Russia

Terminals for Oil Transportation

On 7 October 2005, the State Duma passed the first reading of the amendments to the law "On Natural Monopolies" extending the list of terminals which oil companies can use for oil transportation. In addition to the trunk pipeline and sea port terminals oil companies will be able to use railway platforms that are owned or leased by major oil producing companies.

Deloitte

A Draft Law "On Subsoil"

It has been reported that on 5 October, the Federation Council Committee for Natural Resources recommended that the draft law "On Subsoil" be rejected. The Federation Council suggests introducing amendments, according to which regions sharing equal rights with the federal centre will be allowed to develop deposits and use subsoil along with the federal government. It is also suggested that competition procedures for the right to use subsoil be returned to the law; a method should be established to differentiate resources annuities and taxation of the extraction of natural resources, which would take into account natural-geographical factors and mining and geological parameters of deposits.

Deloitte

Supervision of Natural Resources Usage

Federal Service for Supervision in the Sphere of Natural Resources Usage Order No. 239, dated 19 September 2005, has officially been published. It establishes the procedure for the publishing and the coming into effect of Federal Service for Environmental Management Usage acts recognized by the Ministry of Justice as not requiring state registration.

Deloitte

Cancellation of Export Customs Duties for Liquefied Natural Gas

On 8 November 2005 German Gref, the Minister of Economic Development and Trade, announced that the Committee for Protection Measures in Foreign Trade and Customs Tariff Policy plans to consider abolishing export customs duties for liquefied natural gas at the end of November.

Deloitte

On the Classification of Oil and Gas Deposits

The Ministry of Natural Resources issued the order "On Approval of Classification of Deposits and Resources of Oil and Burning Gases" defining the categories of oil and gas deposits on the basis of their economic effectiveness, state of geological investigation and level of industrial development. The new classification complies with the principles of classification used by UN and western oil and gas companies. The order will come into effect on 1 January 2009.

Deloitte

Russian Oil Industry

An all-Russia meeting devoted to the development of the oil industry in Russia, is set to debate the concept of modernizing oil-processing plants in Russia, and the possibility of introducing a differentiated rate of tax on the extraction of minerals which will not depend on world oil prices. It is also expected that participants will discuss a number of issues related to the optimization of the tax legislation with regard to customs duties, profit tax and excise duties on oil products.

Deloitte

Export Customs Duty on Crude Oil

The Government Resolution No. 682 of 17 November 2005 provides that effective from 1 December 2005, export customs duty on crude oil and crude oil products processed from bituminous rocks (codes 2709 00 as provided by the Russian Trade Nomenclature of the Foreign Economic Activities) and exported from the territory of the Russian Federation outside the Member States of the Customs Union will amount to USD 179.6 per 1,000 kg.

Deloitte

Interested Party Transactions and Minority Squeeze Out: Draft Laws Amending JSC Law

Amendments to Federal Law No. 208-FZ "On Joint Stock Companies" dated December 26, 1995 (as amended) (the "JSC Law"), have been considered recently in the State Duma. These are Draft No. 395087-3 ("Interested Party Draft") on expanding the list of the transactions which should not be deemed interested party transactions and Draft No. 67304-4 ("Consolidation Draft") on establishing a consolidation procedure to squeeze out minority shareholders.

Interested Party Transactions

According to the JSC Law, a transaction would be deemed an interested party transaction under the following circumstances: a member of the Board of Directors or a managing body of a company, their spouses, relatives or affiliates; shareholders holding 20 percent or more of the voting shares of the company independently or jointly with their affiliates, are a party, the representative or an intermediary to this transaction; they hold 20 percent or more of shares, or are members of governing bodies in the party to the transaction. In this case, a special procedure for approving such a transaction is required.

In practice, there are situations where a party must execute a transaction and simultaneously effect the special procedure for approving an interested party transaction. However, pursuant to the Interested Party Draft, transactions would not be considered interested party transactions if, according to a Federal Law, they are mandatory for the company and payment is at fixed prices and rates set by state agencies.

Consolidation

The Consolidation Draft provides for the right of a shareholder owning (independently or together with its affiliates) 90 percent of the ordinary shares plus one share to redeem all of the shares owned by the other shareholders at a "market price" confirmed by an independent appraiser.

To balance the interests of minority and majority shareholders, the draft stipulates that decisions on the redemption of shares, the form of the demand, and decisions on appointing an independent appraiser must be approved by the General Shareholders Meeting. The scope for abuse of this position is considerable and minority shareholders should be vigilant to protect their interests. However, currently it seems unlikely that this draft will be passed in its current form.

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Franchise Agreements

On August 12,2005, the Ministry of Finance signed Order No. 105n "Concerning the Registration of Franchise (Sub Franchise) Agreements" (the "Order"). The Order establishes a new procedure for the state registration of franchise and sub franchise agreements with the government in addition to establishing a new procedure for amending and terminating such agreements.

The Order maintains the requirement that those agreements must be registered either at the site of the franchisor or, in the event that the franchisor is a foreign legal entity, at the site of the franchisee. Franchise and sub franchise agreements must be registered with the tax authorities within five business days of execution.

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Electric Power Sector Reform in Russia: Where are We Now?

Reform in the electric power sector ("Power Reform") has been a major work in progress for years. According to an article published in "Vedomosti" on November 22,2005, power reform seems to be shifting in a new direction. Under the most recent plan, RAO "UES of Russia" should itself be phased out at the end of 2006. But, according to the internal materials of RAO "UES of Russia," this is unlikely to happen earlier than 2008. This note looks at the progress to date and what we can expect in the short and medium term.

Legal Framework

The basic principles for Power Reform were legislated during 2001-2003. In July 2001, these principles were defined in the Decree on Restructuring the Electric Power Industry of the Russian Federation ("Restructuring Decree"). In mid-2003, a series of laws came into force, including the Law on the Electric Power Industry. In connection with this decree and these laws, several regulations were adopted, in particular the Rules of the Wholesale Electric Power Market (Capacity) During the Transitional Period. Rules on the operation of the electric power retail market should be adopted shortly.

Power Reform Objectives

Power Reform envisages restructuring formerly vertically integrated companies that combined all industry functions, by splitting them into a separate monopoly sector (electric power transmission

and operational dispatcher control) and a competitive sector (electric power generation, sales, repairs and related services).

Wholesale Electric Power (Capacity) Market ("Wholesale Market")

The end goal of Power Reform is a fully competitive wholesale market. However, a prerequisite for such a market to develop is the full demonopolization of the electric power sector.

Electric power sale-purchases during the transitional period are to be made through two sectors: the free sector, launched on November 1, 2003, and the regulated sector (within the regulated sector there is also a trade in differential between the actual and requested capacity of electric power production or consumption).

To be eligible to engage in electric power sale and purchase transactions, the Administrator of the Trading System ("ATS") must give a participant the status of a wholesale market participant, followed by subsequent registration with ATS. In addition, a participant must execute a standard agreement with ATS for access to the wholesale market trading system.

According to the Law on the Electric Power Industry, the functioning of the wholesale market depends on freedom for the participants in the wholesale market to choose the procedure for the sale and purchase of electric power through the formation of market prices, and the selection of offers of purchasers and sellers proceeding from minimum prices for electric power existing in specific price sectors of the wholesale market, or through the conclusion of bilateral agreements for the sale and purchase of electric power. For additional information, please refer to the graph below.

Functions of the Sector's Key Institutions:

(1) The Federal Grid Company administers the unified national electric power grid.

(2) The System Operator ("SO"):

- **!** secures the sustainable operation and development of the unified electric power system;
- **!** provides technological grid connection of power equipment held by any legal entity or individuals pursuant to their ownership or other rights; and
- **!** offers electric power transmission services.

Note: under the targeted model, over 75 percent of FGC and SO will be state owned.

(3) ATS organizes electric power sale-purchases in the wholesale market. For example:

- **!** ATS, together with the SO, enters into an agreement with a new member of the wholesale market regarding the terms and conditions of access to the trading system of that market; and
- **!** ATS registers electric power sale-purchase agreements between the supplier and consumer.

Price Setting

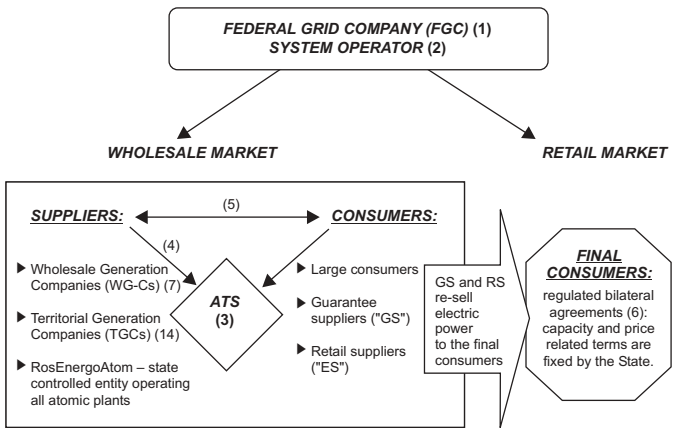
Wholesale market: The parties are free to determine the price based on a so-called equilibrium price, which is formed by supply and demand as a result of comparing the bids of electric power providers with the selection process done by ATS (4), or they can fix the contract price at their own discretion by means of a two-party agreement (5).

Retail Market: To ensure stable power supply conditions and to prevent price escalations, the State introduced regulated bilateral agreements, in which capacity and price related terms are defined directly by the State (6).

At present, over 30 Regional Generation Companies ("AO-Energos") are privatized. All seven Wholesale Generation Companies ("WGCs") have been established, and the majority of 14 Territorial Generation Companies ("TGCs") have completed their state registration. By 2008, RAO "UES of Russia" is intended to be phased out. Following the end of the transitional period, the majority of shares in WGCs and TGCs will be privately owned.

According to information available on the web-site of RAO "UES of Russia," the shares of the new companies will be proportionally distributed among the shareholders of respective AO-Energos.

Chart. **Targeted Model of the Russian Electric Power Sector**



Retail Electric Power (Capacity) Market (the "retail market"): For political reasons, the State has been taking very gradual steps to exit this market. A transitional retail market, where part of the electric power supplied will be at competitive prices, is scheduled for 2006. However, the State will keep control over prices for individual consumers even when the transitional retail market is in operation.

Dispute Resolution

An Arbitration Tribunal has been established within ATS. This is a permanent arbitration tribunal, which considers economic disputes arising out of civil contracts in the electric power industry, provided the parties have agreed to submit to its authority, except in the field of management. The Tribunal provides the parties to a dispute with the following advantages: shorter periods for consideration of their dispute as compared with other arbitration courts; a simplified arbitration hearing procedure, the right of the party to select an arbitrator to hear a dispute; and enhanced confidentiality.

Investments

In September 2005, the Ministry for Industry and Energy submitted to the Russian Government a draft of a planned Decree on Investment Guarantee Mechanisms for the Construction of Generation Facilities (the "Draft"). The aim is to ensure that investors will be reimbursed for the amount equivalent to the difference between the market electric power price and the payback price for a fixed payback period. The Draft is currently under consideration within the Russian Government.

Under the terms of the Draft, an investor will be selected through a tender to be held by the System Operator with the participation of representatives of the local authorities. Preferred projects will be those using state-of-the-art technologies for generating facility construction. According to the information available, the Draft proposes to limit the aggregate capacity of the facilities built under the investment guarantee mechanism to 5,000 MW. The mechanism contemplated in the Draft is planned to be realized at a transitional stage of reforming the power sector as a provisional measure providing for the construction of new generation facilities in certain regions with power deficit.

There is still a lack of investment into the Russian electric power sector. There are several underlying reasons but the majority of large industrial consumers would expect to be served directly by generating companies, and the niche of distribution companies will be participation in the retail market. Generation activities, on the contrary, look more attractive to potential investors. The Draft will be the subject of a future note soon.

Conclusions

Despite some delays in the implementation of certain elements of the future market model and a complex coordination process between the Government and RAO "UES of Russia," Power Reform seems to be almost halfway there. The transition market model is scheduled to run through 2008. From the year 2009 onwards a free competitive market is expected to be in place.

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In-Kind Charter Capital Contribution: Conditional Use

On August 15, 2005 the Federal Customs Service issued Letter No. 01-06/27838 "Concerning Goods Imported as a Contribution to the Charter Capital of Legal Entities Under Reorganization" (the "Letter").

Pursuant to Article 151 of the Customs Code and Government Resolution No. 883, dated July 27, 1996, fixed production assets (the "Goods") imported into Russia as a contribution to the charter capital of legal entities are exempt from customs and VAT. For customs purposes, the Goods are deemed to have been imported for "conditional use," meaning that the Goods must be used only for the purposes for which they are imported and that the company must not sell or otherwise dispose of the Goods. The law does not provide for the exact term upon which this limitation ceases.

The Letter confirms that a subsequent transfer of the imported Goods to a company that is the legal successor of a reorganized entity will be not considered a disposal and does not violate the "conditional use" of the imported Goods. Therefore the transfer will not result in an obligation of the company or its successor to pay customs duties and VAT for the imported Goods.

The Letter affirms that, as a result of reorganization, the legal successor of a reorganized company becomes liable to the customs authorities for the "conditional use" of the imported Goods and in the event that the Goods are not used in accordance with the condition, the successor company will be solely liable and will pay customs duties and the VAT.

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Ukraine

Ukraine Central Bank Clarifies Settlement Procedures for Foreign Investments

The National Bank of Ukraine ("NBU") has issued a new regulation addressing the issue of payments in connection with foreign investment in Ukraine. The regulation "On the Regulation of Issues of Foreign Investments in Ukraine," and adopted by the Decree No. 280 of the NBU of August 10, 2005 (the "Regulation"), came into effect on September 9, 2005.

The Regulation supersedes an earlier regulation that, despite clear statutory provisions to the contrary in other laws, required all foreign investments to be made in hryvnias ("UAH"). That regulation was challenged in court,[1] suspended and ultimately repealed.

At the same time, the new Regulation appears to retain the rule from the earlier regulation that settlements may only be made through Ukrainian banks. The Regulation does not apply to payments for Ukrainian securities traded on foreign markets with the permission of the Ukrainian Securities Commission. The new Regulation also confirms that foreign investment settlements are not subject to licensing by the NBU.

Types of Investment

For settlement purposes, the Regulation divides all foreign investment into three categories: direct investments, portfolio investments, and investment deposits. Direct investments include acquisitions of immovable (real) and movable property in Ukraine, as well as contributions of money or other property into the capital of a Ukrainian company. Portfolio investments refer to acquisitions of Ukrainian securities, derivatives, and other financial assets on the securities markets. An investment deposit is a deposit in foreign currency placed with a Ukrainian bank for at least one year with no right of early withdrawal.

Settlement Currency

According to the Regulation, investment assets must be paid for in a foreign currency recognized by the NBU as convertible; a list of convertible currencies is published by the NBU. Payment in UAH is allowed in the event of reinvestment only when a foreign investor uses income from an existing Ukrainian investment to acquire new investments.

Settlement through Ukrainian Banks

All payments for investment assets must be made through Ukrainian banks. Although the Regulation makes no exception for transactions in which both parties are nonresidents, the NBU, in a recent clarification, explained that this requirement should not affect such transactions. However, failure by a nonresident to pay for such investment assets through a Ukrainian bank may impede the repatriation of an investment (investment income) from Ukraine because the acquisition of foreign currency for repatriation purposes requires proof that the investment was paid for through a Ukrainian bank.

Settlement Methods

In the case of a direct investment, a foreign investor may pay a Ukrainian resident directly from an offshore account or from a foreign currency investment account opened with a Ukrainian bank. Foreign investors may also sell foreign currency held in their investment accounts with Ukrainian banks to acquire UAH for direct investments.

For portfolio investments essentially the same procedures apply, except that the funds must be transferred to an authorized Ukrainian securities trader acting as an intermediary in the transaction. This raises the question of whether Ukrainian securities may be bought and sold directly between private parties, Ukrainian or foreign, without the involvement of a securities trader. Conceivably, a transaction in which payment is made directly to the securities' owner might be considered a direct investment. However, the issue remains unclear.

Finally, investment deposits may be funded either from an investor's offshore or a foreign currency investment account with a Ukrainian bank.

Repatriation of Investment and Income

For repatriation, the path of the investment into Ukraine must be retraced: investments funded from offshore accounts are returned to the respective offshore accounts where they are derived and those investments funded from investment accounts

[1] In Ukrainian, the word which translates as "court" in English is also used to describe these newly created entities. Since these new entities are extra-judicial and private, we have used the word "tribunal," an accepted designation of such panels in other jurisdictions, to avoid confusion with Ukraine's state judicial system.

with Ukrainian banks are likewise returned to such accounts. Investments and income are returned in the foreign currency in which they were made, unless they were intended for reinvestment, in which case payment may be in UAH to the investor's UAH investment account. All payments are subject to proof of payment of the applicable Ukrainian taxes, in the form of a special tax certificate to be filed with the bank handling the payment.

In-Kind Investments

The Regulation permits repatriation in cash of investments made in another form, such as equipment or goods (in-kind investments). The value of such investments for repatriation purposes must be confirmed by a certified Ukrainian appraiser. As for investments made before the Regulation's effective date, their value may be confirmed by the appropriate customs documentation and/or the investment information statement filed with the Ukrainian authorities.

Conclusion

Overall, the Regulation appears to be an improvement over the previous regime. The Regulation should spare foreign investors the delays, costs and risks involved in acquiring and holding Ukrainian currency for investment purposes. At the same time, the Regulation introduces new restrictions. In particular, it appears to prohibit UAH deposits funded by the conversion of foreign currency through investment accounts. It also limits the minimum duration of an investment deposit to one year. Finally, by addressing only foreign currency investment deposits, the Regulation raises the question of whether UAH deposits are indeed allowed for foreign investors. Answers to these questions are not clear as yet.

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Kazakhstan

Parliament Moves to Restrict the Sale of Listed Natural Resource Companies

A bill was recently adopted by both houses of the Kazakhstan parliament providing the government with the ability to limit or prevent the transfer of shares of companies holding mineral resources (including oil and gas) in Kazakhstan, or to preempt such sales. This bill follows on last year's amendments to the Kazakhstan Underground Resources Law to preempt the sale or transfer of the assets themselves. This bill would need to be signed by the President to become law. If adopted, it could complicate the efforts of various foreign bidders to acquire some high-profile oil and gas assets. The *Oil & Gas Quarterly* will continue to follow developments on this issue in the next quarter's edition.

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