

STATUS OF RUSSIAN PETROLEUM LEGISLATION

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I. INTRODUCTION.....	316
II. THE JOINT VENTURE LAW	317
III. THE LAW ON OIL AND GAS	318
IV. THE LAW ON PRODUCTION SHARING AGREEMENTS.....	320
V. THE SUBSOIL LAW.....	322
VI. CONCLUSION	325

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I. INTRODUCTION

The Author's first exposure to the laws of the Soviet Union and Russia took the form of an international contract conference presentation in Moscow in October 1989.¹ The Ministry of Geology, the main point of contact in the Soviet Union for foreign investors, had invited the Author's employer to make a presentation about the three main types of international petroleum contracts (tax royalty/concession agreements, service contracts, and production sharing agreements), covering both the legal and economic aspects of each.² Three specialists and an interpreter were sent to conduct the conference.³ There were many lawyers in attendance from various institutes around the country, as well as a few KGB agents and some Ministry personnel. Many insightful questions were asked, and it was apparent that there was a fairly high level of understanding of many issues.⁴

Although the Author was convinced that the audience would view the tax/royalty system, which is basically the modern concession agreement, as the most suited to their own administrative law system, they were indifferent to the suggestion.⁵ Unfortunately, due to the bad experience with concession agreements during the 1920s,⁶ the Russians viewed these agreements as giveaways.⁷ So, concession agreements had a bad name, and the audience was not interested for that reason. The attendees said, in effect, it didn't work before, so what else can you tell us about?⁸

1. *Conference Proceedings, Investing in Russia Under the Law on Production Sharing Agreements*, 20 HOUS. J. INT'L L. 517, 520 (1998) [hereinafter *PSA Law Conference Proceedings*].

2. *Id.* at 520–21.

3. *See id.*; see also James Skelton, *Drafting the Russian Law on Oil and Gas: An Oil Industry Lawyer's Perspective*, 15 HOUS. J. INT'L L. 463, 464 (1993) [hereinafter Skelton, *Drafting Russian Law on Oil & Gas*].

4. *PSA Law Conference Proceedings*, *supra* note 1, at 521.

5. *Id.* at 521.

6. Anthony Heywood, *Soviet Economic Concessions Policy and Industrial Development in the 1920s: The Case of the Moscow Railway Repair Factory*, 52 EUROPE—ASIA STUD. 549, 550 (2000).

7. *PSA Law Conference Proceedings*, *supra* note 1, at 521.

8. *Id.*

It was made clear to the audience that international oil companies prefer to acquire equity interests in available properties and would usually not be interested in entering into a service contract unless it was the only option.⁹ As a consequence, not much time was devoted to discussing service contracts, which shifted the focus of the legal presentation to the production sharing agreement (PSA) form of investment.¹⁰ It became a theoretical discussion, however, because the existing legislation would not support such a system.

II. THE JOINT VENTURE LAW

The only legislation that existed in the Soviet Union in connection with foreign investment from 1987 to early 1992 was the Joint Venture Law (JV Law).¹¹ The JV Law permitted a foreign investor to own an interest in a Soviet limited liability joint venture company (JVC) that was formed with an existing domestic license holder to obtain the rights to develop an oil field under a reissued license.¹² Due to the lack of alternatives and the desire to participate in the Russian oil industry, a few foreign investors entered into such joint venture agreements (JVAs).¹³ Most of these joint ventures were established through the execution of a JVA between a U.S. or European international oil or service company and a Russian exploration or production association, followed by the registration and formation of a JVC.¹⁴ All of these JVCs suffered through countless changes in the tax laws, increases in the rates of tariffs and taxes, battles for VAT refunds, and pipeline access

9. *Id.*

10. *See id.*

11. Procedure for the Establishment on the Territory of the USSR and Activity of Joint Enterprises with the Participation of Soviet Organisations and Firms of Capitalist and Less Developed Countries, Decree No. 49 of the U.S.S.R. Council of Ministers, adopted Jan. 13, 1987 [hereinafter Decree No. 49].

12. *Id.* art. 4.

13. *See PSA Law Conference Proceedings, supra* note 1, at 521 (stating that none of the companies for which the other panelists worked had entered into a JVC agreement).

14. *See, e.g., id.* (noting the formation of Polar Lights Company). *See generally* Decree No. 49, *supra* note 11 (discussing the legal process for establishing a Joint Venture Company in the USSR).

complications throughout the 1990s.¹⁵ It was, therefore, no wonder that the foreign investors became convinced that the PSA approach must be a better way to make investments in Russia.¹⁶

In general, JVCs were subject to the infamous current tax regime (CTR), there were no exemptions from any of the tax laws, and those that were granted on an *ad hoc* basis were short term in nature and subject to change without notice.¹⁷ Investors came face to face with the fact that once a foreign investor was captured within a JVC in Russia it was subject to all new and amended laws, the JVA lacked tax and fiscal stability, and neither the JVC nor the foreign investor was in privity of contract with either the federal government or the local government, both of which were the ones that granted the JVC the ultimate rights through the license.¹⁸ By contrast, upon entering into a PSA, the foreign investor would be in privity of contract with the host country government or its national oil company as the rights granting authority, meaning that there could be significant exemptions from various tax and customs laws, and there could be some predictability and stability under a separate legal and fiscal regime.¹⁹

III. THE LAW ON OIL AND GAS

In late August 1991, the first meeting of the University of Houston's Russian Petroleum Legislation Project (the UH Project) took place between the Western representatives of academia, government, and the oil industry, and their Russian counterparts from various ministries and legislative

15. See, e.g., Barnaby Feder, *Soviet Joint Ventures Face Obstacles*, N.Y. TIMES, June 20, 1988, at D5 (addressing the challenges facing western countries engaged in joint ventures with Soviet countries, particularly taxation and ownership issues).

16. *Id.*

17. See, e.g., *id.* (discussing the legal instabilities faced by JVCs).

18. *Id.*

19. See James Skelton, *New Developments in the Evolution of International E&P Agreements*, 44 INST. ON OIL & GAS L. & TAX'N 11, 11.04 (Matthew Bender 1993) (noting that a PSA is an agreement between a foreign oil company and a host country which gives the foreign oil company the right to produce petroleum and recover costs through its share of the overall production).

committees.²⁰ The purpose of the UH Project was to recommend a legislative framework for the new Law on Oil and Gas (O&G Law) based on then-current practices and laws in the international petroleum industry.²¹ The Author's employer was one of the corporate sponsors of this daring endeavor, and the Author was named as one of the three reporters for the Exploration and Production (E&P) Licensing Working Group that was charged with the responsibility of drafting the proposed Licensing Code.²²

In 1993, the proposed Licensing Code was published as part of the overall Petroleum Code that was prepared by the UH Project.²³ One of the recommendations for the Licensing Code was to establish a flexible licensing system that would permit the issuance of both production licenses and production sharing licenses.²⁴ This was an attempt to finesse the administrative law system by allowing an alternative form of investment to occur under the Russian civil law system.²⁵

Unfortunately, by the end of July 1992, the UH Project was out of funds and was taken over by the World Bank.²⁶ Thereafter, competing drafts of the O&G Law began to be published by the Joint Parliamentary Commission (JPC) of the Supreme Soviet in October 1992 and by the Inter-Departmental Commission (appointed by then Deputy Prime Minister

20. George Hardy, *The University of Houston Russian Petroleum Legislation Project: A Brief Perspective*, 15 HOUS. J. INT'L L. 263, 264 (1993).

21. Skelton, *Drafting Russian Law on Oil & Gas*, *supra* note 3, at 464.

22. *Id.* at 479 n.57.

23. *Proposed Licensing Code of the Russian Federation*, 15 HOUS. J. INT'L L. 641, 641-704 (1993).

24. See Gary B. Conine, *Petroleum Licensing: Formulating an Approach for the New Russia*, 15 HOUS. J. INT'L L. 322, 359-61 (1993) (explaining the need for flexibility in licensing so as to allow for particular financial and production terms to be negotiated on a case by case basis).

25. See *id.* at 358-59 (explaining that the incumbent bureaucracy lacked experience in petroleum licensing and that streamlining the process would take away the ability of several bodies' ability to block the issuance of the license).

26. Jacqueline Weaver, *The History and Organization of the Russian Petroleum Legislation Project at the University of Houston Law Center*, 15 HOUS. J. INT'L L. 271, 289 (1993).

Chernomyrdin) in January 1993.²⁷ Although, or perhaps because, the JPC's draft followed the UH Project's proposed Licensing Code to a large extent, it fell out of favor. Eventually, the battle of the drafts ended in 1995, and the fatally flawed version of the O&G Law written by the JPC passed the third reading—only to be vetoed by President Yeltsin, never to be heard from again.²⁸ Thus, what had begun so favorably as a collaborative and creative legislative effort ended as an unceremonious, disappointing and anticlimactic failed attempt to produce useful legislation geared to work within the dual administrative and civil law systems.

IV. THE LAW ON PRODUCTION SHARING AGREEMENTS

The first time the words “production sharing” were ever published officially in Russia was on February 21, 1992, when the Law on Subsoil Resources (Subsoil Law) was enacted.²⁹ The next significant event occurred on Christmas Eve, 1993, when President Yeltsin signed the Presidential Decree on Production Sharing and its Implementation in the Russian Federation, which was quickly dubbed the “Christmas Present” because it paved the way for the executive branch to propose this new system of production sharing to the State Duma.³⁰

By July 1995, a draft Law on Production Sharing Agreements (PSA Law) had been passed by the State Duma.³¹ In the draft, there were a number of excellent provisions that would have provided the type of stability and predictability that foreign investors and financing institutions would need in a

27. James Skelton, *Investing in Russia's Oil and Gas Industry: The Legal and Bureaucratic Obstacles*, 8 NAT. RES. & ENV'T 26, 27 (1993) [hereinafter Skelton, *Investing in Russia's Oil & Gas Industry*].

28. Andrea Chandler, *Presidential Veto Power in Post-Communist Russia, 1994–1998*, 3 CAN. J. POL. SCI. 487, 510 (2001) (listing the veto of the Oil and Gas Law in item 42).

29. Law of the Russian Federation Concerning Subsurface Resources, No. 2395–1, effective on Feb. 21, 1992, as amended [hereinafter Subsurface Law].

30. *PSA Law Conference Proceedings*, supra note 1, at 523.

31. James Watson, *Foreign investment in Russia: The Case of the Oil Industry*, 48 Europe-Asia Stud. 429, 434 (1996).

country that was in a volatile state of transition like Russia.³² Unfortunately, between June 1995 and December 1995, the opposition legislators, who viewed the PSA Law as some sort of wholesale giveaway of Mother Russia's natural resources, had the influence to modify the draft to the point at which it became only marginally viable.³³

Consequently, when the PSA Law came into effect on January 11, 1996,³⁴ it was apparent to the reformist legislators and outside observers that many other laws needed to be amended, more laws needed to be passed, and normative acts had to be enacted.³⁵ The conflicts that were created by this final version of the PSA Law were so striking that most foreign oil companies decided they were not going to invest under the PSA Law until these conflicts and contradictions were resolved.³⁶ Many of those conflicts were resolved by the amendments to the PSA Law and the enabling legislation.³⁷ Nevertheless, there were still a few significant shortcomings in the legislation that were never addressed by the Russian government or the State Duma.³⁸ As a result, the international oil companies refused to invest under the PSA Law until the remaining conflicts and contradictions were eliminated.³⁹

32. See *id.* at 436 (discussing the benefits that foreign investors would have received under certain provisions of the draft law).

33. *Id.* at 437.

34. World Petroleum Arrangements 2004, Russia and NIS: Legislative Contractual Requirements for Petroleum Exploration & Exploitation (2004), available at <http://www.barrowscompany.net/WPA/wparnis.pdf>.

35. *PSA Law Conference Proceedings*, *supra* note 1, at 522.

36. *Id.*, at 523.

37. See Russian Federation Federal Law on Production Sharing Agreements, No. 225-FZ, effective Jan. 11, 1996, as amended Jan. 7, 1999, translated at [http://tax.eycis.info/RL.nsf/c4d5cf0d070b5574c325695f003ef625/f0052aad4246615ac32569b300657f95/\\$FILE/FLAW225.RL1.pdf](http://tax.eycis.info/RL.nsf/c4d5cf0d070b5574c325695f003ef625/f0052aad4246615ac32569b300657f95/$FILE/FLAW225.RL1.pdf) (showing the amendments to the law).

38. See Nowell Bamberger, *In the Wake of Sakhalin II: How Non-Governmental Administration of Natural Resources Could Strengthen Russia's Energy Sector*, 16 PAC. RIM L. & POL'Y J. 699, 682-83 (2007) (discussing the politically swayed attempts to amend Russia's original PSA law and the fundamentally unstable result).

39. See *id.* at 684 (stating that Russia failed to use PSAs to encourage foreign energy investment).

Despite the fact that Russia was viewed as the last frontier in the oil industry, there was no good reason to commit to a major investment until the time when the legal and fiscal regime that was constructed for PSAs would provide such investments with adequate protection—especially a stable tax regime. That time never came. In fact, just the opposite occurred in June 2003, when an amendment to the PSA Law was passed, making it virtually impossible to obtain approval to utilize the PSA form of investment.⁴⁰ The new amendment provided that: (1) projects are only eligible for PSA terms under exceptional circumstances, e.g., huge investments for greenfield projects; (2) eligible projects must endure a dual auction process in order to become qualified; and (3) the applicable license holders must surrender their licenses in favor of such auctions.⁴¹ This type of legislative interference rendered the PSA Law useless for all practical purposes. Some have claimed that the Russian legislators confused the PSA concept with privileges for foreign investors.⁴² The Author believes, however, that the legislators knew exactly what they were doing and that they intended to strike a mortal blow against the PSA form of investment because they viewed it as being both incompatible with the administrative law system and inadequate in providing sufficient control mechanisms.

V. THE SUBSOIL LAW

As stated in the section above, the Subsoil Law was passed in February 1992.⁴³ The Subsoil Law served to perpetuate the only available rights-granting mechanism in the Russian petroleum industry and codified the application of the old Soviet command system of administrative law licensing.⁴⁴ In so doing,

40. KPMG, *Production-Sharing Agreements-A New System of Taxation*, RUSSIA TAX NEWS, July 18, 2003, at 1, 1, available at http://www.kpmg.ru/dbfetch/52616e646f6d4956f98933e34b3efbf5995408b107590bfe/russia_tax_news_n_12_2003.pdf.

41. Yuli Grigoryev, *The Russian Gas Industry, Its Legal Structure, and Its Influence on World Markets*, 28 ENERGY L.J. 125, 130 (2007).

42. See *id.* at 130–31 (stating that owners of domestic oil companies and the media claim PSAs are counter to the national interest).

43. See Subsurface Law, *supra* note 29.

44. See Skelton, *Investing in Russia's Oil & Gas Industry*, *supra* note 27, at 27.

the Subsoil Law essentially memorialized the old nationalist approach and made it more difficult for the reformist legislators to introduce alternative legislation.

Certain provisions of the new law made it clear that licenses could not be issued through direct negotiations and that competitive bidding would be required in all cases.⁴⁵ The Russian legislators claimed this was necessary in order to minimize corruption in the licensing process, but that ignored the practical reality that enormous projects in remote locations that require complicated development operations are usually enhanced by the give and take of negotiations as a means of agreeing to a mutually beneficial set of terms and conditions.⁴⁶

The Committee on Geology then promulgated a new set of regulations on the licensing procedure (licensing regulations),⁴⁷ which did not provide any details about the types of contracts (concession agreements, PSAs and service contracts) that were referred to in Article 12 of the Subsoil Law.⁴⁸

There have been various revisions over the years, including the recent amendments to the Subsoil Law that introduced important fundamental provisions such as the conditions required for renewing subsoil licenses, as well as the transfer of rights from a subsidiary to a parent company and between subsidiaries.⁴⁹ Otherwise, the basic framework of the Subsoil Law supported by the licensing regulations has remained relatively unchanged in terms of there being no express restrictions on foreign ownership participation.⁵⁰ As a practical matter, however, there had always been an unspoken fifty percent cap placed on foreign ownership in a JVC.⁵¹

45. *Id.*

46. *Id.*

47. Decree on the Procedure for Enacting Regulation on Licensing Subsoil Use, N. 3314-1, July 15, 1992 (effective August 15, 1992).

48. *Id.* art. 8.2.

49. Darya Vasilevska, *Russia's Government to Revise Its Laws on Subsoil Use this Year*, OIL OF RUSSIA, No. 2 (2007), available at <http://www.oilru.com/or/31/588/>.

50. *Id.*

51. Skelton, *Drafting Russian Law on Oil & Gas*, *supra* note 3, at 465 n.5.

That all changed on February 10, 2005, when officials of the Ministry of Natural Resources (MNR) began openly discussing new rules for licensing terms.⁵² In particular, Yuri Trutnev, the Minister of the MNR, announced that only companies registered in Russia and at least fifty-one percent owned by Russian investors would be eligible to participate in “closed auctions” for development of Russia’s most important strategic fields.⁵³ This restriction on foreign participation was revealed as part of the overall plan to pass a new foreign investment law that would replace the current version of the Subsoil Law and was viewed as further evidence of the “growing government efforts to reassert control over the oil industry.”⁵⁴

This unprecedented attempt to produce a substitute for the Subsoil Law has been in the works for more than two and a half years, but it has not been finalized. Just recently, however, it was reported that the State Duma has asked the government for clarification of what the term “strategic” means in connection with those strategic industries in which foreign investment would be limited to forty-nine percent.⁵⁵ Thereafter, a spokesman for the Ministry of Natural Resources stated that, “the government has effectively abandoned its efforts to pass a new foreign investment law,” and the Ministry would seek changes to the existing Subsoil Law instead.⁵⁶ Such sudden changes in direction are not uncommon in the recent history of the Russian legislative process. Whether the restriction on foreign ownership takes the form of an amendment to an existing law or a new law is not the main issue, however. What

52. Irina Rybalchenko, *We Make No Jokes at Work*, KOMMERSANT, Feb. 23, 2005, http://www.kommersant.com/p548960/We_Make_no_Jokes_at_Work/.

53. INST. OF ENERGY POLICY, *THE NEW RUSSIAN SUBSOIL LAW AND ITS IMPLICATIONS ON OIL & GAS UPSTREAM BUSINESS AND FOREIGN INVESTMENT* 2, 5–6 (2005).

54. Konstantin Kovalenko and John Webb, *Russia’s New Subsoil Licensing Rules: Closing the Door on Foreign Investment in Future Big-Ticket Oil Projects?* CERA INSIGHT, March 23, 2005 at 1, available at <https://www.cera.com/asp/cda/client/report/reportpreview.aspx?CID=7266>.

55. GLOBAL INSIGHT, *UNCERTAINTY CONTINUES AS RUSSIAN GOVERNMENT PUTS PLANNED NEW SUBSOIL LAW ON HOLD* (2007), available at <http://www.globalinsight.com/SDA/SDADetail10827.htm>.

56. *Id.*

matters is that the Russian government appears to be determined to place express restrictions on foreign participation in the oil industry.

This is significant because transactions like BP's purchase of fifty percent of TNK for \$6.75 billion in February 2003 would not have been possible if the new rule had been in effect at that time.⁵⁷ Some other joint ventures would have been possible since the foreign ownership share was less than fifty percent, but the effect of this new legislative effort is very negative in terms of its perception and its practical applicability to future transactions in Russia.

VI. CONCLUSION

During the past five years, we have witnessed the demise of Yukos and the emergence of Rosneft as a significant and powerful national oil company, and Gazprom has gained more influence and power in the gas industry.⁵⁸ These and other events have provided more than enough evidence to show that the Russian government is wielding a tremendous amount of influence in its effort to renationalize a portion of the oil industry. Both the political will and the practical need to reform are distant memories due to the onset of very high crude oil prices and the change in the political climate.

It appears that foreign investors expected too much too soon in terms of market and legislative reforms in the 1990s, and now the tide has turned against them. Contrary to the investment climate in the 1990s, not many officials in Russia are making an effort to encourage foreign investment.⁵⁹ On the other hand, a limited number of examples have been recognized as being

57. Guy Chazan, *Russia to Tighten Access to Oil and Gas Reserves*, WALL ST. J., June 14, 2006, at A7.

58. Peter Finn, *Sale of Building Seals Yukos's Demise*, WASH. POST, May 12, 2007, at A11; Andrew W. Kramer, *Moscow Presses BP to Sell a Big Gas Field to Gazprom*, N.Y. TIMES, June 23, 2007, at C4.

59. See Miriam Elder, *Kremlin Delays New Subsoil Investment Law*, MOSCOW TIMES, Oct. 16, 2007, at 1 ("In the eyes of potential investors, Russia is also lackadaisical about welcoming new investments . . .").

models for the new paradigm, such as ConocoPhillips' equity investment in OAO Lukoil.⁶⁰

The legislative landscape is cluttered with countless numbers of drafts of abandoned and forgotten proposals, some of which could have been beneficial to the Russian economy and foreign investors. While the prospects for any improvements in the legislation appear to be gone, there is still a possibility that further attempts to prohibit foreign investment will fail.

60. Chazan, *supra* note 57, at A7.