

Oilfield Services in Russia: Running the Gauntlet

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As the Oil & Gas Quarterly reported in the last edition, oil and gas production in Russia continues to increase (albeit less rapidly), although exploration lags. But in both cases, the demand for oilfield services remains robust: Russia's domestic industry has not been able to keep pace with demand. For the foreign oilfield service company, there are a number of administrative and legal barriers to be surmounted in order to access this growing market; this article considers some of the more important issues facing new entrants.

Acquiring a Company versus Acquiring Assets

Provided that the most important assets – the contractual relations and key employees – can be transferred without significant delay, then a transfer of assets is the preferable method to acquire a Russian oilfield services business. If we assume that a foreign investor wants to acquire the business of a target Russian company, the foreign investor can form a new Russian shell company (“NewCo”) to acquire the assets, hire the employees and enter into new service agreements with the target company's clients. What happens to the liabilities and employees of the target company?

Liabilities

Generally, the target company's liabilities do not follow the title to its the assets, so NewCo will not be liable for any of the target company's obligations. This is the advantage of the acquisition of assets over the acquisition of shares, but there are factors limiting this advantage. In particular, in certain specific circumstances (for example a sale to a creditor on preferential terms, or on unfavorable terms for the seller generally) under Russian law, the court may invalidate the transaction.

Care must also be taken in the transfer of assets to ensure that the sale of an “enterprise” (entire business) provisions of Russian law do not apply. The sale of assets (unlike shares) is VATable. Thus, although as a general rule creditors do not have any legal recourse against NewCo, if the target company becomes bankrupt or there are other defects in the transaction there is a risk that the acquisition of assets could be invalidated by a Russian court.

Employees

If we assume that most of the existing employees will voluntarily agree to be employed by NewCo in the event of an asset sale as described above, most of the usual employment – related liabilities will remain with the target company and not NewCo. The time of transfer of employees from one company to another company does not have any legal significance under Russian law.

In fact, the target company and not NewCo will be liable for any damages incurred by the employees during the remaining validity of their employment contracts with the target company (Article 232 of the Russian Labor Code) (i.e., the termination of an employment contract does not relieve the target company from liability to compensate the employees for damages incurred during the period of employment).

Under normal circumstances NewCo should not be liable to compensate the target company's employees under the situation described above. Among other compensation, each of these employees will be entitled to receive “severance pay” equal to his/her monthly salary, or more if the employment agreement so provides, or provides for a supplemental bonus. In addition, the employee will receive his or her salary for 2 months following the redundancy date from the target company.

Purchasing versus Leasing

Equipment can also be supplied to Russian oil and gas projects via a cross-border (international) lease or a domestic lease. If the service company uses an international lease, it would be covered by the UNIDROIT Convention, while domestic leasing is governed by the Russian Law “On Leasing.” International leasing is not widespread in Russia, largely because of enforcement/repossession issues. Domestic leasing is now simpler and more flexible, and most important for the lessor it expressly permits the seizure of leased assets. Domestic leasing provides certain tax benefits, but it is still subject to VAT.

How to Operate Legally: Laws and Licenses

The first consideration in any services contract is the counterparty (sponsor). Even if a company other than the licensee in an oilfield is financing

its operations, the contractor will often need to enter into its service/supply contract directly with the licensee because of the licensee's rights to the development site. Also, the terms of the license may restrict the licensee's ability to use contractors.

Beyond the counterparty, the primary issue for service and engineering companies is licensing requirements, as Russian law imposes licensing requirements on a wide variety of activities relating to oilfield services.

To start from the top, the fundamental Russian law regulating E&P activity is the law "On Underground Resources" (the "Underground Resources Law"), which imposes licensing requirements for various related activities including regional geological studies, geological surveys and site surveys, geological studies, including exploration and estimates of mineral deposits, and construction and operation of underground facilities other than for the extraction of mineral resources.

In addition, Article 24 of the Underground Resources Law provides that a separate license for dangerous activity must be obtained if the work involves dangerous conditions.

The Russian Law "On Licensing Certain Types of Activities" (the "Licensing Law"), in turn, mandates a license for a variety of other activities, including mine surveys, geodesic (land-surveying) activity, map-making, the use of oil and gas production equipment, including servicing oil and gas wells, and the use of flammable, hazardous or explosive industrial equipment, and the use or storage of explosive industrial materials.

Further, in addition to the Underground Resources Law and the Licensing Law, there is a separate requirement for a specialized "Oilfield Activities License." Any services related to the operation of hydrocarbon production facilities require a special license which is issued by the Federal Service for Ecological, Technological and Atomic Control ("Industry Control Service"). The Industry Control Service issues licenses for the exploitation of oil and gas production facilities for a term of 5 years, which is generally renewable. The Industry Control Service is not permitted to exercise discretion, and must issue a license within 60 days of receiving a complete and accurate application with all of the required supporting documentation.

In addition, depending on the services provided, other licenses and permits may be needed. These include:

- ! Licenses for the use of chemically hazardous industrial objects;
- ! Licenses for processing, storage and transportation of oil, gas and related products through trunk pipelines; Licenses to operate lifting equip-

ment (mobile jib cranes) (with or without the right to perform technical maintenance and repair of third parties' lifting equipment); Licenses to operate equipment for geophysical and hydrodynamic research and well tests;

- ! Licenses to carry out maintenance of and repairs to oil and gas equipment generally;
- ! Licenses to use specialized industrial explosives (explosive seismic shooting as well as fracturing and other services in oil, gas, water and other wells);
- ! Licenses to operate oil and gas production facilities (including for drilling in oil-and-gas bearing formations with the use of perforating equipment); and
- ! Licenses to carry out any work that will "actively impact the geophysical processes and phenomena."

And besides licenses, certain administrative approvals may be required, for example approvals for design and feasibility studies, pilot projects and development plans, and for construction of any facilities on site.

In order to obtain any of these licenses the applicant will usually need to file the following documents with the appropriate licensing authority(ies):

- ! An application indicating the title, corporate form and official address of the applicant, as well as the location of the licensed activity;
- ! Copies of the foundation and registration documents of the applicant;
- ! A copy of a certificate from the Russian tax authorities confirming registration of the applicant as a taxpayer;
- ! A document confirming payment of the duty for the review of the application (i.e., a filing fee);
- ! Data on the relevant qualifications of the applicant's employees; and
- ! Various technical documents according to the type of license requested.

The licensing authorities are generally required to decide whether to issue the license within 60 days of receiving a complete application with all of the supporting documentation, however delays can result in determining what constitutes "all of the supporting documentation." After the decision has been reached, the applicant must be notified immediately.

Thereafter, within three days of the date of submission of the document confirming payment of the duties for the provision of the license (the license fee), the licensing authorities must issue the document confirming the license.

What happens if the service or engineering company doesn't get all the appropriate licenses? It depends on the missing license. For example an administrative liability can be imposed in the form of a penalty in an amount ranging from 30,000 to 2,000,000 Rubles (approximately US\$1,000 to 70,000), as well as confiscation of equipment, for any of the following licensing violations:

- ! engaging in entrepreneurial activities (unlicensed business) without a license;
- ! using subsoil without a permit (license) or in violation of the terms of the permit (license);
- ! violating the restrictive rules (or standards) or terms of a license for any activities in the internal seas, territorial waters, on the oceanic continental shelf and/or within the economic zone of Russia, including any violation of the rules for the safe exploration or development of mineral resources and drilling; and
- ! violating the safety requirements or the terms of a license for using hazardous industrial objects.

Worse, criminal liability of varying degrees can be imposed on responsible officers, ranging from a penalty in the amount of 300,000 Rubles (approximately US \$10,500) up to imprisonment for 5 years, for engaging in entrepreneurial activities without a special permit (license) (where licensed), or in violation of the licensing requirements and conditions, if the action is found to have caused "significant damage" to human beings, organizations or the State, or, interestingly, if the offender is found to have gained significant profit from it. Not surprisingly, the offender's Oilfield Activities Licenses can also be suspended, amended or terminated for failure to comply with the license requirements.

Administrative liability (including fines) is generally imposed for failing to make timely payments of levies and taxes for subsoil use, failing to provide geological information to the appropriate agencies or failing to meet other reporting requirements.

Geological Information

Under Russian law, geological information is accorded a special status. Article 27 of the Underground Resources Law mandates that information on the geological structure of a subsurface deposit, its reserves, and its development conditions, as well as other characteristics of the deposit included in geological reports and other materials, may only be owned by the state or the licensed user of underground resources, and never by a contractor or service provider.

Geological information is presumed to be owned by the state. However, if geological and other information on the deposit was obtained by the licensee and paid for with the licensee's own funds, it is treated as

the property of the licensed user (the licensee). This information must be reported to the appropriate government agencies, including the federal and territorial geological information funds. Commercial and other use of this information must likewise be coordinated with the appropriate governmental agencies.

Under the Russian Law "On State Secrets", certain geological information (including seismic data for the oceanic continental shelf) is considered a state secret and is subject to a special confidentiality regime. Additionally, according to Article 8 of the Russian Law "On Participation in International Informational Exchanges," the export of confidential information is allowed only in cases expressly provided for by the Russian government. The most important restriction is that the owner of the confidential information (e.g., the operator) or its users (e.g., the operator's shareholders) may only have access to the documents containing the confidential geological information within Russia.

Certification

Almost as important as licensing, certification of foreign products and services is also required in Russia. Certification is regulated by Russian Law No. 184-FZ, dated December 27, 2002, "On Technical Regulations" (the "Technical Law"), and certain other administrative regulations.

Certification includes confirmation of compliance of the products or services in Russia with certain standard requirements. According to the Technical Law these standard requirements are called "technical regulations," although none have been adopted to date. At present, the GOSTs (State Standards) are applied.

There are two types of GOSTs: i) "old" GOST – standards which were adopted during the Soviet period but still applicable; and ii) GOST R – Russian standards which were adopted since that period and are generally stricter than GOST.

Under the Technical Law, confirmation that the goods comply with GOSTs (in general) may be either mandatory or optional. Mandatory certification takes two forms: adoption of a declaration of compliance or mandatory certification.

The form of certification generally depends on the type of equipment certified based on two categories:

- ! The list of products subject to mandatory certification under Resolution No. 64 of the Russian State Committee on Standardization, Metrology and Certification, dated July 30, 2002 (Category 1); and
- ! The list of products where compliance may be confirmed by a declaration of compliance under Resolution No. 64 of the Russian State Committee on Standardization, Metrology and Certification, dated July 30, 2002 (Category 2).

Certification of Oilfield Services

In 2004, oilfield services were excluded from the list of goods and services subject to mandatory certification (Russian Government Resolution No. 72, dated February 10, 2004). At present, therefore, it is not necessary to confirm the compliance of oilfield services to any GOST. However, for competitive reasons it is advisable to undergo the procedure of optional certification. Optional certification is at the initiative of the applicant, pursuant to an agreement between the applicant and the appropriate certification authority. Optional certification can confirm compliance with national standards (for instance GOSTs), internal standards of the sponsors, optional certification systems and even with the terms and conditions of certain agreements.

Certification of Equipment

Most of the equipment used in oilfield services is subject to mandatory certification. Section 36 entitled "Petrochemical Machinery" of Category 1 contains a list of equipment subject to mandatory certification. For instance, Section 36 includes:

- ! Complete drilling units for operational and deep exploration drilling (GOST 1629389);
- ! Drilling rotors for the workover of oil and gas wells (GOST 4938-78);
- ! Drill bits and diamond heads and heads equipped with superhard composite materials (GOST 2647485);
- ! Electric downhole motors (GOST 15880-83);
- ! Lifting units for workovers (GOST 28113-89); and
- ! Oilfield wellhead and production equipment (GOST R 51365-99).

Under Resolution No. 11 of the Russian State Committee on Standardization, Metrology and Certification, dated March 17, 1998, a compliance certificate under the GOST R system for oilfield equipment subject to mandatory certification is a prerequisite to use or distribute that equipment. As a general rule, equipment manufactured in Russia must be certified by the manufacturer. Hence, if a company acquires or leases equipment made in Russia for oilfield services, the equipment is deemed to be already certified. If a company imports the equipment it must process the certification of the imported equipment itself. Some exclusions may be applicable to equipment imported under certain customs regimes.

Certification Procedure

The certification procedure is regulated by Regulations No. 11 of the State Committee on Standardization, Metrology and Certification, dated March 17, 1998.

Certification requires the following steps:

- ! submission of the application for certification;
- ! consideration and adoption of a decision on the application by the certifying authority;
- ! verifications (document analysis, testing, production tests, etc.)
- ! analysis of the results of the verification, followed by a decision on issuance (or denial) of a compliance certificate;
- ! issuance of the certificate; and
- ! inspection and oversight of the certified equipment in accordance with the certification schedule.

Any domestic or foreign company, or even an individual entrepreneur, can apply for certification. The certification authority is required to consider the applications and notify the applicant of its decision on the application not later than 15 days from the date when the application was received. If the result of the examination is positive, the certification authority must issue a compliance certificate to the applicant.

Environmental, Health and Safety Issues

Environmental impact must be assessed prior to commencing any project for the use of natural resources in Russia; this is generally the operator's responsibility. Operational licenses and permits usually authorize the discharge of pollutants into the air, water and soil under a "pay-to-pollute" regime. If discharge exceeds permissible levels, the company is subject to fines calculated as a multiple of the original "fee" set for the discharge of pollutants.

Russian environmental legislation consists of numerous federal and regional regulations which often contradict one another and cannot be consistently interpreted. As a result, full environmental compliance may not always be possible. There is nothing like the US rules of CERCLA or Superfund in Russia, and environmental penalties are often nominal. Even so, it is a good idea to check for any existing court cases or documents concerning administrative proceedings for a given site or project, and contractors should pay special attention to the use of any hazardous substances (e.g., asbestos).

Conclusion

Oilfield services can be inherently dangerous and potentially polluting, and so are naturally highly regulated in most jurisdictions, but Russia's overlapping administrative system presents special challenges. As with any business in Russia, patience and thoroughness are key to accessing this growing market. □