

Concluding Production Sharing Agreements without a Tender(s)

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Summary:

This article looks at a tender-free process for production sharing agreements for certain subsoil plots located on Russia's continental shelf, in Russia's exclusive economic zone and on the Caspian Sea floor, or which can be developed under international treaties. We made our analysis in the light of changes made in 2003 to the Federal Law "On Production Sharing Agreements."

This article also assesses the potential negative consequences of concluding production sharing agreements through a tender process.

Production sharing agreements (PSAs) are the first, and so far, the only type of contracts for development and production of natural resources that can successfully be applied in practice.

To date, the Russian Federation has adopted 18 federal laws to designate subsoil plots in Russia and on its continental shelf for the development of natural resources under PSAs.¹ So far, just three PSAs are in operation (Sakhalin-1, Sakhalin-2 and the Khariaginskoye field PSA), and these were concluded before the Federal Law "On Production Sharing Agreements" of 30 December 1995 came into effect (the "PSA Law").²

PSAs are not common in the area of subsoil development, mainly due to their political aspects and the complicated procedure for concluding them which became even more intricate and opaque when changes to the PSA Law have been introduced by the Federal Law of 6 June 2003 titled No 65-FZ "On Additions to Part Two of the Russian Tax Code, Amendments and Additions to Other Legal Acts of the Russian Federation, and Invalidation of Some Legal Acts of

the Russian Federation" ("Federal Law No 65").³ In this article we attempt to understand the complexity and specifics of the procedures surrounding PSAs in the Russian Federation nowadays.

Current Procedure for Concluding PSAs

Article 6 of the 1995 version of the PSA Law, which sets out the procedure for concluding PSAs, provided that the State will award a PSA through a tender.

Article 6.2 of the PSA Law provided that in some cases, subject to a joint decision of the Russian Government and the relevant regional executive body, a PSA could be concluded without a tender. This could include a PSA with an investor that was already a subsoil user for exploration and development under a subsoil license when the PSA Law entered into force.

The previous and current versions of the PSA Law provide that lists of subsoil plots to be granted for use under PSAs should be established by federal laws.

Since the PSA Law was passed in 1995, both the procedure for including subsoil plots into these lists, and the procedure for concluding PSAs have changed dramatically.

In 1999, the PSA Law was changed to provide that subsoil plots

¹ For example, see Federal Law of 12 February 2001 No 13-FZ "On Subsoil Plots for which Usage Rights can be Granted under Production Sharing Agreements (Kovyktinskoye Gas Condensate Field)," Collected Legislation of the Russian Federation. 2001. № 7. Article 618; Federal Law of 8 October 2000 No 131-FZ "On Subsoil Plots for which Usage Rights can be Granted under Production Sharing Agreements (Tianskoye Oil Field)," Collected Legislation of the Russian Federation. 2000. № 41. Article 4043; Federal Law of 8 October 2000 No 129-FZ "On Subsoil Plots for which Usage Rights can be Granted under Production Sharing Agreements (Kharampurskoye Oil and Gas Condensate Field)," Collected Legislation of the Russian Federation. 2000. № 41. Article 4041.

² Federal Law No 225-FZ of 30 December 1995 "On Production Sharing Agreements," Collected Legislation of the Russian Federation. 1996. № 1. Article 18.

³ Federal Law No 65-FZ of 6 June 2003 "Additions to Part Two of the Russian Tax Code, Amendments and Additions to Other Legal Acts of the Russian Federation, and Invalidation of Some Legal Acts of the Russian Federation," Collected Legislation of the Russian Federation. 2003. No 23. Article 2174.

can be included into these lists only once the Russian Government provides a feasibility justification. One such justification for example, is if continuing the development of a mineral deposit is unprofitable both for the State and the subsoil user but promises high production levels, and terminating the development would have a negative impact on the local economy. That version of the PSA Law provided that in individual cases, lists of PSA subsoil plots could be established based on a decision of the Russian Government and the corresponding local government body without the endorsement of a federal law.

In 2003, Federal Law No 65 significantly changed the PSA Law concerning the procedure to exploit subsoil plots under PSAs. Under Article 4 of this Law, subsoil plots permitted for use under PSAs may be included in the list if it is the only possible way to undertake geological surveys, and the exploration and production of natural resources are impossible under any other conditions for subsoil use. To prove this, it was necessary to bid for the right to use subsoil plots based on non-PSA terms and conditions in tenders held in the procedure and on the terms provided in Article 2.4 of the PSA Law, and to declare the tender void if there was only one or no bidders. In this situation, if a subsoil user, who was granted the subsoil plot for use under the subsoil license, is willing to conclude a PSA, it must first request the early termination of its subsoil use rights under the license before the tender can be held.

Federal Law No 65 also excluded Article 6.2 from the PSA Law, which permitted the conclusion of PSAs without a tender.

Therefore, now subsoil plots can be granted for use under PSAs only after two tenders: first to establish that a subsoil plot can only be granted for use under PSA terms; and second to determine the potential investor under a PSA.

As mentioned above, before Federal Law No 65 came into effect, several federal laws allocated subsoil plots for use under PSAs (“Listed Subsoil Plots”). To set the procedure for concluding PSAs for Listed Subsoil Plots, Article 7 was added to Federal Law No 65 which should be applied as follows.

the first tender is held and declared void because there is only one or no bidders. When this condition is met, a PSA can be concluded only with the winner of the next tender for the right to conclude a PSA.

In accordance with Article 7.4 of Federal Law No 65, this article, i.e., the tender procedure, shall not apply to PSAs for Listed Subsoil Plots which were granted for exploration and development of natural resources under a subsoil license before Federal Law No 65 entered into force but PSA in their respect have not been concluded before the Federal Law No 65 entered into force, if:

- 1) these subsoil plots are located on Russia’s continental shelf or
- 2) these subsoil plots are located in Russia’s exclusive economic zone, or in Russia’s part of the Caspian Sea floor or
- 3) international treaties with the Russian Federation provide for the development of these subsoil plots (hereinafter, “Special Subsoil Plots”)

Therefore, when Article 7.4 was added to Federal Law No 65, the legislator meant that the general tender procedure for granting subsoil plots for use under PSAs should not apply to Special Subsoil Plots.

Although the legislator was willing to withdraw Special Subsoil Plots from the scope of the changes to the PSA Law, the Law does not provide for either a mechanism or conditions for implementing Article 7. This is primarily because Article 7 of Federal Law No 65 does not regulate any specific subject—it merely provides that the tender procedure shall not apply to Special Subsoil Plots. In other words, it abolishes the previous procedure for granting subsoil plots for use under PSAs, but does not establish new rules to conclude PSAs for Special Subsoil Plots.

The adverse consequences of this and the impossibility to implement the above provision in practice can be seen with respect to Special Subsoil Plots for which no PSA Drafting and Conciliation Committees were created (for example, no Committee was created for the Komsomolskoye Oil and Gas Condensate Field in the Yamalo-Nenets Autonomous District).⁴ Currently, in the absence of special regulations, these committees can be created *only after the second tender is held*, i.e. a tender for the right to use a subsoil plot under a PSA, which goes against the special provision of paragraph four in Article 7 of Federal Law No 65.

The first paragraph of Article 7 of the Federal Law No 65 establishes that PSAs can be concluded for Listed Subsoil Plots only after

⁴ Komsomolskoye Oil and Gas Condensate Field qualifies as a field to be used under PSAs in accordance with the Federal Law of 8 October 2000 No 130-FZ “On Subsoil Plots the Right to Use which can be Granted under Production Sharing Agreements (Komsomolskoye Oil and Gas Condensate Field),” Collected Legislation of the Russian Federation. 2000. No 41. Article 4042.

Furthermore, the provisions of Article 7 of Federal Law No 65 cannot be treated as a part of the PSA Law, because they do not directly change or amend its corresponding provisions. Therefore, establishing special procedure to conclude PSAs for Special Subsoil Plots which is not expressly provided for in the PSA Law contradicts the PSA Law itself.

Under Article 1.4 of the PSA Law, even if legislative acts of the Russian Federation establish rules to govern relations arising in the conclusion, implementation and termination of PSAs contradicting those provided by the PSA Law, then the provisions of the PSA Law shall apply. Accordingly, we believe that at the moment, state authorities do not have any legal grounds to apply Article 7 of the Federal Law No 65 because it contradicts the PSA Law.

Therefore, it seems impossible to implement now the provision of paragraph four of Article 7 of Federal Law No 65 to conclude PSAs for Special Subsoil Plots without bidding in a tender. In order to fulfill the spirit of the law and withdraw Special Subsoil Plots from the scope of the changes to the PSA Law, the latter should be amended as soon as possible to provide for a mechanism and conditions to conclude PSAs for Special Subsoil Plots. Otherwise, if the holders of licenses for Special Subsoil Plots want to conclude PSAs without a tender, it might be impossible based on the legislation currently in force.

The main issue is how many tenders are required to conclude PSAs for Special Subsoil Plots, and in particular, is it necessary to hold two tenders, as mandated by the PSA Law, or just one tender be sufficient for a PSA?

Two Tenders Required under the PSA Law to Conclude PSAs for Special Subsoil Plots

In accordance with Article 2.4 of the PSA Law,⁵ the purpose of the first tender is to confirm that the right to use a subsoil plot can only be granted under PSAs. If the tender is declared void because there was only one or no bidders, a subsoil plot should be added to Listed Subsoil Plots which can be used under PSAs.

If by the time the respective changes were made to the PSA Law, subsoil plots were already among Listed Subsoil Plots which can be used under

PSAs, i.e. it was already provided in the federal laws that usage rights for these plots could only be granted under PSAs, it can be reasonably argued that the first tender is not necessary.

In practice, several views have been expressed on the requirement to hold a second tender. Some analysts believe that there are no grounds for holding a second tender.⁶

In our view, second tenders for PSAs for Special Subsoil Plots are necessary because the current version of the PSA Law requires that PSAs can be concluded only after the second tender.

This issue was considered during work on drafting the laws "On Amendments to the Federal Law On Production Sharing Agreements," which were designed to correct the contradictions caused by the lack of a procedure for concluding PSAs for Special Subsoil Plots. Explanatory notes to Draft Federal Law No 116615-4 provide that the tender-based procedure to conclude PSAs established by the PSA Law cannot be applied to Special Subsoil Plots in view of Article 7 paragraph four of Federal Law No 65. Yet the PSA Law itself does not provide for any procedure to conclude PSAs for these subsoil plots. There is another Draft Federal Law, No 127993-4, whose explanatory notes say that "currently, there are no sufficient legal grounds to conclude production sharing agreements for several subsoil plots, which prevents opening up for development huge hydrocarbon reserves on the continental shelf of the Russian Federation and on the Caspian Sea floor."⁷

Tendering Procedure to Conclude PSAs

Having discussed the requirement on the second tender, we turn to the consequences for the subsoil user holding a license for a Special Subsoil Plot. Currently, Russian law does not establish any procedure for announcing and holding a second tender. Without it, the following negative consequences are likely.

- 1) Generally, when a tender is announced the subsoil plot should be in the unallotted subsoil fund. Therefore, the holder of the subsoil license should surrender its license to the plot before a tender is held, thus exposing itself to a significant risk.

⁵ As amended by Federal Law No 65.

⁶ See for example, *J. Hines, A. Bardin: Status and future prospects of Russian PSA laws // Neft, Gaz i Pravo. 2003. # 5.*

⁷ Legislative materials are available on the website of the State Duma of the Federal Assembly of the Russian Federation: <http://www.duma.gov.ru/>.

- 2) Russian legislation does not establish any timeframe for a PSA tender. Nor does it obligate the authorized bodies to hold PSA tenders. Thus, if the license holder surrenders its license and the tender is not held, it does not have any lawful grounds to win it back other than by those provided in subsoil legislation, which is completely unacceptable for a license holder.

Current Draft PSAs should be Revisited

Since federal laws were adopted on subsoil plots which can be used under PSAs, and with respect to several Special Subsoil Plots, the PSA Drafting and Conciliation Committees have been created, and PSAs have been negotiated. Draft PSAs on several Special Subsoil Plots have been agreed with all interested governmental authorities and could have been submitted to the State Duma for approval. What is the future of these draft PSAs given that the second tender is still required?

In accordance with the PSA Law, after the second tender was held (for the right to conclude a PSA) the task of drafting a PSA, and negotiating it with an investor, should be given to a special committee which must be created within six months of announcing the tender results. Therefore, if the second tender must be held, draft PSAs which have been to some extent agreed upon by such special committees should be approved in accordance with the statutory procedure.

The work of previous committees that discussed draft PSAs for such deposits, including agreed PSA texts, may be taken into consideration by new committees or serve as the starting point for further negotiations. However, these drafts should

not be regarded by new committees as final texts which must not be changed or amended in obtaining further approvals.

This stems in particular from the fact that after Federal Law No 65 became effective on 10 June 2003, previous committees existed without any legal grounds, as this law abolished the provision that created them. Accordingly, PSAs which have been agreed upon for deposits/fields and negotiated by these committees with subsoil users after Federal Law No 65 came into force, are not final and cannot be enforced.

Based on the above, we conclude that today it seems to be impossible to avoid revisiting draft PSAs with committees which must be created after the second tender. There are sufficient grounds to argue that to conclude PSAs for Special Subsoil Plots the first tender, granting the right to use a subsoil plot only under a PSA, is not necessary. However, under current Russian law it is impossible to conclude PSAs for Special Subsoil Plots without the second tender, which establishes the right to conclude a PSA for a particular investor.

We believe that the only way to find a lawful solution to this situation would be to amend the PSA Law, and thus deal with the problem of the statutory requirement to hold tenders for the right to conclude PSAs for Special Subsoil Plots. Such amendments should be comprehensive, specific and interpreted as only applying to the specific subsoil plots to which they refer. This would facilitate the process of agreeing these amendments with interested authorities and their subsequent adoption. This is of primary importance for the implementation of several investment projects on the Arctic shelf and in the Caspian Sea. □