

# Legislation on Production Sharing Agreements

By Evgeny Danilov, Head Attorney, Pepeliaev, Goltsblat & Partners\*

A production sharing agreement (PSA) is concluded between the state and a business entity (the investor). Under a PSA, the investor obtains the exclusive right for a specific period of time to prospect for and extract mineral raw materials from the subsoil sector. The output produced is subject to sharing between the state and the investor under the PSA, in consideration of compensation for the investor's expenditures.

Up until 1996, in the absence of an appropriate legal framework, Russia and investors concluded three PSAs, known as:

- Sakhalin-I (the Odoptu, Chaivo and Arkutun-Dagi deposits)
- Sakhalin-II (the Piltun-Astokhskoye and Lunskoye deposits)
- Kharyaga (the Kharyaginskoye deposit).

The texts of the PSAs were not published. These PSAs are subject to fulfillment in accordance with the terms included therein. The PSAs are being implemented in practice. Subsequent provisions of Russian legislation are applicable to the given PSAs to the extent that their application does not contravene the terms of the PSAs themselves or restrict the rights acquired and exercised by the investors there under.

The Federal Law of Dec. 30, 1995 "On Production Sharing Agreements" (the FL) came into effect on Jan. 1, 1996. It laid the legal foundations for conclusion, fulfillment and termination of subsequent PSAs. Since that time, however, not one new PSA has been concluded, so there is a complete absence of any enforcement practice with respect to this FL.

The FL has priority over other Russian legal acts in application to PSAs. Relations not regulated by the FL are regulated by the Law of Russia "On Subsoil" and other Russian laws.

A PSA governs the process of the search and prospecting for and extraction of mineral raw materials, sharing the output produced, as well as its transportation, working, storage, processing, use, sale or other disposal. The rights and obligations of the parties to PSAs, which are of a civil law nature, are determined in accordance with the FL and the civil legislation of Russia.

Federal laws establish the list of subsoil sectors, right of use to which may be granted on production sharing terms. No more than 30 percent of mineral reserves on the state balance may be granted on such terms.

In relation to a specific subsoil sector, an auction is held for the right to conclude a PSA. The terms of the auction must envisage participation by Russian legal entities in implementation of the PSA in proportions determined by the government of Russia. The winner is the investor that offers the highest price for the given right.

Within a period of six months following the auction, a commission is set up for holding negotiations with the investor and drawing up the draft PSA, which may be concluded no later than a year from the date on which said commission is set up. On the part of the state, the resolution on signing of the PSA is passed, and the PSA itself is signed by the government of Russia.

The right to use a subsoil sector is granted to the investor on the basis of the PSA and is certified by a license issued in accordance with the Russian legislation on subsoil use. The license is issued within 30 days of the signing of the PSA, for the same term as the PSA, and is subject to prolongation, reissue or termination under the terms of the PSA.

PSAs associated with use of subsoil sectors on Russia's continental shelf and (or) the exclusive economic zone of Russia, as well as amendments and sup-

\* Published in the Doing Business in Russia section of the American Chamber of Commerce in Russia website.

plements to such PSAs, are confirmed by separate federal laws.

Performance of the work under a PSA is organized by the investor or, on its instructions, by the operator of the PSA. At the same time, the investor bears material liability towards the state for the actions of the PSA operator as for its own actions.

For the purpose of coordinating the work under the PSA, it envisages creation of a management committee with equal numbers of representatives from the parties and determines the committee's powers.

Work under the PSA is performed in accordance with programs, plans and estimates approved in the manner established by the PSA. Russian legal entities enjoy the preemptive right to participate in the work as contractors, suppliers, carriers and so on under contracts with the investors. Russian citizens shall account for at least 80 percent of all manpower engaged. A minimum of 70 percent of the total value of the equipment and materials acquired each year and for which the investor's compensation is from output produced shall be of Russian origin. During work under a PSA on territories inhabited by small groups of indigenous peoples, the investor pays appropriate compensation. It is established that if any of these provisions do not comply with the requirements of the World Trade Organization, when Russia joins the WTO they will be suitably amended or lose their validity.

The output produced is subject to sharing between the state and the investor. At the same time, a special tax regime is applied (Chapter 26.4 of the Tax Code of Russia), under which the production sharing replaces payment by the investor of some of the taxes and levies.

For production sharing purposes, the PSA secures the terms and procedure for:

- determining the total volume and value of the output produced
- determining the part of the output produced that is transferred to the investor as its property as recompense for its outlays on work under the PSA (compensatory output)
- sharing profitable output (i.e., output produced minus the part the value equivalent of which is used to pay severance tax and minus compensatory output for the reporting (tax) period)

- the investor to hand over to the state the part of the output produced or the value equivalent thereof that belongs to the latter

- the investor to receive the part of the output produced and belonging to it.

As an alternative, for PSAs a method is permitted by which the production is shared out immediately after its total volume and value have been determined, i.e., without the compensatory output being determined and profitable output shared out.

The PSA may envisage only one of the given production sharing methods and interchanging them is not permitted.

The investor's share of the output produced belongs to it by right of ownership. It may be exported from Russia on the terms specified in the PSA without restriction (with certain exceptions).

Assets created or acquired by the investor and used by it for working under the PSA are its property, unless otherwise stipulated in the PSA. On the terms of the PSA, this property may transfer from the investor to the state as federal property (for example, when the value of the assets is reimbursed to the investor in full), yet during the term of the PSA, the investor enjoys the exclusive right to use such assets free of charge for performing work under the PSA.

Geological and other such information obtained by the investor in fulfilling the PSA belongs to the state, but the investor may make free and gratuitous use of it for work under the PSA.

The investor has the right of free access on a contractual basis to pipeline transportation facilities without any discriminatory conditions being applied, as well as the right, within the framework of performance of work under the PSA, to build facilities for the storage, processing and transporting of mineral raw materials.

Accounting of the financial and business activities of the investor in fulfillment of the PSA is to be performed in the manner determined by Russian legislation and separately from such accounting of any other of the investor's activities.

For the purpose of monitoring fulfillment of the PSA, authorized representatives of the relevant federal state authorities have the right to unobstructed access to facilities involved in work under the PSA and to documentation relating to this work. Instru-

ctions issued by supervisory authorities in accordance with the legislation of Russia for the purpose of ensuring safe performance of the work, protection of the subsoil, the environment and the health of the population, as well as for the purpose of guaranteeing public and state security, shall be binding on the investor.

The terms of the PSA remain in effect throughout its term of validity. Amendments to the PSA are permitted on agreement between the parties and at the demand of one of the parties in the event of a material change in circumstances in accordance with the Civil Code of Russia.

If, during the term of the PSA, the legislation of Russia or its constituent entities or local government acts establish rules (apart from rules on safe performance of work, protection of the subsoil, the environment and the population's health) that have a detrimental effect on the investor's commercial results, amendments shall be introduced into the PSA to ensure for the investor the commercial results that it could have obtained under the legal regulation in effect at the time the PSA was concluded.

The investor has the right, with the state's consent, to assign its rights and obligations under the PSA in whole or in part to any other legal entity or individual. The transfer is to be made by draw-

ing up a special act, constituting an integral part of the PSA, accompanied by reissue of the license granting the right to use the subsoil within 30 days of the signing of the given act.

The parties shall be liable for failure to perform or duly perform their obligations under the PSA in accordance with the terms of the latter and in observance of the civil legislation of Russia.

The PSA terminates on its expiry, or earlier on agreement between the parties, as well as on other grounds established by the PSA in accordance with the legislation of Russia in force at the time the PSA is signed. If the provisions of the PSA on the methods by which the investor is taxed do not come into effect within a year of its signing, the PSA shall terminate.

Disputes between the state and the investor arising from fulfillment, termination or invalidity of the PSA shall be resolved in accordance with the terms of the PSA in a court of law, an arbitration court or tribunal (including international arbitration institutions). At the same time, PSAs concluded with foreign legal entities and foreign citizens may, under the legislation of Russia, envisage waiver by the state of legal immunity in relation to bringing to trial, provisional remedy of a suit and execution of a court and (or) arbitration ruling. □