Key Changes and Trends of 2018 in Regulation of Russian Subsoil Use

December 12, 2018

This *Debevoise In Depth* outlines the changes and trends that, in our opinion, have been the most significant in the regulation of Russian subsoil use in 2018.

These changes include the following:

- the restrictions on the participation in strategic subsoil users and acquisition of control over them (or their fixed production assets) have become applicable to all foreign investors which do not disclose information on their beneficiaries, beneficial owners and controlling persons (regardless of the place of registration of such investors);

- in the field of taxation, the tax on additional income from hydrocarbon production is introduced, and the *tax maneuver* in the oil industry is being completed;

- the procedure for the provision of subsoil sites of the Russian continental shelf, when they are claimed by two or more applicants, has been changed; and

- in the international arena, it is noteworthy that Russia and other Caspian littoral states have signed a convention that sets forth a procedure for agreeing on the boundaries of subsoil sites and routes for laying pipelines and cables in the Caspian Sea (work on this document has been conducted since 1996).

Based on the legislative initiatives, the main regulatory trends concern the oil and gas sector, in particular:

- disinterest of the state in liberalizing (i) the export of liquefied natural gas (LNG) and (ii) access to the subsoil sites of the Russian continental shelf;

- exemption of a number of goods from customs duties, taking into account the specifics of offshore hydrocarbon production and the need to increase the volume of such production;

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- stimulating the production of hard-to-recover oil; and

- harmonization of regulation of prevention of, and response to, spills of oil and oil products.

Among other initiatives, the promotion of the use of mineral waste, as well as attempts to combine all environmental payments into a single environmental tax are noteworthy.

These changes and trends are described in more detail below.

Changes in the Regulation of Subsoil Use

Extension of Restrictions with Respect to Strategic Subsoil Users to All Foreign Investors That Do Not Disclose Information about Their Beneficiaries, Beneficial Owners and Controlling Persons

On June 12, 2018, amendments to Federal Law No. 57-FZ on Foreign Investments in Companies of Strategic Importance for the Defense and Security of the State dated April 29, 2008 (the "Strategic Investments Law") came into force.

The new edition of the Strategic Investments Law provides for a new special subject of restrictions—foreign legal entities or other foreign organizations that do not submit to the Federal Antimonopoly Service of Russia (the "FAS Russia") information about their beneficiaries, beneficial owners and controlling persons (the "non-disclosing investors").

Non-disclosing investors and organizations controlled by them:

- may directly or indirectly acquire more than 5% of the voting shares (participation interests) of a company-user of subsoil sites of federal significance (the "strategic subsoil user") only with the prior consent of the Russian Governmental Commission for Control over Foreign Investments; and

- may not acquire (i) control over a strategic subsoil user (including by directly or indirectly acquiring 25% or more of its voting shares (participation interests)) or (ii) the fixed production assets of a strategic subsoil user, the value of which represents 25% or more of the balance sheet value of the assets of such user.

Since July 1, 2017, these restrictions have applied to offshore companies (*i.e.*, legal entities registered in offshore zones according to the list approved by the Russian Ministry of Finance). Currently, the Strategic Investments Law does not contain the

definition of "*offshore companies*" and the restrictions applied to them have been extended to all foreign legal entities and other foreign organizations (regardless of their place of registration) depending on the fulfillment of the obligation to disclose certain information to the FAS Russia.

Introduction of Tax on Additional Income from Hydrocarbon Production

From January 1, 2019, the tax on additional income from hydrocarbon production (the "AIT") will apply in addition to the mineral extraction tax (the "MET").

The AIT rate is 50% of the tax base, which is calculated as the estimated revenue from the sale of hydrocarbons produced from the subsoil site, reduced sequentially by the amount of actual expenses and the amount of estimated production costs.

The AIT will apply to the four groups of deposits:

- deposits with a degree of depletion of oil reserves of less than, or equal to, 5% as of January 1, 2017, or with oil reserves first recorded on the state balance sheet after January 1, 2017 in Eastern Siberia (in the Republic of Sakha (Yakutia), Irkutsk Region, Krasnoyarsk Region), Nenets Autonomous District, north of 65 degrees North latitude within the boundaries of the Yamalo-Nenets Autonomous District, and also within the Russian part of the Caspian Sea bed;

- deposits enjoying an exemption on export duty (specified in Explanatory Note 8 to the single Commodity Nomenclature of Foreign Economic Activity of the Eurasian Economic Union as of January 1, 2018);

- deposits in Western Siberia (in the Tyumen Region, Khanty-Mansi Autonomous District—Yugra, Komi, Yamalo-Nenets Autonomous District) within certain geographical coordinates with a degree of depletion from 10% to 80% (provided that the total production over all the subsoil sites located in these geographical coordinates is no more than 15 million tons); and

- deposits in Western Siberia (in the Tyumen Region, Khanty-Mansi Autonomous District—Yugra, Komi, Yamalo-Nenets Autonomous District) within certain geographical coordinates with a degree of depletion of 5% or less and initial recoverable reserves of less than 30 million tons (provided that the total initial recoverable reserves of the subsoil sites located in these geographical coordinates do not exceed 150 million tons).

The users of the deposits of the first group will have the right to receive an exemption from the payment of the AIT—this requires sending a notification to the tax authority.

The users of the deposits of the second group will switch to the AIT only if they send a notification to the tax authority of the exercise of the right to use the AIT by January 1, 2020. The switch to the AIT is mandatory for the users of the deposits of the third and the fourth groups.

The MET rate for the deposit users, which have switched to the AIT regime, is significantly reduced.

Tax Maneuver in the Oil Industry

Export Customs Duty and MET

The amendments introduced into the Russian Tax Code set forth a gradual decrease in the maximum marginal rate of the export customs duty on oil and oil products up to its zeroing within six years (from 2019 to 2024). To ensure a gradual reduction of the duty on oil and oil products, a special corrective factor is introduced, which will decrease from year to year.

At the same time, it is provided that the Russian Government can urgently introduce an increased export customs duty rate in the event of a sharp increase in world oil prices (by 15% within one month). The amount of such customs duty will be 60% of the increased rate of the export customs duty on oil.

At the same time, a gradual increase in the MET is foreseen. The term of application of the multiplying factor introduced in 2017 into one of the formulas underlying the calculation of the MET will be increased by another year—until the end of 2021.

Thus, economically, a decrease in budget revenues from a decrease in export duties will be offset by the MET.

Excise Taxes

To avoid a sharp rise in prices for oil products on the domestic market caused by a reduction in the rate of export customs duty and an increase in the MET, tax deductions are introduced for oil refineries (the "refineries")—a mechanism for reverse excise tax on oil. This mechanism will come into effect on January 1, 2019.

First, a logistic factor is introduced into the formula for calculating the excise tax on oil, which will allow for an increase in the deduction for the refineries that are located far from the sales markets. The value of the factor varies from 1 to 1.5, depending on the region. The largest logistic factor of 1.5 will be applied to the refineries located in Khakassia and in the Krasnoyarsk Region.

Second, a damping factor is introduced into the formula for the return of the excise tax on oil. The factor is calculated as the difference between export prices (calculated according to a certain formula) and domestic prices (established statutory). If domestic wholesale prices for Class 5 gasoline and Class 5 diesel fuel deviate from the prices established by the law by more than 10% up, then the value of the damping factor is assumed to be 0.

The above mentioned factors can be applied only by the refineries that have received a certificate of registration of a person performing operations on the processing of crude oil. Such a certificate can be obtained by Russian organizations that process their own oil or oil on a give-and-take basis if they have the production capacity necessary for the implementation of technological processes for the processing of crude oil, which also:

1. as of January 1, 2018, fell under the sanctions;[1]

2. produce 10% or more of Class 5 gasoline from all crude oil sent for refining and sell it on the domestic market in the amount of not less than 5,000 tons per year; or

3. by June 1, 2019 will have concluded with the Russian Ministry of Energy (the "MinEnergy") an agreement on refinery modernization, provided that this agreement is valid and no facts of its non-performance have been identified.

Such certificate can also be obtained by a Russian organization that has entered into:

- an agreement on the provision to it of oil refining services with an organization that meets one of the requirements specified in paragraphs 1 and 2 above; or

- an agreement on the provision to it of oil refining services with its subsidiary (a participation interest in which is more than 50%), provided that such subsidiary will have entered into a refinery modernization agreement with the MinEnergy by June 1, 2019 providing for the investment in upgrading capacity of at least 60 billion rubles from January 1, 2015 to January 1, 2024.

The refinery has the right to conclude a new modernization agreement with the MinEnergy, provided that it sent for refining crude oil in the amount of more than 600 thousand tons in 2017. Meanwhile, the refinery that has entered into a modernization agreement with the state is obliged to either reach the production of at

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[1] Including Russian organizations, at least 50% of the charter capital of which is directly or indirectly owned by Russian organizations that were under the sanctions as of January 1, 2018.

least 10% of Class 5 gasoline from crude oil sent for refining, or invest in upgrading capacity of not less than 60 billion rubles from January 1, 2015 to January 1, 2024.[2]

Change of the Procedure for the Provision of Subsoil Sites of the Continental Shelf Claimed by Two or More Applicants

On December 9, 2018, a law which repeals the provision of Federal Law No. 187-FZ on the Continental Shelf of the Russian Federation dated November 30, 1995 (the "Shelf Law") on the provision of subsoil sites of the continental shelf without an auction came into effect.

Currently, the subsoil sites of the continental shelf can be provided upon the decision of the Russian Government only to state-owned companies, namely:

- Russian legal entities with at least five years of experience in developing such sites in which Russia (i) directly owns more than 50% of the charter capital or (ii) directly or indirectly controls more than 50% of the voting shares (participation interests); and

- Gazprom (from the sites that contain gas and are included in a special list approved by the Russian Government).

Only one change has been made to the Shelf Law—the provision that the subsoil sites of the continental shelf are provided for use without auctions has been removed. Meanwhile, the developers of the law did not seek to expand the list of potential users of such sites (for example, by including private Russian producers or foreign companies), but only tried to establish a procedure for determining the winner in cases where two or more state-owned companies simultaneously claim the same subsoil site.

In late November 2018, the Russian Ministry of Natural Resources and Environment published draft amendments to Resolution of the Russian Government No. 4 dated January 8, 2009, according to which if the boundaries of the subsoil sites of the Russian continental shelf claimed by different applicants overlap, the Federal Agency for Subsoil Use (the "RosNedra") holds a conciliatory meeting with participation of such applicants; if they do not reach an agreement following such meeting, the RosNedra suggests holding an auction in respect of such sites.

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[2] Contrary to the provisions of the Russian Tax Code, the draft agreement with the MinEnergy published for public commentary provides that both criteria are mandatory.

Determining the Procedure for Agreeing on the Boundaries of Subsoil Sites and Routes for Laying Pipelines and Cables in the Caspian Sea

On August 12, 2018, all the Caspian littoral states—Russia, Azerbaijan, Kazakhstan, Turkmenistan, and Iran (the "Parties")—signed the Convention on the Legal Status of the Caspian Sea. Work on this document has been conducted since 1996. The Convention will come into force after the ratification by each of the Parties and transfer of all the instruments of ratification to Kazakhstan.

Among other things, the Convention sets forth which of the Parties in certain cases participate in agreeing on (i) the boundaries of subsoil sites of the Caspian Sea and (ii) routes for laying submarine pipelines and cables.

Delimitation of the Caspian Sea Subsoil

Until now, serious disputes have been caused by the delimitation of the seabed and subsoil of the northern Caspian among Russia, Kazakhstan, and Azerbaijan (after the collapse of the USSR) and the southern Caspian among Iran, Azerbaijan, and Turkmenistan.

The Convention provides for the delimitation of the Caspian Sea seabed and subsoil into *sectors*. However, it lacks a procedure for such delimitation—the boundaries of the sectors shall be established on the basis of separate agreements between (i) adjacent Caspian states and (ii) states located opposite the assumed boundary of the relevant sector. Thus, it is not necessary for all the Parties to participate in agreeing on the boundaries of each sector.

Within its sector, each Party:

- exercises jurisdiction over artificial islands, installations, fixtures, its submarine cables and pipelines;
- has the exclusive right to construct artificial islands, installations and fixtures, as well as to authorize and regulate their creation and use;
- may establish necessary safety zones (up to 500 meters) around artificial islands, installations and fixtures in order to ensure the safety of both shipping and artificial islands, installations and fixtures;
- may take reasonable measures in relation to the ships of other Parties (including search, inspection, pursuit, detention, arrest and trial) that may be necessary to ensure compliance with its laws and regulations;

- has the exclusive right to regulate, authorize and conduct marine scientific research related to the exploration and development of the seabed and subsoil resources (ships of other Parties may conduct such research only with its written permission and on such terms as it may establish).

Agreeing on Routes for Laying Submarine Pipelines and Cables

Of great importance are the provisions of the Convention on the procedure for laying submarine pipelines and cables along the seabed of the Caspian Sea. Previously, this issue caused serious disputes among the Caspian littoral states (in particular, regarding the Trans-Caspian Gas Pipeline project from Turkmenistan to Azerbaijan).

According to the Convention, the route for laying submarine pipelines and cables is determined by agreement between (i) the Party laying the pipeline or cable and (ii) the Party through which seabed sector the pipeline or cable is to be laid. The remaining Parties are only notified by the latter of the agreed route.

Meanwhile, the projects of main submarine pipelines along the seabed of the Caspian Sea should comply with the environmental requirements and standards established in international agreements among the Parties, including the Framework Convention for the Protection of the Marine Environment of the Caspian Sea dated 2003, and the relevant protocols to it.

On July 20, 2018, the Parties signed one of such protocols—the Protocol on Environmental Impact Assessment in a Transboundary Context (the "Protocol"). According to its terms, before the Party makes a decision on laying a trunk pipeline on the bed of the Caspian Sea, a procedure for environmental impact assessment (the "EIA") of this activity is required. Other activities in the Caspian that require an EIA include, for example, (i) offshore oil production (more than 500 tons per day) or natural gas (more than 500,000 m^3 per day); (ii) large-scale open-cast mining, extraction and on-site enrichment of metal ores or coal; (iii) construction of refineries, chemical and petrochemical enterprises; and (iv) construction of large storage facilities for petroleum, petrochemical and chemical products. All the Caspian littoral states that may be affected by the relevant activity participate in the EIA procedure. The final decision on the start of the planned activity should be made taking into account the comments of such states. In addition, it provides for the possibility of inspection regarding the initiated activities.

Thus, the Parties have the opportunity to influence the laying of pipelines and other activities related to subsoil use in the Caspian region, even if this activity is not carried out directly in their sector.

Major Trends in Subsoil Use Regulation

Disinterest of the State in Further Liberalization of LNG Exports

On February 14, 2018, the State Duma rejected Draft Law No. 531218-6, which proposed to give the right to export LNG to holders of licenses for the subsoil sites of federal significance, providing as of *July 1, 2014* (i) building an LNG plant or (ii) sending the produced gas to an LNG plant. This draft law was submitted to the State Duma back in May 2014.

We remind you that starting December 1, 2013, the right to export LNG is enjoyed by:

- holders of licenses for the use of the subsoil sites of federal significance, containing the above stated conditions as of *January 1, 2013*;
- Russian users of the subsoil sites of inland waters, the territorial sea, the continental shelf of Russia, the Black and Azov Seas, in which Russia controls directly or indirectly more than 50% of the voting shares (participation interests) and which produce LNG from gas produced in the specified subsoil sites or when carrying out production sharing agreements; and
- companies in which the subsoil users specified in the previous paragraph own more than 50% of the voting shares (participation interests) and which produce LNG from gas produced in the indicated subsoil sites of these subsoil users or when carrying out production sharing agreements.

Until December 1, 2013, gas (including LNG) could only be exported by Gazprom, its 100% subsidiaries, and also by subsoil users under current production sharing agreements.

The conclusion of the State Duma Committee on Energy concerning the rejection of the draft law is remarkable. Based on its conclusions, the further liberalization of LNG exports does not meet the strategic and economic interests of Russia as it can lead to a reduction in revenues to the Russian budget, a decrease in demand for pipeline equipment of Russian producers and a lack of return on investment in pipeline transport.

Exemption of Goods Required for Offshore Hydrocarbon Production from Customs Duties

On November 14, 2018, the Russian Government introduced to the State Duma Draft Law No. 587183-7, exempting from customs duties fuel, engine oils and lubricants which are exported from Russia to the exclusive economic zone, to the Russian

continental shelf or to the Russian part (Russian sector) of the Caspian Sea for the ships used in the process of geological survey, exploration and development of hydrocarbons.

According to the developers of the draft law, the proposed amendments are due to the need to increase hydrocarbon production on the shelf and the projected significant increase in the volume of work carried out there.

Since May 2013, exemptions from customs duties, taxes, bans and restrictions have applied to foreign goods imported into artificial islands, installations, fixtures or other objects located in the exclusive economic zone or on the Russian continental shelf in order to create and use such objects and conduct life activities on them. Fuel, engine oils and lubricants specified in the draft law are not such goods and are currently subject to customs duties.

Stimulating the Production of Hard-to-Recover Oil

At the beginning of 2018, the Russian Ministry of Natural Resources developed draft amendments to Law No. 2395-1 on Subsoil dated February 21, 1992 (the "Subsoil Law"), providing for a new type of subsoil use—the establishment and operation of a scientific and technological test site. The changes are aimed at stimulating the development of hard-to-recover oil reserves. The draft law has not yet been submitted to the State Duma.

A *scientific and technological test site* is a test site for carrying out scientific (research), scientific and technical and innovation activities and developing technologies for geological survey, exploration and development of hard-to-recover oil.

Hard-to-recover reserves include:

- Bazhenov, Abalak, Khadum or Domanik productive deposits; and
- deposits with oil viscosity of more than 10,000 mPa-s.

According to the draft law, a scientific and technological test site can be established and operated on a subsoil site which is:

- (i) allocated by the RosNedra from a site previously provided to a subsoil user under an exploration and development license or a combined license (geological survey, exploration and development) at the request of such subsoil user, and then (ii) provided to it under a separate combined license (the establishment and operation of the scientific and technological test site, exploration and development) on the basis of a decision of the commission consisting of representatives of the

RosNedra and executive authorities of the relevant Russian region (for a period of up to 7 years with an option of one-time extension for a period of up to 3 years); or

- provided under a special license for the establishment and operation of a scientific and technological test site based on the results of a tender (for a period of up to 15 years with an option of multiple extensions for a period of up to 5 years).

A one-time payment for subsoil use will not be charged when a subsoil site is provided for the establishment and operation of a scientific and technological test site (both by allocating a site and by the results of a tender).

In the process of establishing and operating a scientific and technological test site, a subsoil user will have the right:

- on the basis of project documentation, to produce (i) hard-to-recover hydrocarbons in specified volumes and (ii) common minerals and groundwater for its own production and technological needs;

- to place in the rock formations associated waters and waters used for its own production and technological needs during the exploration and development of hydrocarbons; and

- not to make regular payments for subsoil use.

Promotion of the Use of Mining Waste

On December 27, 2016, Russian President Vladimir Putin instructed the Russian Government to consider by September 1, 2017 the possibility of (i) easing the restrictions on handling overburden and enclosing rocks, as well as tailings belonging to Class V hazardous waste and (ii) imposing on subsoil users the obligation to use them.

Overburden rocks (overburden) are rocks that cover and contain minerals that are to be excavated and moved during open pit mining. Enclosing rocks are overburden rocks that include minerals. Thus, enclosing rocks are a type of overburden rocks. In this *Debevoise In Depth*, both are referred to as "overburden".

In pursuance of this instruction, at the beginning of 2018, the Russian Ministry of Natural Resources prepared draft amendments to the Subsoil Law and Federal Law No. 89-FZ on Production and Consumption Waste dated June 24, 1998 (the "Waste Law"). The draft law has not yet been submitted to the State Duma.

The draft law proposes that the production and consumption waste (the "waste") should not include overburden which is:

- to be used for subsoil use purposes in accordance with approved technical projects or other project documentation (including for recultivation of disturbed land and elimination of mine workings); or

- used in the construction, overhaul, reconstruction or liquidation of capital construction objects in accordance with the project documentation provided for by the legislation on urban planning.

At present, overburden is considered to be mining waste, and restrictions of the Waste Law apply to its placement and use, in particular: formation standards and placement limits, mandatory state environmental expert review of the project documentation for placement facilities, and the obligation to pay for negative environmental impact when placed.

The Subsoil Law contains the term "*mining and related processing industries waste*", which is not defined in either the Subsoil Law or the Waste Law. The draft law replaces this term with the general concept of "*mining waste*", which refers to waste generated during primary processing, geological survey, exploration, production and/or beneficiation of minerals.

According to the draft law, unless otherwise provided for in the license or production sharing agreement, subsoil users will have the right to (i) use mining waste generated as a result of their activities and considered waste according to the Waste Law and (ii) store, bury and/or use non-waste overburden (including for the elimination of mine workings).

In addition, the draft law provides for the right of the authorized bodies of the Russian regions to refuse to provide subsoil sites for the extraction of common minerals for the production of building materials if, instead of such minerals, overburden or mining waste can be used.

Harmonization of Regulation of Prevention of, and Response to, Spills of Oil and Oil Products

On March 27, 2018, the State Duma passed in the first reading Draft Law No. 376642-7 amending Federal Law No. 7-FZ on Environmental Protection dated January 10, 2002 in order to harmonize the regulation of prevention of, and response to, spills of oil and oil products on land and in sea areas of Russia.

From July 1, 2013, organizations (i) using artificial islands, installations, fixtures or submarine pipelines and conducting drilling operations during geological survey, exploration and extraction of hydrocarbons, as well as during transportation and storage of oil and oil products on the continental shelf, in inland sea waters or the territorial sea, or (ii) engaged in transshipment of oil and oil products, bunkering (refueling) of ships using bunker ships in inland sea waters and in the territorial sea, independently develop and approve plans for the prevention of, and response to, spills of oil and oil products (the "Plans"), followed by notification of various Russian executive bodies.

The draft law provides for a similar procedure for approving the Plans for organizations engaged in the extraction, processing, transportation, storage and sale of oil and oil products on the land territory of Russia. Currently, the Plans for land areas are developed by such organizations in coordination with regional and federal executive authorities, and then approved by the MinEnergy and the Ministry of Emergency Situations. The existing procedure delays the commissioning of the constructed oil industry facilities on land.

According to the developers, the draft law establishes a notification procedure for approving the Plans on land by analogy with the approval of the Plans for sea areas. However, in both cases, it is not envisaged to approve the Plans without state participation—draft Plans for sea areas are subject to preliminary verification by the Federal Service for Supervision of Use of Natural Resources (the "RosPrirodNadzor") within the framework of the state environmental expert review, whereas it is proposed to approve draft Plans on land only after coordination with the RosPrirodNadzor. As indicated in the explanatory note to the draft law, a simpler and faster procedure for coordination with the RosPrirodNadzor is proposed instead of the state environmental expert review due to a much larger number of oil and gas facilities on land compared to sea areas.

Attempts to Combine All Environmental Charges into a Single Environmental Tax

The Russian Ministry of Finance has developed a draft law which, in particular, combines payments for discharges of pollutants into the water, their emissions into the atmosphere, waste burial and other types of harmful effects on the environment into a single environmental tax. This initiative is part of the work of the Russian Ministry of Finance on the systematization of non-tax payments. The draft law has not yet been submitted to the State Duma.

In case an environmental tax is introduced, its administration will be handled by the Russian Federal Tax Service instead of specialized environmental agencies. According to the Russian Ministry of Finance, the replacement of existing payments for

environmental damage with a single tax will increase the efficiency of their collection due to the possibility of applying penalties, ways of ensuring the fulfillment of the obligation to pay taxes and a mechanism of compulsory and indisputable collection.

The draft law is being actively discussed and, following the results of the discussions, may be finalized by the Russian Ministry of Finance.

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Please do not hesitate to contact us with any questions.

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