

Chapter 20

Subsoil Law

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- § 20:1 Introduction
- § 20:2 Legal framework
- § 20:3 Regulatory authorities
- § 20:4 Ownership rights to subsoil
- § 20:5 Use of subsoil—Purposes
- § 20:6 —Restrictions on use
- § 20:7 —Term of use
- § 20:8 —Grounds for acquiring the right to use subsoil
- § 20:9 Two regimes of the use of natural resources: licensing and a production sharing agreement
- § 20:10 Natural resources development (production) under the licensing regime
- § 20:11 —Subsoil licenses
- § 20:12 —Obtaining the subsoil use right in the event of discovery of a deposit
- § 20:13 —State expertise of mineral reserves
- § 20:14 Geological allotment, mining allotment
- § 20:15 Subsoil licenses cannot be freely transferred or assigned
- § 20:16 Tenders and auctions
- § 20:17 Subsoil users, their rights and obligations
- § 20:18 Regulation of natural gas industry and transportation—Regulation
- § 20:19 —Transportation of natural gas via the UGSS, access to the UGSS and regional gas supply systems
- § 20:20 —Prices and tariffs in the natural gas industry
- § 20:21 Regulation of oil and oil products transportation
- § 20:22 Title to land plots
- § 20:23 Geological information that constitutes a state secret
- § 20:24 Operational licenses
- § 20:25 Environmental permits

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- § 20:26 Payments for the use of subsoil
- § 20:27 Recent material changes in subsoil legislation
- § 20:28 Recent changes in Subsoil Law and other legislation of foreign investors and Russian license holders with foreign investment

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§ 20:1 Introduction

This chapter provides an overview of the relevant Russian laws pertaining to the use of natural resources, in particular the “Subsoil Law.”¹ The bulk of the currently effective laws governing the use of subsoil emerged around 1995 and has been evolving since then. Many key laws in this area, especially the Subsoil Law, have continuously undergone significant changes. The importance of these laws is difficult to overestimate. Russia is the largest natural gas producer and the second largest crude oil producer in the world. It is also one of the largest consumers of natural resources. The matters of natural resources research, replenishment, development and ownership therefore play a very important role in the Russian economy.

§ 20:2 Legal framework

The following laws of the Russian Federation primarily form the legal framework of the natural resources industry of the Russian Federation:

- the Constitution of the Russian Federation;
- the Civil Code of the Russian Federation;

[Section 20:1]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

- Federal Law “On Subsoil” (the “Subsoil Law”);¹
- Federal Law “On Gas Supply in the Russian Federation” (the “Gas Supply Law”);²
- Federal Law “On Natural Monopolies;”³
- Federal Law “On the Continental Shelf of the Russian Federation;”⁴
- Federal Law on Precious Metals and Precious Stones of 1998; and
- Federal Law “On Production Sharing Agreements.”⁵

The following laws are also relevant to the legal framework of the natural resources industry of the Russian Federation:

- The Codes of the Russian Federation: Civil Code, Land Code, Water Code, Forest Code, Tax Code, Code on Administrative Violations, Criminal Code;
- Federal Law on Environmental Protection of 2002;
- Federal Law on Ecological Expertise of 1995; and
- Supreme Council Regulations on the Procedure of Enactment of the Provisions on the Procedure of Licensing of the Subsoil Use of 1992 (“Subsoil Use Licensing Regulations”).

In addition to the laws of the Russian Federation (federal laws), constituent regions of the Russian Federation are entitled, pursuant to the Constitution of the Russian Federation, to adopt their regional laws on subsoil, which must comply with the federal law.

§ 20:3 Regulatory authorities

The federal executive bodies with the regulatory authority in the area of natural resources include, in particular:

- the Ministry of Natural Resources and Ecology of the

[Section 20:2]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

²Federal Law “On Gas Supply in the Russian Federation,” No. 69-FZ (Mar. 31, 1999).

³Federal Law “On Natural Monopolies,” No. 147-FZ (Mar. 17, 1995).

⁴Federal Law “On the Continental Shelf of the Russian Federation,” No. 187-FZ (Nov. 30, 1995)

⁵Federal Law “On Production Sharing Agreements,” No. 225-FZ (Dec. 30, 1995).

- Russian Federation, that, *inter alia*, prepares and adopts the procedures used in accounting of natural resources on state balances, transferring licenses, classifying reserves, monitoring geological research and permitting the use of historical data owned by the state;
- the Federal Agency for Subsoil Use, an agency subordinate to the Ministry of Natural Resources and Ecology, that is the key regulator of the natural resources industry and that, *inter alia*, issues exploration, combined and production subsoil licenses and supervises the holders' compliance with the terms of such licenses, takes decisions on the termination or suspension of subsoil licenses, organizes geological exploration of the subsoil by the state, maintains the federal and territorial funds of geological data on the subsoil, organizes the conduct of tenders and auctions for the right to use subsoil, and maintains the state cadastre of deposits, takes decisions on discovery of deposits by holders of geological research licenses and participates in consideration and approval of the deposits' development plans prepared by subsoil licenses holders based on the principles of rational use of natural resources;
 - the Federal Service for Environmental, Technological and Nuclear Surveillance, a government service subordinate to the Ministry of Natural Resources and Ecology, that, *inter alia*, issues mining allotments determining boundaries of deposits, issues industrial safety certificates and operating licenses, including for the operation of oil and gas extracting and treatment facilities and oil and gas pipelines, as well as licenses for performing various types of other activities, including the transportation of oil and gas products; and
 - the Federal Service for Surveillance in the Sphere of Nature Use, a government service subordinate to the Ministry of Natural Resources and Ecology, that, *inter alia*, monitors environmental protection and the rational use and protection of the subsoil by holders of subsoil licenses, and finds and forwards information on breaches of license terms to the Federal Agency for Subsoil Use.

The structure of the federal executive bodies is established by the President of the Russian Federation and, as a practical matter, is subject to frequent modifications. The current structure was generally established in 2004 (when the overall administrative reform in Russia was launched).

The Federal Agency for Subsoil Use and the government services have their territorial branches in each region that constitutes the Russian Federation (as of March 1, 2008, there were 84 such regions). Regional authorities have limited jurisdiction in the area of natural resources regulation as compared to the federal executive bodies.

§ 20:4 Ownership rights to subsoil

According to the Constitution, natural resources in subsoil are state property and are subject to the joint jurisdiction of the Russian Federation and the region (constituent region-member of the Russian Federation) of the location of the relevant natural resources. They are not owned by a holder of a subsoil license until they are extracted. Unlike in the common law jurisdictions, Russian law does not provide for any rights of an owner of the land surface to the subsoil underlying the land surface.

Disposal of subsoil deposits is prohibited. According to the Subsoil Law,¹ subsoil deposits may not be the subject of any purchase, sale, gift, succession, contribution or pledge or be disposed of in any other form. However, the rights to use subsoil may be disposed of or transferred from one person to another to the extent that their circulation is permitted by federal laws. The Subsoil Law includes very restrictive limitations on any transfers of the rights to use subsoil which will be further described in this chapter.

The Subsoil Law further provides that minerals and other resources extracted from the subsoil under a license may be in the federal state ownership, ownership of the constituent members of the Russian Federation, or in municipal, private and other forms of ownership. Consequently, while extracted, natural resources become property of the holder of the right to use subsoil and extract the relevant natural resources. Such right is to be certified by a subsoil license and is further discussed in this chapter.

The so-called “two-key principle” for subsoil management was based on this constitutional provision and constituted a system by which subsoil licenses were issued by the federal

[Section 20:4]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

Ministry of Natural Resources and Ecology, or its regional body, together with the executive body of the relevant region. The amendments to the Subsoil Law effectively abolished the “two-key principle” in 2004 and replaced it with the new principle of a “consulting role” of the constituent regions in the key matters, such as state programs of geological research and development of natural resources, granting of the rights to use subsoil and determinations of the terms of such use, termination of the rights to use subsoil, etc. The regions only retained the rights in relation to widely spread natural resources.

§ 20:5 Use of subsoil—Purposes

The state may grant use of the subsoil to private entities or individual entrepreneurs.

According to the Subsoil Law,¹ the subsoil may be provided for use for the following purposes:

- regional geological research (including geological survey, engineering-geological research, geological operations intended to forecast earthquakes and explore volcanic activity, and other operations conducted without substantial disruption of the subsoil integrity);
- geological research, including searching for and assessment of mineral deposits;
- minerals exploration and production;
- construction and operation of subsurface facilities not associated with minerals production;
- creation of specially protected geological objects of scientific, cultural, and other value (scientific and training testing grounds, caves, etc.);
- gathering of mineralogical, paleontological and other geological collection materials;

The subsoil may be provided for use simultaneously for geological research and development of natural resources. In such an event, development can be conducted in the course of geological research as well as upon its completion.

[Section 20:5]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

§ 20:6 Use of subsoil—Restrictions on use

The following restrictions may be imposed on the use of the subsoil:

- the use of some subsoil deposits may be restricted or prohibited for the sake of national security and protection of the natural environment; and
- the use of the subsoil in the territory of populated centers, suburb zones, industrial, transport and communications facilities may be prohibited in full or in part if such use may jeopardize the life and health of people or harm business facilities or the natural environment.

§ 20:7 Use of subsoil—Term of use

The subsoil may be provided for use either for a definite period of time or without time limitation. The following terms of subsoil use are stipulated in the Subsoil Law:¹

- for geological research—for a term of up to 10 years;
- for development of minerals—for a term necessary for development of a deposit, determination of which is based on the feasibility study of its development, providing the criteria of rational use and protection of the subsoil are followed;
- for underground waters extraction—for a term up to 25 years;
- the subsoil may be provided for use without time limitation for the construction and operation of subsurface facilities not associated with mineral production, establishment of specially protected objects and for other purposes.

The term of use of the subsoil commences from the date of the state registration of a subsoil license.

The term of use may be extended on the initiative of a user of the subsoil if necessary for the completion of research and assessment or development of a mineral deposit, or for liquidation, subject to the absence of any breaches of the license by the applying subsoil user.

[Section 20:7]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

§ 20:8 Use of subsoil—Grounds for acquiring the right to use subsoil

The right to use the subsoil may be acquired pursuant to a decision of any the following bodies depending on the nature of a deposit, nature of the particular natural resource, purpose and nature of the use of the subsoil:

- the Government of the Russian Federation;
- the Federal Agency for Subsoil Use or its territorial division;
- a commission, formed by the Federal Agency for Subsoil Use, and including representatives of the executive authority of a respective constituent region of the Russian Federation;
- a tender or an auction commission;
- an executive body of a constituent region-member of the Russian Federation, agreed with the Federal Agency for Subsoil Use or with its territorial division; or
- an authorized state body of a constituent region-member of the Russian Federation according to the legislation of a constituent region-member of the Russian Federation.

In addition, the right to use the subsoil may be acquired as a result of a transfer of such right permissible under the Subsoil Law and under an effective production sharing agreement entered into pursuant to the Law On Production Sharing Agreements.

§ 20:9 Two regimes of the use of natural resources: licensing and a production sharing agreement

Russian law generally provides for the following two regimes of the use of natural resources: licensing regime and a production sharing agreement. The licensing regime is governed primarily by the Subsoil Law¹ and the subsoil regulations adopted pursuant to the Subsoil Law. The use of subsoil under a production sharing agreement is governed primarily by a production sharing agreement entered into pursuant to the Law On Production Sharing Agreements but is also certified by a license issued pursuant to the Subsoil

[Section 20:9]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

Law. The licensing regime is generally based on administrative relationships between the state (the owner of subsoil) and private entities and individual entrepreneurs (users of subsoil). This is the dominating regime in Russia and is described in detail in other parts of this chapter. The production sharing regime is characterized as a civil-law type of relationship between the state and a private investor. However, it has very limited application in terms of active projects and future potential. Due to the overall disappointment and even frustration about the terms and results of the production sharing agreements that are effective in Russia, it is extremely unlikely that any new subsoil deposits will be granted pursuant to this regime of the use of subsoil in the future.

According to the Law On Production Sharing Agreements,² a production sharing agreement is a contractual arrangement between the Russian Federation and an investor that primarily provides that: (i) all or part of taxes are replaced by a share of production; (ii) development costs are recovered out of proceeds on the terms agreed between the parties; (iii) after recovery of costs, profits are divided between the parties as agreed; (iv) operations conducted under a production sharing agreement, including the right to use subsoil, are governed by such agreement and are not affected by Russian legislation to the contrary, including the Subsoil Law and the tax laws; and (v) investors enjoy the stabilization rule screening them from potential adverse changes in federal and regional legislation.

Currently there are only three effective hydrocarbon projects based on the production sharing regime: Sakhalin 1, Sakhalin 2 and Kharyaga. Ironically, all three projects came into effect prior to the enactment of the Law on Production Sharing Agreements which, therefore, “grandfathers” these projects even in relation to its own provisions.

Only deposits approved by way of passing a special federal law for granting under a production sharing agreement can be granted under this regime. The Law on Production Sharing Agreements includes various limitations on the deposits that are eligible under the regime. In particular, no more than 30% of the natural reserves prospected and registered

²Federal Law “On Production Sharing Agreements,” No. 225-FZ (Dec. 30, 1995).

on the state balance of reserves can be granted; only the deposits geological research, exploration and development of which are impossible on terms other than production sharing. This must be shown by the failure of an auction for the right to develop a particular deposit on the basis of a usual regime (i.e. on the licensing regime). Even if the auction fails, the government must still follow a number of additional requirements in order to include the deposit in the list of those eligible. Most of the additional requirements focus on the technical difficulty and expensiveness of the development of the deposit.

After a deposit has been approved by the federal law (as one that may be granted under a production sharing agreement), an auction for the right to enter into such agreement must be conducted. The winner of such an auction is determined as the bidder offering the highest price for the right to enter into the agreement. Once the results of the auction are announced, the winner of the auction and the government negotiate the production sharing agreement. Though a particular production sharing agreement is generally negotiated by the parties, it must comply with certain limitations of the Law.

The Law On Production Sharing Agreements sets forth certain numerical thresholds that must be complied with, such as: (i) at least 80% of the workers must be Russian citizens; and (ii) at least 70% of the cost of all technological equipment, technical facilities and materials recoverable by an investor must be of Russian origin (only equipment, facilities and material produced by Russian entities or individuals, and 50% of the value of which is created in Russia by Russian entities or individuals, are considered to be of Russian origin).

The Law On Production Sharing Agreements also sets forth certain thresholds in relation to the amounts of production available for cost recovery. For the production sharing arrangement that provides for the transfer of compensation production to the investor to recover the cost, such compensation production cannot exceed 75% (or 90% on the continental shelf). For the production sharing arrangement that provides for the direct sharing between the investor and the government, the investor's share cannot exceed 68% of the overall production.

A production sharing agreement can provide for only one

sharing arrangement and cannot provide for a change of the arrangements.

§ 20:10 Natural resources development (production) under the licensing regime

In order to produce natural resources, a company must obtain a number of licenses and permits, including in particular, a subsoil license, a mining allotment, land use permits, operating licenses and a favorable environmental assessment.

§ 20:11 Natural resources development (production) under the licensing regime—Subsoil licenses

As outlined above, pursuant to the Subsoil Law,¹ subsoil is considered the property of the state and can be used only upon grant of a subsoil license. Natural resources extracted from the subsoil become the property of the subsoil user upon their extraction. Subsoil licenses are generally granted through auctions or tenders. As will be described in more detail below, the most important criterion for granting a subsoil license at an auction is the total amount the bidder is prepared to pay for the right to use the subsoil. Other factors to be considered include scientific, technical, economic, environmental and national security issues. In certain limited instances, a subsoil license may be issued without a tender or an auction, such as a geological research license if there is only one applicant for such a license, upon discovery of a deposit pursuant to a license for exploration, execution of a production sharing agreement, certain corporate reorganizations, the transfer of a subsoil license to a subsidiary of a license holder or the acquisition of a license in the course of a bankruptcy proceeding against the license holder.

Until 2004, most subsoil licenses, including licenses for geological research, exploration and production of natural resources, were issued jointly by the Ministry of Natural Resources and Ecology and the relevant authority of the regional government in which the field was located. Currently such licenses are issued solely by the Federal Agency

[Section 20:11]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

for Subsoil Use or by its territorial agency (in the event that such agency is specifically authorized through delegation of the right to issue a license by the Federal Agency for Subsoil Use).

A subsoil license grants the license holder an exclusive right to use a particular subsoil plot on the terms and conditions specified in the license (e.g. purpose of the subsoil use, borders of the land plot granted for subsoil use, deadlines (such as the start and end of the production) production volume, payments for subsoil use, etc.) and may be specified in more detail in a license agreement entered into by a competent state authority and the license holder.

There are several types of subsoil licenses granted in relation to geological research and exploration and production of natural resources, including: (i) a license for the geological exploration and assessment of a subsoil plot that may be issued for up to ten years; (ii) a license for the production of natural resources that may be issued for the expected operational life of the field as determined by a feasibility study; or (iii) a combined geological research, exploration and production license allowing for geological exploration and assessment and subsequent production of natural resources.

Pursuant to the Subsoil Law, the right to use the subsoil will be extended upon the license holder's request if it is necessary to finalize exploration, appraisal, production or remediation activities, provided that the license holder is not in breach of the terms of the license. This provision of the Subsoil Law guarantees a subsoil user an extension of the subsoil use term if necessary. In such case, no tender or auction is conducted. The Subsoil Law does not include detailed regulations on the procedure for extending a subsoil license. As a matter of practice, license holders often reach agreement with the authorities on such extension. All types of licenses can be extended. The failure by the authorities to extend a license or the non-action of the authorities can be challenged in court.

Upon expiration of a license, a license holder must, at its own expense, re-cultivate the land and return it to a condition adequate for future use.

Generally, a subsoil license cannot be held by more than one legal entity. Licenses granted in accordance with the

Subsoil Law cannot be sold or transferred to another entity, except in limited circumstances described below, such as a transfer to a spin-off company or a subsidiary in which the license holder owns not less than 50%. No restrictions are imposed by the Subsoil Law on a change of control over a license holder.

The license, the license agreement and/or other documents enclosed with the license impose certain obligations on the license holder to reach agreed levels of production, provide employment, develop local infrastructure, pay local and federal taxes and meet certain environmental requirements, as well as other obligations that may be agreed between the license issuer and the license holder.

The right to use the subsoil can be suspended or terminated in a number of cases and, in particular, if:

- there is a direct threat to the life and health of people working or living in the area affected by the subsoil use;
- the license holder has breached the material terms of the license;
- the license holder systematically violates the subsoil use procedures;
- the occurrence of an emergency situation (disaster, military action, etc.);
- the license holder's production does not reach the volumes required by the terms of the license;
- the license holder has been liquidated;
- the license holder requests suspension or termination;
or
- the license holder has failed to file reporting data in accordance with the subsoil laws.

§ 20:12 Natural resources development (production) under the licensing regime—Obtaining the subsoil use right in the event of discovery of a deposit

The Subsoil Law¹ and the subsequent regulations adopted in 2005 assures the right of the holder of a geological explo-

[Section 20:12]

¹Federal Law "On Subsoil," No. 2395-I (Feb. 21, 1992), restated as Federal Law "On Subsoil," No. 27-FZ (Mar. 3, 1995).

ration license in the event of discovery of a deposit (as a result of the conduct of geological research by the license holder at its own expense or with the use of loaned funds) to apply to the Federal Agency for Subsoil Use for a production license to develop the discovered deposit without the need to obtain a production license through an auction or tender. The decision on granting the license shall be taken in a relatively straightforward procedure within the statutory specified timeframe.

§ 20:13 Natural resources development (production) under the licensing regime—State expertise of mineral reserves

The state expertise of reserves is conducted for the purposes of establishing conditions for rational and complex use of the subsoil, state accounting of natural reserves and subsoil deposits granted for development and for the purposes not associated with development of natural resources, delimitation of the deposits granted for use, determination of the accuracy of the data on the volumes and quality of prospected reserves and other characteristics of the subsoil material determining its value or hazard. The requirements relating to the documentation to be submitted for the purposes of the state expertise are established by the Ministry of Natural Resources and Ecology.

The state expertise can be conducted at any stage of geological research, provided that geological data is sufficient to reach conclusions on the volumes and quality of prospected reserves, their commercial value, mining, technical, geological, ecological and other conditions of development.

The granting of subsoil licenses for development of mineral reserves is allowed only upon completion of the state expertise on reserves. Recording reserves on the state balance of reserves is permitted based on the conclusions of the state expertise on commercial value of reserves.

§ 20:14 Geological allotment, mining allotment

Pursuant to the Subsoil Law,¹ the subsoil area is provided to a subsoil user as a “geological allotment” for geological research and as a “mining allotment” for exploration and development. A geological allotment does not allow its holder to develop natural resources and does not provide for an exclusive right for geological research within its boundaries. A mining allotment is a geometric block of subsoil. Preliminary mining allotment boundaries are determined at the time a license which provides for the right to develop is issued. Exact mining allotment boundaries are established upon preparation of a development plan by the subsoil user and its approval by state mining supervision authorities and an environmental examination committee and are certified in a mining allotment act issued to the license holder. Only a holder of a mining allotment has exclusive rights to the relevant subsoil deposit specified in such mining allotment.

The Federal Service for Environmental, Technological and Nuclear Surveillance has the authority to approve development plans and to issue mining allotment acts. The documents defining the mining allotment boundaries shall be included into the license as an integral part thereof.

A combined subsoil license grants a geological allotment that can, upon the license holder’s application, (prior to commencement of full scale commercial development of a deposit) be converted entirely or partially into a mining allotment, subject to the license holder’s compliance with the project development documentation, payments obligations and all terms of the license.

§ 20:15 Subsoil licenses cannot be freely transferred or assigned

In general, under Russian law, rights to use natural resources held by a subsoil user cannot be transferred to third parties via an asset acquisition. As a result, following acquisitions of shares (participation interests) in Russian companies, holders of subsoil licenses remain the primary

[Section 20:14]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

mechanism of acquiring any interest in natural resources in Russia. Rights to use natural resources cannot be pledged.

The original version of the Subsoil Law adopted in 1992¹ was silent on the matter, and therefore subsoil use rights were originally not transferable. Since the mid-1990s, Russia has been gradually liberalizing its regulation on the transfers of subsoil use rights. Currently, the Subsoil Law provides for a number of cases where subsoil use rights are, or can be, transferred from a subsoil user to another person or entity and the underlying subsoil use license is reissued in the name of the transferee without the need to undergo the procedure of applying for a new license through a tender or auction. Such cases generally include corporate reorganizations, acquisitions of businesses in the course of bankruptcy proceedings, and transfers of subsoil use rights to related companies.

The Subsoil Law provides for two distinct grounds allowing transfers of subsoil use rights to related companies.

One ground, available since 2000, is the establishment by a subsoil user of a new legal entity for the purpose of continuing operations on the field, provided, among other things, that:

- the new entity: (i) is organized under the laws of the Russian Federation; (ii) has been provided with assets necessary to carry out the activities specified in the subsoil use license; and (iii) has obtained the permits and authorizations required to carry out the relevant activities; and
- the transferor's share in the charter capital of the new entity is not less than 50% at the time of the transfer of subsoil use rights.

The other ground, available since late 2006, is the transfer of subsoil use rights to a subsidiary or parent company, upon the instruction of such parent company, provided that the transferee:

- is a legal entity organized under the laws of the Russian Federation;

[Section 20:15]

¹Federal Law "On Subsoil," No. 2395-I (Feb. 21, 1992), restated as Federal Law "On Subsoil," No. 27-FZ (Mar. 3, 1995).

- meets: (i) Russian law requirements to subsoil users; (ii) specific requirements established by the terms of the auction or tender for the subsoil block in question; and (iii) the requirements set forth in the subsoil use license in respect of that particular block; and
- has been provided with assets necessary to carry out activities specified in the subsoil use license, including field facilities.

The second ground, unlike the first ground, does not require a subsoil user to specifically form a new entity in order to transfer the subsoil use rights. Under Russian corporate law, a company is deemed a subsidiary of another company (the parent company) if that other company can determine decisions taken by the first company: (i) due to its predominant participation in the charter capital of the first company; or (ii) on the basis of an agreement between the two companies; or (iii) otherwise.

§ 20:16 Tenders and auctions

Decisions on the conduct of tenders and auctions for the right to use subsoil units, on the members and working procedure of the tender and auction commissions, as well as on each subsoil deposit or group of subsoil deposits located on the territory of constituent region—members of the Russian Federation are made by the Federal Agency for Subsoil Use or its territorial body, and on each subsoil deposit or group of subsoil deposits of inland sea waters, territorial sea and the continental shelf of the Russian Federation, by the Federal Government. Decisions on the approval of tender or auction results are adopted within a period not exceeding 30 days from the day of the auction or tender.

Tender or auction commissions also include representatives of the executive bodies of the relevant constituent region-member of the Russian Federation, except for those dealing with inland sea waters, territorial sea and the continental shelf.

The main criteria for determining a winning bidder are:

- scientific and technological level of programs on the subsoil deposits geological research and use;
- completeness of minerals extraction;
- contribution to the social and economic development of the area;

- programs implementation terms;
- efficiency of the subsoil and environmental protection measures; and
- taking account of the Russian Federation national security interests.

The main criterion for determining the winner of an auction is the highest amount of the lump-sum payment offered for the right to use the subsoil deposit.

A subsoil license may be issued to the only participant of a tender on the terms of such tender, even if it has been declared a failure for the reason that the bid has been made by the only participant.

Notifications on auctions are published in all-Russia mass media and that of the relevant constituent members of the Russian Federation no later than 45 days, and notifications on tenders no later than 90 days, before taking place. The choice of mass media for the publication of such invitations is made by the Federal Agency for Subsoil Use, its territorial division or the Government as the case may be.

An application for participation in a tender or auction may be rejected on the following grounds:

- a license application has been filed in violation of the established requirements, including if the contents thereof do not meet the declared terms and conditions of a tender or auction; or
- an applicant has willfully presented incorrect data on itself; or
- an applicant has failed to prove that it has, and is unable to present any proof to the effect that it had or would have had, qualified specialists and the required financial and technical means for efficient and safe works execution; or
- antimonopoly requirements would be violated if the license is issued to the given applicant.

Since 2003, subsoil licenses have been granted through auctions only and no tenders have been conducted. This tendency has obviously come as a result of the attempts to combat corruption in Russia.

§ 20:17 Subsoil users, their rights and obligations

Individual entrepreneurs, including participants in

partnerships, foreign citizens and legal entities may be subsoil users, unless federal laws provide for restrictions. The rights and obligations of the subsoil users become effective from the date of the state registration of a license for the use of the subsoil. In cases where the legislation prescribes that for the execution of particular subsoil use rights subsoil users are to have particular operational licenses, subsoil users are required to obtain such operational licenses or enter into agreements with organizations holding such licenses.

The subsoil users or other entities and individuals engaged by them for the use of the subsoil are required to have special qualification and experience certified by a state license (certificate or diploma) for a relevant type of activity, such as geological research, exploration, various methods of minerals production, construction and operation of subsurface facilities and other types of the subsoil use.

The main rights of any subsoil user are the following:

- use of the subsoil deposit granted to it for any form of business or any other activity consistent with the objectives stated in the license or in the production sharing agreement;
- to independently choose the forms of such activity not contradicting the existing legislation;
- to use the results of user's own activity, including minerals produced in accordance with the license or the production sharing agreement and the existing legislation;
- to utilize the waste of user's own mining and associated processing facilities, unless provided for otherwise in the license or in the production sharing agreement;
- to confine construction within the boundaries of the granted mining allotment;
- to conduct, without any additional authorizations, geological research of the subsoil at user's own expense within the mining allotment provided under the license or under the production sharing agreement; and
- to apply to the government bodies that issued the license regarding a revision of the license terms and conditions if any circumstances, substantially differing from those existing at the time of the license issuance, occur.

The user of the subsoil shall provide for:

- compliance with the requirements of the law as well as with the standards (norms and rules) approved in accordance with the established procedure concerning the technology of operations involved in the use of the subsoil and in the primary raw material processing;
- compliance with the requirements of technical projects, plans and schemes of mining operations development, prevention of excess losses, depletion and selective extraction of minerals;
- maintenance of geological, mine surveying and other documents in the course of all types of the subsoil use and for its security;
- delivery of geological data to the federal and corresponding territorial fund of geological information;
- delivery of reliable information on the explored, extracted and remaining mineral resources in the subsoil, their components, on the use of the subsoil for purposes not associated with minerals production, to the federal and corresponding territorial funds of geological information and to the state statistics agencies;
- safe conduct of operations in the use of the subsoil;
- compliance with the standards (norms and rules), approved in accordance with the established procedure, regulating conditions for the protection of the subsoil, atmospheric air, land, forests, waters, as well as buildings and structures from the harmful effects of operations involved in the use of the subsoil;
- bringing land plots and other natural objects disrupted in the use of the subsoil to the condition fit for their further use;
- conservation of exploration mining workings and drilled wells, which may be used in the development of deposits and/or for other business purposes; removal in accordance with the established procedure of mining workings and drilled wells not to be used; and
- execution of the terms and conditions established by the license or by the production sharing agreement, timely and proper payments for the use of the subsoil.

§ 20:18 Regulation of natural gas industry and transportation—Regulation

The Gas Supply Law¹ sets forth specific requirements applicable to the Russian natural gas industry. The Gas Supply Law grants the Russian federal authorities a wide range of rights over natural gas development and supplies, including in part the following:

- the development and implementation of a governmental policy on natural gas supply;
- the development and implementation of federal programs for promoting the use of natural gas as a fuel and energy source;
- the regulation of strategic natural gas reserves;
- supervision and control over industrial and environmental safety of sites and facilities within the natural gas supply system; and
- standardization and certification in the gas supply industry.

Pursuant to the Gas Supply Law, the government is authorized to conduct the following:

- set projected natural gas production and sales balances in Russia;
- approve rules for natural gas deliveries, use and supply; the federal natural gas supply program; safety rules for trunk pipelines, natural gas distribution networks and other gas system units; procedures for giving independent producers access to natural gas transportation and distribution networks; procedures for using natural gas as fuel; and a list of end customers whose natural gas deliveries may not be suspended or terminated; and
- establish the principles for determining natural gas prices and transportation tariffs for gas transportation and distribution networks, and for reimbursing gas distributors for losses incurred in connection with gas deliveries to individual customers.

Pursuant to the Gas Supply Law, gas suppliers and their agents may not unreasonably refuse to enter into gas supply

[Section 20:18]

¹Federal Law “On Gas Supply in the Russian Federation,” No. 69-FZ (Mar. 31, 1999).

agreements with end customers provided that such gas suppliers have gas available and there are ways to transport that gas to the end customer. If these criteria are met but a gas supplier refuses to enter into a gas supply contract, a purchaser is entitled to initiate an action against the gas supplier before a competent court in order to force the gas supplier to enter into such a contract. The state regulates the price of gas sold by Gazprom and the tariff charged to independent gas producers to transport their gas through the United Gas Supply System (“UGSS”) owned and operated by Gazprom.

In accordance with the Rules of Gas Supply in the Russian Federation, in order to enter into a gas supply agreement, a purchaser must send an application to a supplier. Upon receipt of the application, the supplier makes an offer to the purchaser, which, as a general rule, the purchaser can consider within 30 days. A gas supply agreement must comply with the requirements of paragraph 3 of Chapter 30 of the Civil Code of the Russian Federation and must set forth the daily average gas supply volume or a dispatching schedule. If, without the prior consent of the supplier, a customer takes more gas from the system than the agreement allows, the prices and transportation tariffs for the additional gas are to be multiplied by a certain ratio (depending on the season). If a consumer fails to pay for gas in a timely manner, a supplier has the right to limit or suspend natural gas deliveries to the consumer in accordance with procedures established by the government. The government also establishes a list of end customers whose natural gas deliveries may not be suspended or terminated, such as military units, penitentiaries and fire fighting units.

§ 20:19 Regulation of natural gas industry and transportation—Transportation of natural gas via the UGSS, access to the UGSS and regional gas supply systems

In accordance with the Law On Natural Monopolies¹ and government Resolution No. 858 (July 14, 1997), Gazprom, as the owner of the UGSS, is obligated to provide independent

[Section 20:19]

¹Federal Law “On Natural Monopolies,” No. 147-FZ (Mar. 17, 1995).

gas producers access to its natural gas transportation system, such access is subject only to the availability of capacity on the UGSS, the compliance of the gas being transported with established quality and technical parameters, and the availability of connecting and branch pipelines to consumers. According to the Law On Natural Monopolies, in determining whether to provide access to independent producers, Gazprom is required to take into account the protection of the rights and legitimate interests of citizens, the security of the state, and the protection of environmental and cultural heritage.

Similar access rights to regional gas supply systems have been established. Any legal entity in the territory of the Russian Federation has the right to access the regional gas supply systems to facilitate delivery of natural gas.

§ 20:20 Regulation of natural gas industry and transportation—Prices and tariffs in the natural gas industry

Natural gas prices and transportation tariffs in Russia are regulated pursuant to the Law on Natural Monopolies¹ and the Gas Supply Law,² as well as pursuant to a number of government resolutions. Wholesale price regulation applies to gas produced by Gazprom and its subsidiaries, Yakutgazprom, Norilskgazprom, Kamchatgazprom and Rosneft-Sakhalinmorneftegas, but does not apply to gas produced by entities not affiliated with Gazprom.

The wholesale price of natural gas produced by independent gas suppliers is not regulated. However, certain consumers, such as residential consumers, are entitled to fixed retail gas prices.

FTS regulates the price of gas sold by Gazprom and the tariff charged to independent gas producers to transport their gas through the UGSS. The principles of pricing are, in part, the recovery of economically reasonable expenses by suppliers and transportation companies, maintenance of reasonable operating margins, and satisfaction of demand for gas.

[Section 20:20]

¹Federal Law “On Natural Monopolies,” No. 147-FZ (Mar. 17, 1995).

²Federal Law “On Gas Supply in the Russian Federation,” No. 69-FZ (Mar. 31, 1999).

§ 20:21 Regulation of oil and oil products transportation

Transneft and Transnefteprodukt control, respectively, the trunk pipelines for the transportation of crude oil and petroleum products in Russia. Transneft is a state-controlled monopoly, Transnefteprodukt is a subsidiary of Transneft. Both companies are involved in activities that are defined as natural monopoly.

Pursuant to the Law on Natural Monopolies,¹ the Ministry of Industry and Energy, based on information provided by the Federal Energy Agency, allocates Transneft's trunk pipeline network and sea terminal capacity to oil producers for export deliveries on a quarterly basis, generally in proportion to:

- the volume of crude oil that such producers declare they will deliver in the upcoming quarter;
- the volume of crude oil that such producers delivered to the Transneft pipeline system in the previous quarter; and
- Transneft's overall capacity.

Once the access rights and volumes for transportation are allocated, oil producers generally are limited in increasing the allotted capacity in the export pipeline system and have limited flexibility in altering delivery routes determined by Transneft.

According to the Law on Natural Monopolies, the Ministry of Industry and Energy establishes volumes to be exported via the Transneft export system. It applies a principle of "equal access" provided for by the Law on Natural Monopolies, whereby it calculates export quotas by dividing the total capacity of Transneft's system by the volume of crude oil delivered to Transneft by all oil companies using the Transneft system. Generally, the percentage of crude oil exported outside the CIS is approximately 40% of total oil deliveries to the Transneft system. The actual percentage, may however vary depending on the location of the producer and the part of the Transneft system it utilizes for the exports.

[Section 20:21]

¹Federal Law "On Natural Monopolies," No. 147-FZ (Mar. 17, 1995).

Deliveries through Transnefteprodukt are generally based on the applications by the oil companies in proportion to the Transnefteprodukt pipeline capacity.

The FTS sets the tariffs for the use of Transneft and Transnefteprodukt trunk pipelines.

§ 20:22 Title to land plots

Pursuant to the Subsoil Law,¹ subsoil licenses are issued subject to the land management authorities' consent to the allotment of a land plot covering the surface of the licensed area. The boundaries of the land plot are determined upon approval of a development plan based upon an agreement between the owner of the land plot and the subsoil user. Should the subsoil user and the land plot owner fail to reach agreement on the final boundaries and other substantial terms (payments, time etc.) for the use of the land plot, the government may take over the land plot necessary for the subsoil extraction subject to paying equivalent compensation to the land owner or user.

A subsoil user is provided with rights to the land pursuant to the land legislation of the Russian Federation and a subsoil user can either purchase or lease the land plot covering its mining or geological allotment.

§ 20:23 Geological information that constitutes a state secret

According to the Law of the Russian Federation On State Secret of 1993 (Law on State Secret), information on volumes of subsoil reserves, as well as details of production and consumption of strategic natural resources of the Russian Federation, to the extent set forth in a list approved by the Federal Government, constitute state secrets. The Federal Government in its decree No. 210 (April 2002), approved the list of specific resources and specific information regarding each such resource as being a state secret. According to this decree, for example, information on oil (and oil dissolved gas) reserves is a state secret.

[Section 20:22]

¹Federal Law "On Subsoil," No. 2395-I (Feb. 21, 1992), restated as Federal Law "On Subsoil," No. 27-FZ (Mar. 3, 1995).

In order to have access to state secret information, a company must obtain a license. One of the licensing requirements is attestation of the company's chief executive officer. If a company is managed by a non-Russian chief executive officer, it will not be able to obtain a state secret handling license. Without such a license the company will not have access to detailed geological maps required for geological research and exploration, approval of reserves, preparation of development plans for production, i.e. for the company's operations. It has been suggested that the problem may be resolved by appointing within a company a special chief executive officer's deputy who will be responsible for the state secret information.

§ 20:24 Operational licenses

The production, storage, transportation, processing and sale of natural resources are subject to licensing requirements. Most operational licenses are issued by the Federal Service for Environmental, Technological and Nuclear Surveillance. The principal operational license for gas production is the license to operate oil and gas extracting facilities. This license is issued for a maximum term of five years. In addition to other documents, to receive the license, the applicant must provide evidence that it meets the operational license requirements, which include, in part, the availability of qualified personnel and equipment required for operations, as well as adequate environmental, health and safety measures. In addition, all equipment used at the oil and gas extracting facilities must be certified by the Federal Service for Environmental, Technological and Nuclear Surveillance for such use.

Certain other gas industry operations, in particular, operations that carry the risk of explosion or fire, oil and gas storage, and transportation of oil and gas products, also require a separate license.

§ 20:25 Environmental permits

Russian environmental legislation establishes a pay-to-pollute regime administered by the Federal Service for Environmental, Technological and Nuclear Surveillance, which issues pollution discharge permits. Separate fees are assessed for pollution under the maximum permitted dis-

charge limits and for pollution in excess of such limits. There are additional fines for certain other violations of environmental regulations. The environmental protection legislation contains an obligation to make compensatory payments into the federal and/or local budgets for all environmental losses caused by pollution. In the event of a dispute concerning losses caused by violations of environmental laws and regulations, the prosecutor's office or other authorized governmental bodies may file a law suit, though no private party has a right to file an action. Courts may impose clean-up obligations in lieu of, or in addition to, imposing fines.

Construction projects, including oil and gas production projects, require both an environmental impact assessment by an independent environmental expert and a prior favorable environmental opinion issued by competent public authorities. The purpose of such evaluation is to verify that the project ensures protection of the environment, a rational use and restoration of natural resources, as well as an assessment of short-term and long-term environmental, economic and demographic impact of the subsoil use. The documents developed in the course of the environmental impact assessment are presented to the state body responsible for the issuance of environmental opinions.

Subsoil licenses are granted on the condition that the license holder undertakes to comply with Russian environmental standards and norms (air, water and soil pollution limits, waste management requirements, animal protection, human health, etc.). Prior to the issuance of a subsoil license, the Federal Agency for Subsoil Use agrees on the environmental requirements with the Federal Service for Environmental, Technological and Nuclear Surveillance. Once a subsoil license is issued, the license holder's compliance with licensing requirements is supervised by the Federal Agency for Subsoil Use, while general state ecological supervision is conducted by the Federal Service for Environmental, Technological and Nuclear Surveillance.

§ 20:26 Payments for the use of subsoil

According to the Subsoil Law,¹ the following types of payment obligations are imposed on the users of subsoil:

- One-time payments in cases specified in the subsoil license;
- Regular payments for subsoil use, such as rent payments for the right to conduct geological research, appraising and exploration;
- Payments to the state for the geological data developed by the state or at its expense;
- Fees for the right to participate in tenders or auctions; and
- Fees for the granting of licenses.

The rates at which various payments are made are commonly set forth in a license. The range of minimum and maximum rates or formulas to determine payments are provided for in the Subsoil Law and the Tax Code.

§ 20:27 Recent material changes in subsoil legislation

The primary recent legal trend that impacts the energy industry in Russia is the restriction of the powers of the regional authorities, both in general, through changes to constitutional legislation, and in connection with subsoil use, through changes to subsoil legislation.

The changes to legislation restricting the powers of regional authorities in connection with subsoil use were introduced by Federal Law No. 122-FZ (August 22, 2004), which amended, in particular, the Subsoil Law.¹ These amendments became fully effective as of January 1, 2005 and are aimed at limiting corruption related to the issuance of subsoil licenses and at simplifying the subsoil licensing procedures.

Whereas under the previous provisions of the Subsoil Law,

[Section 20:26]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

[Section 20:27]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

subsoil licenses required the approval of both the Federal Agency for Subsoil Use and the executive body of the applicable region, under the amended law (Amended Law), regional government approval is no longer required (except in the limited circumstances described below). According to the Amended Law, subsoil use rights are granted based on resolutions of the federal government, the Federal Agency for Subsoil Use or its regional body, and tender/auction commissions. The Regions' role in the constitutionally declared joint jurisdiction is now limited to merely being represented in tender/auction commissions. However, regional governments retain the right to issue licenses to common resources fields or fields of local importance, primarily sand and gravel fields.

Whereas under the previous provisions of the Subsoil Law, federal and regional authorities shared in the decision whether to hold a tender or auction, under the Amended Law, only the federal government (in the case of offshore resources) and the Federal Agency for Subsoil Use (in the case of onshore resources) have such authority.

§ 20:28 Recent changes in Subsoil Law and other legislation of foreign investors and Russian license holders with foreign investment

On April 29, 2008, the Russian President signed into law amendments to the Subsoil Law and certain other laws that address restrictions on the rights of foreign investors to deposits of natural resources that are of federal significance. The terms are defined in the amendments to the Subsoil Law,¹ the Law On the Continental Shelf² and certain other laws. The deposits that qualify are the following:

- Deposits of certain minerals regardless of quantities, such as uranium, diamonds, pure quartz, nickel, cobalt, platinum, beryllium, tantalum, lithium and rare earths of the yttria group.
- Deposits containing “strategic quantities” of certain

[Section 20:28]

¹Federal Law “On Subsoil,” No. 2395-I (Feb. 21, 1992), restated as Federal Law “On Subsoil,” No. 27-FZ (Mar. 3, 1995).

²Federal Law “On the Continental Shelf of the Russian Federation,” No. 187-FZ (Nov. 30, 1995)

mineral reserves: the relevant quantities for these purposes are those recorded on the state balance of reserves beginning from January 1, 2006 and will be classed as “having federal significance” if they exceed 70 million tons of recoverable oil, 50 billion cubic meters of gas, 500,000 tons of copper, or 50 tons of gold.

- Deposits located on any internal sea, territorial sea or the continental shelf or territories used in connection with state security and defense.

The following restrictions are introduced on the ability by foreign companies and Russian companies with foreign investment to acquire or keep control of significant natural resources deposits in Russia by the new law:

- Despite the hope that subsoil licenses already issued would be “grandfathered” under the new law, the new restrictive provisions of the Subsoil Law will not apply only to production licenses issued before its enactment. The new law entitles the Russian government to refuse to grant a production license to, or terminate a combined geological research, exploration and production license held by a foreign or Russian company with foreign investment, if it discovers a deposit that falls under criteria of a deposit of federal significance.
- In addition to a general restriction requiring that a holder of a license, for a deposit of federal significance, must be a Russian company, the new law allows Russian national defense and security executive bodies to prohibit participation of Russian companies with foreign investment in auctions or tenders for the rights to use deposits of federal significance. Any transfers of existing licenses for such deposits to companies with foreign investment that exceed the thresholds or do not otherwise comply with the criteria outlined in the new law on Foreign Investments in Strategic Industries³ with regard to natural resources in deposits of federal significance are prohibited.

The new law also imposes restrictions that apply regardless of whether a license holder is a company with foreign investment. One such restriction is that, going forward, no

³Federal Law “On the Procedure of Foreign Investment in Business Entities Having Strategic Significance for Securing the Defense of the Country and Safety of the State,” No. 57-FZ (Apr. 29, 2008).

combined geological research, exploration and production licenses may be granted for deposits of federal significance. Another restriction is that license holders for deposits located or partially located on the Russian continental shelf must be Russian companies having no less than 5 years experience of working on the continental shelf and having more than 50% of its voting shares directly or indirectly owned or otherwise controlled by the Russian Federation. This restriction effectively prohibits any foreign investment in the Russian continental shelf other than via the Russian state controlled majors.