisable to facilitate both registration and enforcement of mortgages.

other approvals will also have to be obtained,[56] i.a.

- Approvals for the construction of any facilities on site
- Environmental approvals

Where midstream (i.e. transportation) or downstream (i.e. refining or marketing) activities are involved, additional licences may have to be obtained.[57]

5.6.3 Currency issues (see chapter 10 below)

5.6.4 Tax issues

The following major points should be scrutinised:

- Have tax filings been made in time?
- Does the target company have arrears to tax authorities?

> **Practice note:** In some contexts a certificate of "no current tax liability" can be obtained from the relevant tax authority. However, they are not easy to obtain and there would be limitations on the purchaser's ability to rely on such in any event.

- Are there actions by the tax authorities against the company?
- The validity of tax exemptions or audits which the company may be relying on (and which may or may not be recognised by competing tax authorities) should be verified.
- Have social duties and pension fund payments been made?

> **Practice note:** Companies sometimes operate so-called "grey schemes" and may occasionally even have committed tax evasion. In the wake of Russia's strict enforcement of tax legislation it is particularly important to review a target company's tax situation carefully.

5.6.5 State secrets issues

Access to State secrets is restricted to Russian citizens only (Section 5 State Secrets Law). Foreigners may have access to the information which is considered a State secret only with a permit of the appropriate State body and federal security service.

The State Secrets Law considers the quantity and volume of reserves and levels of extraction of Russia's strategic fossil-fuels to be state secrets. Government Decree No. 210 lists "strategic natural resources" and includes information on the balance of subsurface reserves of oil and gas dissolved in oil, also of non-ferrous and rare metals (like nickel, cobalt, tantalum, niobium, beryllium).

> **Practice note:** The State Secrets Law may create issues for foreign managers working in the oil and gas industry in Russia.

5.6.6 Business practices: corruption

The Russian Criminal Code contains provisions prohibiting the unlawful transfer of money or other items of value, including services, to any employee of a commercial enterprise to induce such employee to take or not to take some action in the transferring person's interest.

Punishment can range from 200 to 500 times the minimum wage (approximately US$ 630 to US$ 1,570) to up to 5 years in prison for multiple offences or actions taken by a group of employees.

In addition, the Civil Service Law forbids corruption and abuse of office for civil servants.

5.7 Liabilities

5.7.1 Environmental, health and safety issues

Russian environmental legislation consists of numerous federal and regional regulations. On federal level, the most important laws are the Federal Law "On Environment Protection" and the Federal Law "On State Environmental Expert Evaluation".

> **Practice note:** As a result of the rather complicated Russian environmental legislation, full environmental compliance cannot always be ensured.

An **environmental impact assessment** and a **State environmental expert evaluation** must be made prior to the implementation of an investment related to the use of natural resources.

Furthermore, the company must obtain **operational licences and approvals** authorising the discharge of pollutants into the air and water

[56] See in particular Federal Law No. 80-FZ dated 2 July 2005 amending the Federal Law "On the Licensing of Certain Types of Activity".

[57] The need to licence the exploitation of trunk pipelines was removed by Federal Law No. 80-FZ dated 23 July 2005. However, trunk pipeline construction, ownership and operation remains strictly controlled by law and practice in Russia. To date only Transneft and the Caspian Pipeline Consortium (CPC) can operate crude oil pipelines, Transnefteproduct oil product pipelines and Gazprom natural gas pipelines. – Equally removed was the requirement for licences for the transportation, storage and refining of oil, gas and related products.

under a "pay-to-pollute" regime. If such discharge exceeds permissible levels, the company is subject to fines calculated as a multiple of the original "fee" set for the discharge of pollutants. In practice, often only small penalties apply. Particular attention must be paid to the use of any hazardous substances and to compliance with sanitary zone requirements.

There is also a need to check for any existing court cases or documents concerning administrative proceedings that involve the target company. **Flaring associated gas** is a particular issue in the oil and gas industry. So far it attracted no particular fines as long as it was in principle permitted under the environmental approvals.

5.7.2 Contractual liabilities

The target company may have various forms of contractual liabilities e.g. from loan agreements, employment agreements or under long-term supply contracts. These liabilities will have to be evaluated.

> **Practice note:** It should be noted that many Russian companies have various "off-balance sheet obligations", such as suretyships, guarantees and other contingent liabilities that may not be accounted for in their financial statements.

5.7.3 Liability for failure to comply with licensing requirements

Fines and restrictions may be imposed and/or licences under the current Subsoil Law may be suspended, amended or terminated in the following selected cases:

- Immediate danger to health or safety of the local population
- Material violation of licence terms by the licence holder, e.g. failure to make timely payments of levies and taxes for subsoil use
- Failure of licencee to commence operations in accordance with the terms of the licence
- Liquidation of the legal entity holding the licence
- Failure of the licencee to provide required reports (e.g. geological information) to controlling bodies
- Systematic violation of the subsoil use rules by the licence holder

5.8 Litigation, liquidation and insolvency

It has to be checked whether the target company is subject to litigation or whether creditors have the right to initiate insolvency proceedings.

An issue often arising with oil and gas companies at exploration or development stage is that they may have had a negative asset value for a period of several years. If the value of net assets falls below the minimum amount of the charter capital established by law at the end of the second year or any subsequent year a company is obliged to take a decision on voluntary liquidation. If a company fails to take such a decision within a reasonable time, its creditors may request early termination or discharge of the company's obligations and claim damages from the company. However, if the company has rectified the asset position[58] before any claim on its liquidation is brought, it is possible that it may not be liquidated. Please note, however, that in politically sensitive situations the undercapitalization may be considered by competent courts as an incurable violation of Russian corporate law and thus the company may be forced into liquidation (see e.g. the MNVK case).

5.9 Approvals of the acquisition

The acquisition must be made with the necessary corporate and regulatory approvals.

5.9.1 Corporate approvals

Under Russian law there are certain requirements for transactions between a company and an **"interested party"** which may include the acquisition of shares in a company by such a person. "Interested persons" include managers, directors and shareholders holding jointly with affiliated persons 20% or more of the voting shares of the company involved, as well as persons entitled to give mandatory instructions to the company. Information on all transactions involving "interested persons" must be submitted to the company's board of directors, the company's audit committee and the company's auditor. Interested-party transactions carried out in violation of these rules may be declared invalid by a competent court.

Special approval of the board of directors or the shareholders (depending on the value of the transaction in relation to the company's assets) may also be required for so-called **"major transactions"**, i.e. transactions the va-

[58] Possibly by providing additional equity to the company, which is, however, unclear in Russian law and practice.

lue of which generally exceeds 25% of the book value of the company's assets. Various other company procedures (such as valuation of the subject-matter of the contemplated transaction by the directors) may also be necessary. If a transaction of a stock company is simultaneously a major and an interested-party transaction, the rules for interested-party transaction approvals apply. For limited liability companies there is no such express rule but the conservative approach is to follow both corporate approval procedures.

Practice note: Corporate approvals for state-owned companies may take a certain time due to ministerial approval processes.

5.9.2 Regulatory approvals

- Central Bank
  - Currency regulations in connection with the purchase of assets or shares must be complied with. In particular, it is necessary to ensure that advance payments in foreign currency are in compliance with currency law (see 10.1 below).
- Federal Anti-Monopoly Service ("FAS") or its relevant territorial division
  - The acquisition of more than 10% of a company's fixed assets (by way of asset deal) may require a prior approval or notification of the FAS, depending on the balance sheet value of the fixed assets of the acquirer and the selling company.
  - If the approval is not obtained
- the FAS may file a claim with a competent court for invalidation of the transaction;
- the relevant agreement may be terminated or amended by a competent court
- an obligation may be imposed on the company to enter into an agreement with another company
- profits arising from the violation have to be transferred to the federal budget
- the company may be reorganised by means of a spin-off
- fines may be imposed; this may result in the imposition of a fine on officers or the company for failure to submit a necessary application or petition to the FAS or for failure to fulfill the FAS' directives, provided in each case the transaction violates the competition in the relevant market in Russia.

6. Documentation of acquisitions and divestitures

6.1 Pre-transaction documentation

6.1.1 Confidentiality agreement

A confidentiality agreement is the basis for any commercial transaction. It shall prevent that commercially sensitive information is disseminated beyond the immediate parties involved in a transaction. The parties will focus in their negotiations on the term of a confidentiality agreement (in most cases a confidentiality period of 3-5 years from the date of signing of the agreement should provide sufficient protection; unlimited confidentiality periods should in principle be avoided). They will also deal in particular with the consequences of a violation of the agreement. It is not atypical for M&A transactions to include a liquidated damages clause in a confidentiality agreement which specifies the amount of damages payable for every violation of the confidentiality obligations.

6.1.2 Letters of intent

In M&A transactions letters of intent are issued at various stages. Bidders in divestiture processes submit letters of intent to the seller (typically during the first round an initial letter of intent is issued, during the final round the final letter is provided). In addition, banks often provide support letters of intent to bidders in which they indicate their willingness to support a bidder with debt financing. The legal nature of letters of intent is what the name suggests: they are non-binding expressions of interest provided they are not qualified as a pre-contract under the applicable law (e.g. a preliminary agreement under Russian law). However, even if the letter of intent is not a legally binding document in a commercial sense the letter of intent creates expectations for the other party and it is a step on the way of completing an M&A transaction.

6.1.3 Term sheets

Prior to drafting e.g. comprehensive sale and purchase agreements or financing documentation, the transaction structure and the basic understanding of the parties should be summarised in so-called term sheets. Term sheets can reflect varying degrees of detail; on the one end of the spectrum they can be mere summaries of the most important terms of a transaction and on the other end they may reflect every single provision (in an abbreviated form). Term sheets are an important tool in the documentation process since they allow adaptations in parallel to the parties' negotiation process.

6.2 Acquisitions and divestitures

6.2.1 Acquisition[59]

6.2.1.1 Sale and purchase agreement

The sale and purchase agreement will have to deal with the following main points:

- The correct reference to the **parties** of the agreement, i.e. the seller and the buyer, will be the first point to deal with.
- In a **preamble** the parties will typically describe the transaction in general terms (e.g. sale of shares in an upstream company).
- The agreement will then focus on the parties' main obligations.
  - As far as the seller is concerned it will have to **transfer the shares (or assets)** to the buyer; to this end the sale and purchase agreement will have to describe in detail the shares or assets to be transferred and the seller will also make representations and warranties as to the exact status of the sold shares or assets (e.g. the target company's liabilities).
  - As far as the buyer is concerned it will have to pay the **purchase price**, either in one payment or several installments.[60] The payment obligation may be defined in the form of a so-called earn-out provision. Under such a provision the payment is typically made in installments. The amount of each installment is dependent on the financial performance of the target company. Definitions of earn-out provisions vary widely. Often the parties agree on a retention amount and the use of escrow accounts to synchronise the transfer of shares or assets and the payment of the purchase price. Sometimes the purchase price is not paid in cash but (at least partially) in shares e.g. of the purchasing company.
- The **conditions precedent** have to be met for the sale and purchase agreement to become effective. The conditions precedent indicate at least that seller and purchaser shall deliver to each other documents showing that they can validly enter into the agreement, including
  - a notarised copy of the memorandum of incorporation, charter, and/or other constituent documents of the respective companies,
  - notarised copies of all necessary corporate resolutions of the respective companies authorising the execution and performance of their obligations under the agreement,
  - a notarised copy of the powers of attorney and/or certificates of positions held, and other documents confirming the requisite power of the persons signing the agreement on behalf of the respective party,
  - a copy of antimonopoly approvals, if required;
  - waivers of pre-emptive rights or rights of first refusal;
  - production of certain documents.

In addition, the sale and purchase agreement will require that no 'material adverse effect' has occurred between the date of execution of the agreement and it becoming effective.

> **Practice note:** It is useful to prepare a so-called completion agenda on the basis of the documents which are often complicated. The completion agenda shall summarise the steps necessary to attain the transaction closing.

- The main focus of the negotiations and the documentation will be on the seller's and the purchaser's **representations, warranties and indemnities** as well as the resulting liability for any misrepresentations with respect to the sold shares or assets. The most usual warranties are
  - Warranties with respect to the legal status of the seller and the purchaser (broadly confirming that the parties are legally able to enter into the agreement, not violating law or provisions from the respective companies' constituent documents)
  - Warranties with respect to the assets acquired, including their financial status;
  - Warranties with respect to debts owed by the acquired companies towards third parties
  - Warranties with respect to the regulatory status of the acquired companies
  - Warranties with respect to the legal status of the main assets of the acquired companies (e.g. ownership to the assets)
  - Warranties with respect to the status of the material contracts of the acquired companies
  - Warranties with respect to litigation and investigations against the acquired companies
  - Warranties with respect to insolvency and liquidation of the acquired companies

[59] If the parties decide to form a joint venture they will define their relationship in a joint venture agreement.

[60] If the purchase price is payable in several installments it is sometimes useful to request that the payment obligation is underpinned by a letter of credit by a bank.

Often the seller will issue a **disclosure letter** to the purchaser in which he lists the issues of which the purchaser has been made aware. He may also use contractual means for so-called 'vendor protection', e.g. by limiting his liability to a certain amount.

> **Practice note:** Often legal and financial due diligence will demonstrate risks which cannot be eliminated until the closing of the acquisition. The parties have then five standard ways of mitigating residual risks: (i) They can include conditions precedent in the sale and purchase agreement which ask the seller to take remedial steps prior to closing of the acquisition. (ii) The parties may also agree that part of the purchase price is retained after closing of the acquisition until remedial steps have been completed. (iii) The parties may agree on a price reduction, either immediately in the sale and purchase agreement or in an amendment to the sale and purchase agreement. This is a common approach in Russia. (iv) Fourthly the purchaser may seek protection in the form of warranties and/or indemnities from the seller. (v) Lastly, the purchaser may take a commercial view on the seriousness of a certain risk and seek to rectify the risk himself after closing of the acquisition.

- Furthermore, the seller and the buyer may agree on **additional obligations** (such as a non-compete clause under which the seller is obliged for a certain period not to compete with the target company acquired by the buyer).
- A sale and purchase agreement for international transactions (i.e. an acquisition in which a non-Russian purchaser is involved) will often have a clause under which the agreement is **governed by English law**. It should be noted that English law can only govern the contractual relationship between the parties of the agreement. The transfer of the assets held directly by a Russian company or the shares in a Russian company will inevitably be governed by Russian law since most of the assets will be located in the Russian Federation and a transfer of shares is necessarily governed by the law applicable to the company which will again in many cases be Russian law. However, if the shares of an offshore holding company are acquired, foreign (e.g. English) law may govern any transfers. Please note that mandatory rules of Russian law may apply regardless of the choice of law.
- **Annexes** may in detail describe the sold shares or assets.

6.2.1.2 Farm-in agreement[61]

A farm-in agreement is a transfer of a part of the shares in an oil or gas company in consideration for an agreement by the transferee to meet certain expenditures that would otherwise have to be undertaken by the subsoil rights user. Hence, a farm-in agreement is a combination of a typical sale and purchase agreement and an additional investment commitment.

6.2.1.3 Escrow account agreement

There is a natural conflict between seller and buyer: whereas the seller does not want to transfer his shares or assets to the purchaser prior to receiving the purchase price, the purchaser does not want to pay the purchase price prior to receiving the shares or assets. This conflict is typically regulated by involving an independent escrow account agent (often a bank) who opens an account into which the purchase price is transferred and released only once the shares or assets are transferred.

The seller has to execute and deliver to the purchaser a confirmation that a transfer by the escrow agent to the seller shall be deemed by the seller to have been made on behalf of the purchaser and shall therefore satisfy in full the purchaser's obligations to pay the purchase price under the sale and purchase agreement. Escrow agents typically provide clearing services (also called "delivery versus payment"), i.e. they collect the shares from the seller and the purchase price from the purchaser and ensure a simultaneous transfer of shares versus payment of the purchase price. Thus, the reason for using an escrow agent is to synchronise the transfer of shares with the payment of the purchase price.

6.2.1.4 Shareholders agreement

If several investors make an acquisition or if an investor is joining an existing shareholder the shareholders will want to regulate their relationships in a shareholders agreement. This may deal in particular with the following issues:

- Prior approval rights: investors may want to secure approval rights at shareholders or management level with respect to important company decisions.
- Reporting rights: investors may want to receive certain information in the form of regular reports.
- Investors may want to secure a right of first refusal against other shareholders (pursuant to

[61] The agreements are also often referred to as 'farm-out agreements' thus reflecting the perspective of the transferring party.

which the seller of shares has to offer the shares first to existing shareholders).

- If one shareholder sells his shares he may have drag along rights under the shareholders agreement pursuant to which the other shareholders are under an obligation to sell their shares as well.
- In the reverse situation a shareholder may have tag or take along rights pursuant to which he has the right to sell his shares also if another shareholder sells his shares.

Shareholders agreements are a complex area and will need to be drafted with a view to the specific requirements of the shareholders involved. It should be noted that the status of shareholders agreements remains extremely unclear under Russian law. It is challenging to have the agreement governed by Russian law; that is why most will be governed by English, New York or another non-Russian law.[62] This is of course possible where the shareholders agreement is entered into between Russian and foreign parties. However, the key issue remains whether the rights provided in the shareholders agreement will ultimately be enforceable in Russia. This issue has not yet been tested in the higher courts (decisions may have been rendered at first instance, but such cases have not been reported). For this reason it is to be expected that non-Russian parties to shareholders agreements will seek to include an arbitration provision in the agreement that provides for arbitration of disputes related to a shareholders agreement in a jurisdiction outside the Russian Federation. There is a possible added protection for foreign investors as a party to a foreign-law shareholders agreement, in terms of enforcement of its terms, if the Russian company partner has assets offshore that can be attached to satisfy a damage award obtained in a foreign arbitration or court setting.

6.2.1.5 Corporate documents

A new shareholder of a company, particularly if it is a majority shareholder, will review the existing corporate documents and may want to introduce changes.

6.2.2 Acquisition financing

6.2.2.1 Loan agreement

The loan agreement will focus on the following provisions:

- Parties of the agreement
- Loan purpose, amount and currency
- Interest payable on the loan and repayment of the loan
- Conditions precedent for a drawdown under the loan, in particular satisfactory financing documentation and drawdown notice
- Representations and warranties of the borrower in particular with respect to his financial and legal situation
- Covenants
  - Obligations to create agreed security rights (see also 6.2.2.2)
  - Obligations to provide certain information about the borrower's financial situation
  - Obligations to keep the company's activities within a pre-agreed framework
  - Financial covenants: Critical in any modern financing are so-called financial covenants which allow financial institutions to monitor the financial performance of their borrower on an ongoing basis. The following ratios can be found in financing documentation for acquisition financings of oil and gas companies:
- Senior debt to EBITDA ratio: ratio of (i) amount of the target company's (and NewCo's, if an indirect acquisition structure is chosen) senior debt to (ii) the target company's (and NewCo's, if an indirect acquisition structure is chosen) earnings before interest, taxes, depreciation and amortisation (= EBITDA) on a calculation date
- Loan life coverage ratio: ratio of (i) projected net cash flow (on a discounted present value basis) from proved reserves of all fields in the block until final loan maturity to (ii) principal, interest and other amounts due on all outstanding long-term debt on a calculation date
- Field life coverage ratio (which can be compared to the project life coverage ratio used in typical project financings): ratio of (i) projected net cash flow (on a discounted present value basis) from proved reserves of all fields in the block over the longest life of any such field to (ii) principal, interest and other amounts due on all outstanding long-term debt on a calculation date
- Debt-to-equity ratio: ratio of (i) the target company's (and NewCo's, if an indirect acquisition structure is chosen) amount of debt to (ii) the target company's (and NewCo's, if an indirect acqui-

[62] However, in practice there are such shareholders agreements governed by Russian law.

sition structure is chosen) equity on a calculation date.

  - Note that certain covenants may apply not only to the borrower but also to the borrower's shareholders. Such clauses of a loan agreement are enforceable only if such shareholders are a party to the loan agreement.

- The loan agreement will also deal with the events of default, in which the lender will have the right to terminate early the loan and accelerate the loan repayment.

Where the amount of a loan exceeds 25% of the value of the company's balance sheet assets at the time of execution of the loan agreement the investor should check whether an approval by the internal board of directors was given to the decision to take on the loan which is considered a "**major transaction**" under Russian law. If the amount of a loan exceeds 50% of the value of the company's balance sheet asset an approval of the company's shareholders is required.

6.2.2.2 Security agreements

There are a number of security rights which will typically be an element of an acquisition financing, in particular

- Pledge of shares in NewCo (if an indirect acquisition structure is chosen)
- Pledge of shares in the target company
- Assignment of rights under a PSA or a regulated subsoil contract under the Draft Subsoil Law
- Assignment of rights to obtain proceeds from sales of crude oil or gas under offtake agreements and other agreements (as far as they are not taken as security by lenders to the target company)

Practice note: Russian law does not contain an exhaustive list of legal instruments to secure debts. The most typical ways of taking security are guarantees (an independent obligation which can only be issued for consideration by banks), suretyships (which can be issued by corporate entities or private individuals), performance bonds, retention of ownership, assignment of receivables, promissory notes and repurchase obligations.

There are doubts as to the validity of a pledge of rights under bank accounts. However, a pledge of rights under bank accounts may be substituted under Russian law by the right of the bank to withdraw money from the borrower's bank accounts. The borrower thereby agrees that the bank shall have the right to debit from the borrower's accounts maintained with such bank any and all amounts due to the bank pursuant to the loan agreement, without the borrower's prior consent. Please note, however, that this withdrawal right may be terminated early by the borrower at any time. Under Russian law, account holders cannot be validly restricted from closing the accounts which limits the reliability of this security tool.

- Security right over produced crude oil (or other hydrocarbon products)
- Security right over other moveable property
- Security right over immovable property (or lease agreements if the company leases the land)

Practice note: There are a number of practical limitations of security rights under Russian law. In particular, there are a number of issues with **pledges** such as the requirement to make perfect identification of the pledged assets, the absence of a floating charge concept similar to English law, the complexity of enforcement, the inability to seize the assets and the requirement to sell the pledged assets at a public auction for Roubles. Similarly there are issues with **assignments** (there is e.g. an unclear court position with respect to partial assignment as compared to a complete withdrawal from a contractual obligation).

In relation to financial assistance (in particular in the form of financial support provided e.g. by way of guarantees or other types of security by the target company to a loan borrowed by a NewCo) Russia may offer more flexibility than certain Western jurisdictions including continental Europe since there are no express rules in Russia restricting financial assistance. However, care must be taken to ensure compliance with (i) the provisions of the Civil Code of the Russian Federation prohibiting gifts between commercial organisations and (ii) rules requiring approval by the board of directors or shareholders' meeting if the assistance given constitutes either an interested party or a major transaction (Articles 78-84 Law on Joint Stock Companies). In addition, Article 71 Law on Joint Stock Companies requires directors and officers of a company to operate in the interests of that company as well as to perform their duties reasonably and in good faith. Although Article 71 Law on Joint Stock Companies has not been widely tested in the courts, it should be taken into

account by any directors or officers of a company asked to give financial assistance.[63]

6.2.2.3 Suretyships

It may not be possible to base the debt financing only on the cash flows of the acquired company (i.e. not to have any financial recourse to the purchaser). Financing institutions may, therefore, require additional security in the form of a suretyship by the purchaser of the target company. Please note that under Russian law there is a difference between a guarantee (an independent obligation which can only be issued for consideration by banks) and suretyships (which can be issued by corporate entities or private individuals). Suretyships may be terminated early if, among other things, the surety disagrees with an increase of the secured obligations. Another issue is whether or not the issuance of a suretyship requires consideration.[64]

7. Notifications, registrations and approvals (and related disclosure requirements) for acquisitions and divestitures

7.1 Notifications and registrations

7.1.1 Federal Anti-Monopoly Service ("FAS") or its relevant territorial division

The main regulatory devices of Russian competition law are prior approval of a transaction by the FAS or subsequent notification to the FAS. The two regulatory procedures are closely related – as either notification or prior approval may apply to a particular transaction depending on the transaction value, type of the target and some other factors.

Prior consent of the FAS is required:

- Every time an individual, legal entity or group of entities acquires over 20% of voting shares of another legal entity,
- In case of a merger or an accession of one legal entity with or to another legal entity(ies),
- In case of acquisition by an individual, legal entity or group of entities of rights to control (in various forms) or manage the business activities of another entity, including management agreements, whereby one legal entity becomes the managing company of another legal entity,

provided that the book value of the assets of the acquirer and its 'group of persons' exceeds 30 million times the statutory minimum wage (ca. US$ 108 million as of today)[65] or if one of said legal entities (or an entity of its group) in the transaction has a market share of over 35% and is listed as such in a special state register of monopolies.

In case the book value of the assets of all the legal entities mentioned above is lower than 30 million times the statutory minimum wage but exceeds 2 million times the statutory minimum wage (ca. US$ 7.2 million as of today)[66] the applicant must within 45 days after the date of the relevant transaction notify the FAS about the transaction.

Subsequent 45-day notification of the FAS is also required

- In case of nomination of an individual to a management body of a legal entity, provided that the book value of assets of such legal entity exceeds 2 million times the statutory minimum salary (ca. US$ 7.2 million as of today)[67] or if such legal entity has a market share of over 35% and is listed as such in a special state register of monopolies)
- In case of creation of a legal entity, provided that the book value of assets of its founders exceeds 2 million times the statutory minimum salary (ca. US$ 7.2 million as of today)

The competition authorities in Russia have recently suggested they will require further disclosure not only if Russian companies are involved in a transaction but also with respect to offshore entities controlling Russian companies or assets (which would lead to an extraterritorial effect of Russian competition law).

Practice note: In some bidding situations it may occur that a bidder of a final (binding or non-binding) bid notifies the FAS of its intention to acquire the shares or the assets of a company. This can lead to the situation that several companies notify the FAS prior to the selection of the final bidder.

[63] For the issues of interested-party transactions and major transactions as well as the respective corporate approvals see 5.9.1 above.

[64] For the issues of interested-party transactions and major transactions as well as the respective corporate approvals see 5.9.1 above.

[65] Measured against the worldwide balance sheet asset value of the acquirer and its group of persons and the target company. The threshold was raised in March 2005 and was previously at least 200,000 times the statutory minimum salary which is equal to ca. US$ 727,500.

[66] Measured against the worldwide balance sheet asset value of the acquirer and its group of persons and the target company.

[67] Measured against the worldwide balance sheet asset value of the acquirer and its group of persons and the target company.

7.1.1.2 Acquisition of main production assets of a legal entity

The prior consent of the FAS is required every time a legal entity or group of entities acquires more than 10% of the book value of fixed assets of another legal entity, again provided that the book value of the assets of the acquirer and its 'group of persons' as well as the fixed assets so acquired exceeds 30 million times the statutory minimum wage (ca. US$ 108 million as of today)[68] or if one of the legal entities (or an entity of its group) in the transaction has a market share of over 35% and is listed as such in a special state register of monopolies.

In case the book value of the assets of the acquirer and its 'group of persons' and of the fixed assets so acquired is lower than 30 million times the statutory minimum wage but exceeds 2 million times the minimum wage (ca. US$ 7.2 million as of today)[69] the applicant must within 45 days from the date of the transaction notify the FAS about the transaction.

7.1.2 Federal Service for Financial Markets

Purchasers of shares in Russian joint stock companies must notify the Federal Service for Financial Markets if they acquire a 20% interest in a Russian company, and for any further increase of ownership of 5% or more.

A share issue of a Russian joint stock company must be registered by the local branch of the Federal Service for Financial Markets.

7.1.3 Shareholders' guidance by the target company's board of directors

In 2002 the Federal Commission on Securities Markets (now called "Federal Service for Financial Markets") promulgated a voluntary Code of Corporate Conduct (see http://www.fcsm.ru/eng). Companies with 1,000 or more shareholders must state in their annual reports whether or not they are in compliance with the Code. Chapter 6 of this Code provides that the company's board of directors should provide non-binding guidance to the shareholders with respect to any attempt by an investor to acquire control of the company.

7.1.4 Optional and mandatory offer to other shareholders

7.1.4.1 Acquisition of more than 30% of the voting shares

From 1 July 2006[70] any acquisition of more than 30% of the voting shares in an open joint stock company is subject to the following rules:

A person **intending** to acquire (separately or jointly with its affiliates) more than 30% of the total issued voting shares has a right (but not an obligation) to make a voluntary public offer to the other shareholders. The public offer shall disclose information on the purchaser's identity and his current shareholding, affiliations and corporate governance. Other features are that the payment obligations of the purchaser must be secured by a bank guarantee and the offer may be conditional upon a minimum or maximum number of shares collected. The shares may be paid for either in cash or with securities. There is no requirement that the offer needs to be at market price.

When a shareholder **has acquired** more than 30% of the voting shares (including the shares owned by him before the acquisition) he is obliged to offer to buy the shares of the remaining shareholders at the market price. For listed shares traded at a stock exchange the minimum price is the average price for the last six months. For shares that are not traded, the minimum price is the market price assessed by an independent valuation company. If the same purchaser purchased shares in the company during the previous six months, the price for the previous transaction or transactions is taken as a minimum.

In both situations the offer is made via the board of directors of the target company. They must pass it on to the shareholders' meeting together with their recommendations.

7.1.4.2 Squeeze-out of minority shareholders

From 1 July 2006[71] a person who becomes shareholder of more than 95% of the issued shares in an open joint stock company under the procedure for buying more than 30% of the shares (see 7.1.4.1 above) has the **right** to buy the remaining shares from the minority shareholders (and the minority shareholders are under an obligation to sell their shares) and is under an **obligation** to do so should the minority shareholders wish to sell their shares. The acquirer must pay at least the market price. In the latter case (obligation to buy) his offer must be secured by a bank guarantee and provide for payment in cash.

[68] Measured against the worldwide balance sheet asset value of the acquirer and its group of persons and the target company.

[69] Measured against the worldwide balance sheet asset value of the acquirer and its group of persons and the target company.

[70] See Federal Law No. FZ-7 dated 5 January 2006.

[71] See Federal Law No. FZ-7 dated 5 January 2006.

The minority shareholders may request that their shares are purchased within six months from the date on which the company sent them a notice on the right to claim such a buy-out. In the former case (right to buy) the transaction must be completed within 85 days.

7.1.5 Registration in the company's shareholders register

A change of ownership in a company's shares is recorded in book-entry form in the shareholders register. For this new shareholders must open a "shareholder personal account" with the registrar. Ownership passes to the purchaser upon recording in the shareholders register. The registrar issues an "extract" confirming ownership.

7.1.6 Registration in the company register

There is a public company register where companies are registered. For Russian limited liability companies, the change in shareholders has to be registered at this register.

7.2 Approvals

7.2.1 Federal Anti-Monopoly Service ("FAS") or its relevant territorial division

There is a requirement of prior approval of an acquisition by the FAS if

Either (1) there is a **relevant company and transaction size**, i.e.:

- If the combined assets of the purchaser (including the assets of all affiliates and subsidiaries of the purchaser) and the target company exceed 3 billion Roubles (ca. US$ 107 million) (previously: Roubles 20 million; ca. US$ 700,000) **and**
- **Either** an acquisition (including merger and transfers between members of a group of companies) of more than 20% of the voting shares or participating shares of another company[72]
- **Or** an acquisition or use of more than 10% of the production assets of another company (including transfers between members of a group of companies)
- Or an acquisition of a right to determine the business of a company have been made.

Or (2) there is a **relevant market share**, i.e.:

- One of the parties is entered in a register of companies (maintained by the FAS) and has a market share of over 35% **or**
- If the purchaser is a group of persons controlling the activity of an enterprise with a market share of over 35%

The competition authorities in Russia have recently suggested they will require further disclosure and respective approval not only if Russian companies are involved in a transaction but also with respect to offshore entities that have Russian assets (which would lead to an extraterritorial effect of Russian competition law).

Practice note: Failure to receive consent for an acquisition may lead to the invalidation of a transaction, if the transaction may result in a violation of competition. The respective claim may be filed by the FAS within one year from the moment when it has learned or should have learned of a violation. In practice this risk is remote since the authorities usually impose fines on shareholders (up to ca. US$ 17,000 [RUR 500,000]) and the company's management (up to ca. US$ 170 [RUR 5,000]), rather than seeking invalidation of a transaction.

7.2.2 Federal Service for Financial Markets

Beyond the notification requirements (see 7.1.2) there is no need to obtain an approval from the Federal Service for Financial Markets in the course of an acquisition.

7.2.3 Shareholders' approval

In the case of a **closed** stock company each shareholder has a right of first refusal with respect to the sale of shares by any other shareholder (pursuant to which the seller of shares has to offer the shares first to existing shareholders). In order to be able to exercise this right they must be notified by the selling shareholder.

In the case of an **open** stock company with more than 1,000 shareholders, the law imposes special procedures if an investor wants to acquire 30% or more of the company's shares. These procedures include notifying the company in advance and an offer by the potential buyer to purchase the shares of all other shareholders at a price established in accordance with prescribed procedures.

[72] In addition, any incremental increase of a previous shareholding above this 20% level requires a prior approval by the FAS.

8. Legal issues of the target company

8.1 Corporate governance

In 2002 the Federal Commission on Securities Markets (now called "Federal Service for Financial Markets") promulgated a voluntary Code of Corporate Governance (see http://www.fcsm.ru/eng). It provides a good guideline for reorganising a company after an acquisition in a shareholder friendly manner. Efforts should be concentrated on shareholder structure, management activity and quality of financial information (the same criteria on which the S&P corporate transparency index is based).[73] Good corporate governance is a prerequisite for listings, IPOs and borrowings in the capital markets.

8.2 Shareholders rights under Russian company law

Most of the company matters that fall within the competence of shareholders can be decided upon by a 50% plus-one-share majority.

8.2.1 Minority shareholders

Minority shareholders have a number of rights in the context of divestitures and acquisitions:

- Rights of first refusal pursuant to which the seller of shares has to offer the shares first to **existing shareholders** are applicable only in closed joint stock companies and limited liability companies.
- Shareholder's right to sell shares to an **acquirer**: if the company has more than 1,000 shareholders and more than 30% of the companies shares are purchased
- Shareholder's right to sell shares to the **company**:
  - if the company is reorganised; or
  - the company's corporate documents are changed with a view to limiting shareholders' rights; or
  - a major transaction is to be realised (sale or purchase of more than 25% of the assets or placement of more than 25% of the company's share capital) if the minority shareholder has voted against or not voted at all
- voting right with respect to transactions involving conflicts of interest

A shareholder with **25 and up to 50%** has blocking rights on amending the charter, implementing a reorganisation, commencing a liquidation, determining the quantity, nominal value and class of authorised share capital and approving interested party transactions.

Shareholders with **less than 25%** are in a weak position unless their rights are protected by an investment agreement and such contractual rights are in accordance with Russian law. However, they may influence the election of the members of the supervisory board of the company due to the so-called "cumulative voting requirement" which provides that shareholders must be represented on the supervisory board in proportion to their shares. In addition, they are protected against squeeze-out and asset stripping by legal provisions on public offers and interested party transactions.

A **25%** shareholder can block certain decisions of the general shareholders meeting and has the right to participate in profits and receive yearly reports and minutes of the shareholders and directors meetings. Such shareholders are not entitled to receive financial or book-keeping documentation and minutes of the management board (i.e. the second tier executive management of the company as distinct from the board of directors).

8.2.2 Majority shareholders

A shareholding of between 50% + 1 share and 75% gives the holder the right to determine most major issues except amending the charter, implementing a reorganisation, commencing a liquidation, determining the quantity, nominal value and class of authorised share capital and approving interested party transactions. One way a minority investor can minimise the power of the majority shareholder is by shifting control from the shareholders meeting to the board of directors. In order for a minority shareholder to obtain representation at board level, the charter must provide for cumulative voting for directors.

In cumulative voting the number of votes held by each shareholder is multiplied by the number of persons to be elected to the board. A shareholder has the right to cast all votes received in such a manner for one candidate or may distribute his votes among two or more candidates. Through this method he will receive something along the lines of proportional representation on the board.

There has been a practice in the past of acquiring assets through false bankruptcies or dilution of minority shareholders.

[73] On 13 October 2004 S&P unveiled its corporate transparency index calculated for Russia's top traded companies, which increased from 40% in 2003 to 46% in 2004. In comparison, Russia's index was put at a level of 34% in 2002, while the UK achieved a level of 71% in 2003.

9. Taxes and other payments to the State

9.1 Licence charges and fees

9.1.1 Current Subsoil Law

- Under the current Subsoil Law the following payments are required with respect to licences:
- A one-time subsoil use payment
- Regular payments for the right to explore, prospect and appraise
- Payments for geological information
- Payment of tender participation and licence issuance fees
- License payment

9.1.2 Production sharing agreements

In case of a production sharing agreement ("PSA") the subsoil user pays the subsoil use fees agreed under the PSA. This regime is not entirely open for negotiation and agreement. It is substantially regulated by the PSA Law (Article 13) and the PSA Chapter of the Tax Code.

9.1.3 Draft Subsoil Law

Under the Draft Subsoil Law the following payments have to be made:

- A one-time subsoil use payment
- Regular subsoil use payments
- Payments for geological information
- Auction payment duty

The **one-time subsoil use payment** is paid by subsoil users in the following cases:

- exploration and production of mineral products
- regional geological exploration, conducted at the expense of a subsoil user
- special geological research, conducted at the expense of a subsoil user
- collection of various geological materials

The amount of the one-time subsoil payment is determined in a subsoil use contract. The amount of a single subsoil payment shall not be less than 10% of the mineral extraction tax amount calculated on the basis of the estimated average annual production capacity. The amount of the subsoil payments actually payable is set in the subsoil use contract and determined by the auction results. This amount cannot be paid within the first 30 days after the contract registration. If a subsoil user discovers a new deposit whilst conducting search and exploration works at his own expense or with funds received from third parties, the subsoil payment amount is equal to 10% of the mineral extraction tax amount calculated on the basis of the estimated average annual production capacity. In this case, the single subsoil payment is due only after achieving a certain production capacity.

In case of short term subsoil plot usage (less than 1 year) the single subsoil payment is set by the Russian Government. In case of a PSA the subsoil users pay single subsoil use payment as agreed in the PSA.

Regular subsoil use payments are due on a quarterly basis and charged in addition to the one-time subsoil use payment for the following activities:

- Search and deposit evaluation
- Exploration and prospecting of deposits
- Construction and operation of underground and underwater facilities, which are not related to the mineral extraction, such as oil and gas storage facilities, dumping and disposal grounds for harmful substances, pipelines or cables.

The regular subsoil use payments increase with the different stages of the development process and are as follows:

- For **search and deposit evaluation** the annual regular payments are at least Roubles 120 per km^2 and at a maximum Roubles 360 per km^2. For offshore hydrocarbons these amounts are a minimum of Roubles 50 per km^2 and at a maximum Roubles 150 per km^2
- For **exploration and prospecting of the deposit** the annual regular payment is a minimum of Roubles 5,000 per km^2 and at a maximum Roubles 20,000 per km^2. For offshore hydrocarbons these amounts are at least Roubles 4,000 per km^2 and at a maximum Roubles 16,000 per km^2
- Regular payments for **storage of oil and gas condensate** are equal to Roubles 3.5 per tonne, for natural gas Rouble 0.2 per tcm.

The subsoil users should pay for **federally owned geological or any other subsoil information**, which they use. The amount of payments is determined by the Federal Government. Subsoil users which reimbursed expenses for the Government's search and deposit evaluation for a specific sub-

soil plot for which a subsoil use right has been granted are exempt from this payment.

An **auction participation duty** is paid by **all** auction participants. The auction duty is determined on the basis of the expenses for auction preparation, conducting and closing of the auction. With regard to subsoil which is federal property the duty is set by the Russian Government. If the subsoil is local property the duty is set by the member states of the Russian Federation.

9.2 Acquisitions and divestitures

9.2.1 Seller

There is no separate capital gains tax in Russia. Capital gains are in principle subject only to corporate tax (24%) or income tax (13%). It should also be noted that there is no value added tax payable on the sale of assets or shares in the context of an acquisition.

9.2.2 Buyer

The buyer assumes no specific tax obligations in the context of an acquisition.

9.3 Operations

9.3.1 General tax regime

9.3.1.1 Profit tax

The corporate tax rate which has to be paid by companies is a maximum of 24% in Russia (which can be reduced by up to 4% depending on the region in which a company has its seat). Tax must be transferred to federal and regional budgets in the proportion of 6.5% and 17.5% respectively. There are in principle no regional or local taxes in addition to the general corporate tax. Profit tax is levied on a company's accrued gross tax profits, net of deductions (in particular operating expenses, depreciation and amortisation, interest and financings costs). **Losses** may be carried forward for ten years and offset up to 50%[74] of otherwise taxable profit per year. **Expenses** incurred by a taxpayer can only be deducted under Russian tax law if they are (i) "economically justified", (ii) "properly documented" and (iii) incurred in order to derive income. The list of expenses deductible only within specific limits includes, inter alia, certain types of advertising, entertainment and insurance for employees.

Interest expenses accrued with respect to any kind of debts (loans and borrowings, as well as interest accrued on securities and other debt instruments) are deductible for tax purposes, regardless of the purpose of the borrowing obtained by the taxpayer, the use of the funds or the interest payment schedule. This deduction will only be available if the amount of such interest does not exceed 20% of the average interest rate charged for similar types of loans with comparable terms granted in the same quarter. In the absence of loans granted with comparable terms in the same quarter, the amount of the deductible interest expense should not exceed 1.1 times of the Central Bank refinancing rate (for Rouble loans) or 15% (for loans denominated in foreign currency). Certain double taxation treaties provide additional benefits with respect to interest deductions for Russian companies with foreign shareholders and/or Russian branches of foreign companies.

Chapter 25 of the Tax Code introduces **"thin capitalisation" rules**. Thin capitalisation rules are applicable to interest on loans granted by a direct or indirect foreign parent holding more than 20% of a Russian borrower, loans granted by a Russian affiliate of such a foreign parent and loans guaranteed in any form by a foreign parent or its Russian affiliate. Such interest expense is restricted if the outstanding principal amount of "controlled" debt instruments exceeds more than 3 times (or 12.5 times for banks and leasing companies) the difference between the company's assets and its liabilities (i.e. the net equity). The exceeding amounts will be disallowed as a deduction and reclassified as a (taxable) dividend which is subject to 15% Russian withholding tax on dividends (however, in certain cases partial double tax treaty relief arising from a participation exemption is available).

Federal tax holidays are permitted if set by federal law. Regional and local tax holidays are permitted if set by regional or local law.

9.3.1.2 Mineral extraction tax

A single natural resources tax (also referred to as production tax or unified production tax, UPT) provided in Chapter 26 of the Tax Code replaced three ad valorem taxes (excise, mineral royalty, mineral replacement).

9.3.1.2.1 Notion of commercial minerals

The tax is levied on so-called **"commercial minerals"** extracted from the subsurface within the ter-

[74] From 1 January 2006; previously the maximum depreciation was 30% per annum.

ritory of the Russian Federation or territories under the jurisdiction of the Russian Federation, including territories which are leased from foreign States or used on the basis of an international agreement. The "minerals" subject to mineral extraction tax include hydrocarbons such as

- Dewatered, desalted and stabilised oil (here referred to as "crude oil")
- Gas condensate for all types of deposits which has undergone separation and dewatering processes involving the separation of light fractions and other impurities
- Natural fuel gas from all types of deposits and associated gas (here referred to as "natural gas" or "associated gas").

9.3.1.2.2 Crude oil and gas condensate

9.3.1.2.2.1 Transitional provisions until end 2006

For the period from 1 January 2002 until 31 December 2006 the legislation provides for **transitional provisions** according to which, from 1 January 2005 until 31 December 2006 the **taxable base** for mineral extraction tax on **crude oil** is determined as the quantity of extracted oil in physical terms and is taxable at the rate of Roubles 419 per tonne. In this respect, the tax rate is adjusted quarterly by a coefficient reflecting movements in world prices for Urals oil. This coefficient is determined by the taxpayer itself according to the following formula:

$$C = (P - 9) \times R/261$$

where: **P** is the average price of Urals oil for the tax period in US$/barrel; and **R** is the average US$/Rouble exchange rate established by the Russian Central Bank for the tax period.

The tax amount can thus be calculated by the following formula:

$$T = 419 \times \text{oil extracted (tonnes)} \times (P - 9) \times R/261$$

9.3.1.2.2.2 Taxation from 2007

From 1 January 2007 the **tax base** is determined as the value of extracted minerals calculated on the basis of the volume of extracted minerals and the valuation method used or as the quantity of the extracted minerals in physical terms. The value of minerals may be determined by the following methods:

- On the basis of the realisation (sales) prices prevailing for the taxpayer in the relevant tax period (typically a quarter) without taking into account State subsidies to cover the difference between the wholesale price and the calculated value of minerals, or
- On the basis of the realisation (sales) prices of the minerals prevailing for the taxpayer in the relevant tax period (typically a quarter) less value added tax, excise duty on excisable types of minerals (which is typically not the case for hydrocarbons), customs duties or transportation costs and insurance premiums for compulsory freight insurance,
- On the basis of the calculated value of the extracted minerals as determined using data in tax records which are maintained according to the rules established by Chapter 25 of the Tax Code (if it is impossible to use any of the preceding methods).

The main costs deductible from the tax base are transportation costs, marketing costs, export duties, transportation insurance and VAT for domestic sales.

The **tax rate** for crude oil will be set at 16.5% of the taxable base. For gas condensate the rate of tax will be 17.5%.

9.3.1.2.3 Natural gas and associated gas

From 1 January 2005 the tax arising from the extraction of natural (including liquefied natural gas [LNG]) and associated gas is determined as the quantity of the extracted mineral (tax base) to which the following rates apply:

- Natural gas: Roubles 147 per 1,000 cubic meters
- Associated gas (gas extracted via an oil well): Rouble 0

9.3.1.2.4 Tax calculation and payment

The amount of tax on mineral extraction is calculated as the product of the tax base and the appropriate tax rate.

The amount of tax is calculated monthly for each extracted mineral. Tax is payable at the location of each subsurface site which has been provided to the taxpayer for use. In this respect, the amount of tax is computed based on the proportion of a mineral extracted on each site of subsurface resources to the total quantity of that type of mineral that has been extracted. The amount of tax calculated in respect of minerals extracted outside Russia is payable at the location of a company or at the place of residence of a private entrepreneur.

9.3.1.2.5 Changes to the tax regime

In July 2006 the President of the Russian Federation signed a bill introducing changes to the Tax Code which lead to a differentiation of mineral extraction tax. The bill provides for a ten-year mineral extraction tax holiday for greenfield developments in East Siberia and adjacent regions with a combined exploration and production licence, and a fifteen-year holiday for greenfield developments with an exploration licence only. The tax breaks are to end once cumulative production reaches 25 million tonnes per licence. Fields with a depletion rate above 80% are to see a reduction of the mineral extraction tax of up to 70%. The tax holidays and lower taxation rates will become effective from 1 January 2007.

9.3.1.3 Value added tax (VAT)

The tax rate for value added taxes is 18%. The tax is collected through taxable persons on a basis similar to the EU model (e.g. calculated on the sales value). In principle no VAT is applied to exports. Hence, no VAT has to be paid for oil, condensate and gas (including LNG) exports.

9.3.1.4 Property tax

There is a property tax payable by all Russian and foreign companies owning property in Russia. The tax base is the average net book value of fixed (non-current) assets (after depreciation and amortisation) on a company's balance sheet. The tax rate is determined by the region in which the property is located but limited to a maximum of 2.2%.

9.3.1.5 Export duties

Russia has no export excise taxes for oil and gas, but there are export duties.

- The export duty on **crude oil** is US$ 216.4 per tonne (from 1 August 2006).
- The export duty on **propane, butane, ethylene, propylene, ethylethylene, divinyle** and some other **oil products** is US$ 158.1 per tonne (from 1 August 2006). The export duty on **processed oil products** is US$ 85.2 per tonne (from 1 August 2006).
- The export duty for **natural gas** 30% calculated on the basis of the customs value.

Export duties have increased significantly in Russia during the past few years. One of the reasons is the establishment of the Russian Stabilization Fund set up by the Federal Government which collects surplus income from the taxation of hydrocarbon producers.

9.3.2 Tax regime under production sharing agreements

The Chapter of the Russian Tax Code on PSA provides for two forms of production sharing: standard and direct. The tax consequences of each form are different. Under the **standard method**, an investor/operator is subject to mineral extraction tax. Once the value of produced minerals less mineral extraction tax has been reduced by the amount of exploration, production and other reimbursable costs (in principle up to 75% of the value of the produced minerals, or 90% for production on the continental shelf), the remaining profits are shared between the State and the investor according to a formula included in the PSA. The investor's share is then subject to profit tax. The investor is exempt from customs duties on goods imported/exported under the PSA, as well as property tax and transport tax in respect of property/vehicles used for works under the PSA.

Under the **direct sharing model**, an investor is eligible for a share of up to 68% of the total volume of produced minerals. The investor is exempt from profit tax, mineral extraction tax, customs duties relating to goods imported/exported under the PSA, property tax and transport tax relating to property/vehicles used for works under the PSA, land tax and tax on the use of water. Investors/operators of PSAs are subject to Russian VAT as the previous PSA VAT exemption was abolished by an amendment of the Chapter of the Russian Tax Code on PSA.

9.4 Taxes on financings

The interest payments of Russian companies are subject to a 20% withholding tax if the lender is a non-resident (unless a foreign lender benefits from a favourable double taxation treaty with the Russian Federation). Interest payments to a lender who is a Russian resident are taxed at 24%.

9.5 Situation for foreign investors: double taxation treaties

Partial tax relief for foreign investors may be available under applicable bilateral treaties on the avoidance of double taxation. In order to obtain the benefit of a tax treaty, a payee/lender must apply to the relevant tax authorities.

10. Currency law and export law

10.1 Currency regime

The currency regime was changed by Law No. 173-FZ of 10 December 2003 "Concerning Currency Regulation and Currency Control" (the "Currency Act").

10.1.1 Passport of transaction

The reporting requirements under the new Currency Act include notification to the currency control authorities about currency operations. To this end, a "passport of transaction" must be established for almost every international currency transfer made pursuant to loan transactions, export-import contracts for goods and international service agreements. A passport is also required for Rouble loans between residents and non-residents. Previously, passports were required only for the export and import of goods. The passport has to be opened with an authorised Russian bank (i.e. a bank possessing a licence to conduct operations in foreign currency or a general banking licence) where the Russian company has accounts that it would use for transaction purposes.

The passport must be opened by the Russian party with a Russian bank. It allows currency control authorities to monitor whether currency payments made by residents under cross-border transactions are commensurate with the value of goods or services received.

Other restrictions such as using special bank accounts and deposit requirements have been abolished starting from 1 July 2006.

However, shares in Russian joint stock companies may only be sold and purchased for Roubles if the seller or the purchaser is a Russian legal entity or individual.

10.1.2 Transfer of foreign currency

For opening a bank account outside Russia a special procedure must be observed by a Russian legal entity (that procedure may include a preliminary notification about the account to or the registration of the account with the Russian tax authorities).

10.2 Export law

There are currently no export restrictions for hydrocarbons in Russia. However, in practice the ability to export crude oil is still limited by the constraints of the transportation network, in particular the pipeline capacity of Transneft's crude oil pipelines. Generally, exporters are required to repatriate foreign currency proceeds to Russia, with certain limited exceptions, such as service of debt.

Annex:
Legal framework for acquisitions and divestitures in the Russian Federation

We set out below the most important sources of law which are relevant to acquisitions and divestitures.

- **PRIVATE LAW**
  - Civil Code of the Russian Federation, Parts One and Two of 21 October 1994 and 22 December 1995 (note in particular contract law)
  - Land Code dated 25 October 2001
  - Federal Law No. 2872-1 "On Pledge" dated 29 May 1992 ("Pledge Law")
  - Partnership and Company Law

    Law on Joint Stock Companies dated 26 December 1995

    Federal Law No. FZ-7 dated 5 January 2006

    Law on Limited Liability Companies dated 8 February 1998

- **NATURAL RESOURCES LAW**
  - Current Subsoil Law: Federal Law "On Subsoil" (sometimes also referred to as "Underground Resources Law" ["URL"]) No. 2395-1 dated 21 February 1992 ("Current Subsoil Law")

    On 17 June 2005 the Government submitted Draft Law No. 187513-4 "On Subsoil" to the State Duma ("Draft Subsoil Law")

    Revised draft published by the Ministry of Natural Resources in February 2006 ("Revised Draft Subsoil Law")

- Regulations "On the Procedure for Issuance of Subsoil Use Licenses" as approved by Decision of the Supreme Court of the Russian Federation No. 3314-1 dated 15 July 1992 ("1992 Licensing Regulations")
- Rules for Developing of Design Documentation for the Development of Oil and Gas Fields No. RD153-39-007-96 approved by the Ministry of Fuel and Energy on 23 September 1996 ("Development Plan Regulation")
- Ordinance of the Federal Agency for Subsoil Use No. 531 'On the Central Commission for Development of Hydrocarbon Deposits' dated 26 November 2004
- Ordinance of the Federal Agency for Subsoil Use No. 877 'On Approval of an Interim Order on the Central Commission for Development of Mineral Deposits' dated 15 August 2005
- Ordinance of the Federal Agency for Subsoil Use No. 1107 'On Local Subdivisions of the Central Commission for Development of Mineral Deposits' dated 28 October 2005
- Methodological Guidelines for the Preparation of Terms of and on the Procedure for Holding Tenders and Auctions for the Rights to Use Subsoil Areas as approved by Order of the Ministry of Natural Resources No. 457-p dated 14 November 2002 ("2002 Ministry of Natural Resources Recommendations on Conducting Auctions and Tenders")
- Procedure for Transferring a Licence for Subsoil Use Rights approved by Order of the Ministry of Natural Resources No. 1026 dated 19 November 2003
- Regulation "On the Federal Service for Ecological, Technological and Nuclear Monitoring" approved by Regulation of the Russian Federation Government No. 401 dated 30 July 2004, as amended on 21 January 2006
- Regulation No. 69 of the Government of the Russian Federation dated 1 February 2005
- Procedures for the Review of Applications for the Rights to Use Subsoil for Geological Studies approved by Order of the Ministry of Natural Resources No. 61 dated 15 March 2005
- Regulation on Subsoil Use, Procedures for Consideration of Applications for Subsoil Area Use Rights for a Short Period (up to one year) approved by Order No. 22 of the Ministry of Natural Resources dated 24 January 2005
- Regulation "On State Control over Geological Study, Efficient Use and Protection of the Subsoil" approved by Russian Federation Government Resolution No. 293 on 12 May 2005
- Federal Law No. 225-FZ "On Production Sharing Agreements" dated 30 December 1995 as amended on 29 December 2004

  Old production sharing law: Decree No. 2285 "On the Issues of Production Sharing Agreements" dated 24 December 1993
- Federal Law "On the Continental Shelf of the Russian Federation" No. 187-FZ dated 30 November 1995
- Federal Law "On Gas Supply in the Russian Federation" dated 31 March 1999
- Federal Law "On Natural Monopolies" dated 17 August 1995

■ GENERAL REGULATION OF BUSINESS ACTIVITIES

- Concession agreements

  Federal Law No. 115-FZ of the Russian Federation "On Concession Agreements" dated 21 July 2005
- Licensing of business activities

  Federal Law No. 80-FZ amending the Federal Law "On Licensing Certain Types of Activity" dated 2 July 2005

  Federal Law No. 200-FZ amending the Federal Law "On Licensing of Certain Types of Activity" dated 31 December 2005
- State secrets law

  State Secrets Law dated 21 July 1993

  Government Regulation No. 210 dated 2 April 2002
- Securities markets law

  Law on the Securities Market dated 22 April 1996

  Code of Corporate Governance prepared by the Federal Commission on Securities Markets (now called "Federal Service for Financial Markets")
- Competition law

  Current Competition Law: Federal Law on Competition and the Restriction of Monopolistic Activities on the Goods Market No. 948-1 of 22 March 1991 ("Anti-Monopoly Law") (as amended on 9 October 2002 and 21 March 2005)

  In December 2004 the Federal Anti-Monopoly Service published a new draft competition law; on 3 February 2005 the Government approved the core proposals contained in the draft law; a new draft law was published by the FAS on 16 May 2005

- Banking law

  Central Bank of Russia Directive 1540-U dated 29 December 2004

- Environmental law

  Federal Law "On Environmental Protection" dated 10 January 2002

  Federal Law "On State Environmental Expert Evaluation" dated 23 November 1995

  Ordinance of the Government of the Russian Federation No. 215-r dated 20 February 2006

  Ordinance of the Government of the Russian Federation No. 278-r dated 1 March 2006

- Currency law

  Law "On Currency Regulation and Currency Control" No. 173-FZ dated 10 December 2003 as most recently amended on 18 July 2005 ("Currency Act")

  formerly Currency Control Law – RF Law No. 3615-1 "On Currency Regulation and Currency Control", dated 9 October 1992

- Foreign investment law

  Law "On Foreign Investment" dated 9 June 1999

  Law "On Foreign Investment" No. 160-FZ dated 27 July 2002

■ **TAX AND CUSTOMS LAW**

- Tax Code of the Russian Federation, Federal Law No. 117-FZ dated 5 August 2000
- Customs Tariff Law 2004

■ **CRIMINAL LAW**

- Criminal Code dated 13 June 1996
- State Civil Service Law dated 27 July 2004

Disclaimer

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The material contained in this guide was compiled as of 1 September 2006 and, unless otherwise indicated, is based on information available at that time. □