

Foreign Investment in Russian Oil and Gas: Will 2008 Bring New Restrictions?



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For several years now the Russian government has been considering various pieces of legislation that would restrict foreign investment in the oil and gas sector. Recent Russian parliamentary elections held on 2 December 2007, which resulted in the party closely aligned with President Putin winning the majority of seats, seem to indicate that restricting foreign investment in certain strategic sectors, including the oil and gas sector, will remain on the agenda in 2008.

Of particular note is the draft law "On the Procedure for Making Foreign Investments in Commercial Organisations of Strategic Importance to the National Security of the Russian Federation," and certain proposed amendments to the Subsoil Law. While these are still under discussion and their final form is not yet known, they merit close attention to get a sense of their potential impact on foreign investment in the coming year.

Draft Federal Law "On the Procedure for Making Foreign Investments in Commercial Organisations of Strategic Importance to the National Security of the Russian Federation"

The possibility of legislation restricting foreign investment in certain strategic industries has been under discussion within the Russian Government for several years. In July 2007 the draft law "On the Procedure for Making Foreign Investments in Commercial Organisations of Strategic Importance to the National Security of the Russian Federation" (Draft Law) was submitted to the Lower House of the Russian Parliament (State Duma);¹ less than two months later the Duma passed it in the first reading. The Draft Law will have its second Duma reading² in the Spring 2008 session. If enacted, the Draft Law would regulate foreign investment in Russian companies operating in strategically important sectors. Regulation of investment would likely take the form of restrictions on participation in, or acquisition of control over, these companies.

Although some media comment has suggested otherwise, upon closer examination the Draft Law can be seen as taking a relatively “permissive” approach to the concept of what constitutes a strategic industry and how foreign investors may participate in such industries. There are no absolute prohibitive measures and foreign investors may, in fact, be admitted to the national economy’s strategic industries based on the procedure for transaction approvals set out in the Draft Law.

Regulated Industries

The Draft Law sets out a list of thirty-nine strategically important industries, which can be divided into several groups, including:

1. Weapons manufacture, military technologies and hardware, cartridges, firearms, ammunition and its components, and explosives;
2. Metals and alloys used in defence industries;
3. Aerospace;
4. Aviation safety;
5. Nuclear and radioactive substances, materials and waste, work related to nuclear installations, radiation sources and storage;
6. Work relating to changing hydrometeorological and geophysical processes;
7. Agents of contagious diseases;
8. Coding/cryptographic facilities and devices, and services;
9. Surveillance; and
10. Natural monopolies.

The Draft Law does not refer to an investment in the oil and gas industry (save to the extent that such an investment relates to a natural monopoly). Nevertheless, the Draft Law, adopted in the first reading, is subject to revision before its second reading in the Duma. In particular the Federal Security Service (FSB) has proposed extending the list of activities deemed to be strategic to cover the development of subsoil deposits of federal significance. (The definition of “deposits of federal significance” will be discussed below).

Categories of Investors

The Draft Law applies to a broad range of investors, whose status is closely defined by previous Russian legislation, including:

1. Foreign investors (as defined by the Russian legislation on foreign investments);
2. Russian companies under foreign control; and
3. Groups of persons (as defined by the Russian antimonopoly legislation).

Acquisition of Control

Under the Draft Law, a foreign investor is deemed to acquire control over a Russian company operating in a strategic sector if it enters into a transaction pursuant to which any of the following criteria are met with respect to such Russian company:

1. A foreign investor acquires more than fifty percent of the voting shares (interests);
2. A foreign investor is entitled to appoint a general director or more than fifty percent of the executive body or to nominate more than fifty percent of the board of directors;
3. A foreign state (or a foreign company controlled by a foreign state) or an international organisation acquires more than twenty-five percent of the voting shares or the right to block the decisions of the executive bodies; or
4. A foreign investor obtains the right to control the Russian company by any other means.

With respect to point (4) above, it appears that the drafters of the Draft Law have included a broad “catch-all” provision, which will need to be further elaborated upon to provide a more bright line test of application.

The Draft Law provides a non-exhaustive list of the types of transactions that may lead to a foreign investor’s assumption of control over a Russian organisation, including agreements on sale and purchase, donation or exchange of voting interests, trust management agreements or other agreements dealing with voting interests, management agreements, and other transactions transferring the right to make decisions on behalf of the company to a foreign investor, including determining the terms and conditions of its business activities.

Transaction Approval Procedure

According to the Draft Law, a foreign investor, whose proposed transaction falls under the regulation of the draft, must submit an application supported by relevant documents to a specially designated Government agency (Authorised Body) for approval. The application and documents will be defined by the regulation, but are as yet unspecified. The documents are then transferred to a special Government Commission that reviews the application and adopts the decision on its approval or rejection. Based on these documents, it will determine whether the relevant Russian organisation may be subject to foreign control. Furthermore, in the consideration of the application regard will be given to “negative factors” with respect to the Russian organisation such as the existence of: (i) licenses for access to state secrets; (ii) foreign trade in controlled/defence-related goods/technology; (iii) fulfilment of state defence-related orders within past five years; (iv) natural monopolies position; (v) having a dominant market position; and (vi) exclusive intellectual property rights in certain technologies critical for national security.

If no “negative factors” are identified, the Government Commission must approve the application. The Government Commission will reject an application if one or more “negative factors” are present, and the proposed transaction will harm national security. If “negative factors” are present and foreign control is established, the transaction may be approved only if (i) it is determined that no threat to national security arises as a result of the transaction; and (ii) the foreign investor agrees to assume certain obligations that are set out in an agreement between the foreign investor and the Authorised Body.

If the foreign investor proceeds with the investment in contravention of the requirements of the Draft Law, the transaction can be declared null and void, and the foreign investor can be deprived of its voting rights. The Authorised Body may initiate investigations relating to state secrets, and the Draft Law gives the FSB broad rights to search and investigate in relation to foreigners’ control.

Grandfathering Provisions

According to a statement from the Ministry of Energy and Industry, investments in sectors deemed strategic in the Draft Law that are made before the Draft Law takes effect would not be subject to the restrictions of the Draft Law, as long as the investment complied with the law at the time it was made. The nationalisation of such investments is not part of the draft law at this time. However, the Draft Law does not expressly provide a “grandfathering provision” that would exempt prior investment from application of the law. As a general rule, Russian legislation does not have a retroactive effect unless the law specifically provides that it will apply to matters in existence prior to the date of the law.

Amendments To The Federal Law “On Subsoil”

For some time it appeared that a new law “On Subsoil” would replace the current legislation entirely. A draft of the new Subsoil Law was even prepared and circulated. However, in the past year the Ministry of Natural Resources (MNR) had been campaigning to introduce a number of amendments to the current Federal Law “On Subsoil” instead of replacing the Subsoil Law with new legislation. The proposed amendments, among other things, relate to restrictions on foreign participation with respect to federally significant subsoil deposits were among those proposed (Draft Amendments).

According to recent reports, the MNR was ready to submit the Draft Amendments to the Duma. However, the review of the Draft Amendments was stalled as the FSB has expressed its reservations. The FSB wants to apply the criteria for subsoil deposits of federal significance not only to the deposits that have not yet been distributed (i.e., the undistributed fund), but also retroactively with respect to those deposits for which licenses have already been issued.

In contradiction to MNR’s position of earlier this year, in one of his latest public statements in August 2007, Minister of the MNR Yuri Trutnev appeared to indicate that the adoption of an entirely new draft of the Law “On Subsoil” may still be possible, assuming that the Government is ready to adopt a market approach (as opposed to an administrative approach) to subsoil regulation. Therefore, we are left at the end

of 2007 waiting to see how the changes to the Subsoil Law, if any, will be enacted.

General Regulatory Framework

While the future of the Draft Amendments are currently unclear, we have set out below a brief description of the fundamentals of the Draft Amendments.

The Draft Amendments categorise uranium, diamonds, exceptionally pure quartz, and rare earths of the yttrium group as subsoil deposits of federal significance. Additionally, the following subsoil deposits may be deemed, on a case-by-case basis, to be subsoil deposits of federal significance if the Government so declares:

1. Oil deposits (over seventy million tons);
2. Gas deposits (over fifty billion cubic meters);
3. Copper deposits (over five-hundred thousand tons); and
4. Gold deposits (over fifty tons).

Offshore and in-land deposits that are reserved for national defence and security will be classified as strategic.

The Subsoil Law now provides that if a subsoil user makes a commercial discovery following exploration carried out at its own cost, it is generally entitled to apply for and receive a production license for the discovery. The proposed Draft Amendments do not appear to change this entitlement in that a newly discovered deposit may only be declared a deposit of federal significance if the subsoil user who made the discovery declines, in writing, to undertake production.

As the future of both the Draft Law and the Draft Amendments remains uncertain, 2008 may be another year of waiting and watching for foreign investors in the Russian oil and gas sector. Nevertheless, regardless of how the laws may change in 2008, the transactions of 2007 have given a clear indication that many foreign investors are learning to play the game under a new set of rules, whether these rules are written or not, by either investing in minority positions together with State-controlled or other large Russian companies, or by focusing their investments on small to mid-size prospects.

Marc Polonsky

Marc Polonsky practices in the areas of corporate acquisitions and disposals, joint ventures and financings, with particular expertise in the natural resources sector. Based in Moscow since 1998, he has considerable Russian (and other CIS) transactional experience, having worked on such transactions since 1990. Marc is ranked as a leading project finance lawyer in Russia by the IFLR 1000 (2008). Chambers Global (2007) lists Marc as one of the top energy lawyers in Russia and describes him as "a marvellous strategist with unparalleled knowledge of the energy markets in Russia and the CIS countries."

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- 1 The Russian Parliament consists of two bodies: the Federation Council (the Upper House) and the State Duma (the Lower House).
 - 2 In order to become a law, a draft law must be passed in three readings, approved by the Federation Council, and signed by the President.