

CLIENT UPDATE

CHANGES TO LEGISLATION AIMED AT PROVIDING INCENTIVES FOR HYDROCARBON PRODUCTION AT OFFSHORE DEPOSITS

MOSCOW

Dmitri V. Nikiforov
dvnikiforov@debevoise.com

Alyona N. Kucher
ankucher@debevoise.com

Anna S. Eremina
aseremina@debevoise.com

Oleg V. Semenov
ovsemenov@debevoise.com

On September 30, 2013 Russia's President signed into law Law No. 268-FZ,¹ which amends the Tax Code, the Customs Duties Law and the Continental Shelf Law,² with the aim of **providing incentives for hydrocarbon production** at subsoil sites situated within the following boundaries:

- inland seas and/or territorial waters of the Russian Federation; and/or
- the continental shelf of the Russian Federation; or
- the Russian portion / Russian sector of the Caspian Sea bed.³

¹ Federal Law No. 268-FZ on Amendments to Parts One and Two of the Tax Code of the Russian Federation and Certain Legislative Acts of the Russian Federation in Connection with the Provision of Tax and Customs Duty Incentives for Hydrocarbon Production on the Continental Shelf of the Russian Federation, dated September 30, 2013 ("Law No. 268-FZ") (published on October 1, 2013).

² Parts One and Two of the Tax Code of the Russian Federation No. 146-FZ dated July 31, 1998 and No. 117-FZ dated August 5, 2000, respectively (together the "Tax Code"), Law of the Russian Federation No. 5003-1 on Customs Duties dated May 21, 1993 (the "Customs Duties Law") and Federal Law No. 187-FZ on the Continental Shelf dated November 30, 1995 (the "Continental Shelf Law").

³ The hydrocarbon deposits situated at such subsoil sites are defined in Law No. 268-FZ as "offshore hydrocarbon deposits" ("Offshore Deposits"). Russian laws and regulations refer to projects for the development of such Offshore Deposits as "Shelf Projects".

The incentives provided for by Law No. 268-FZ for hydrocarbon production at Offshore Deposits include:

- creation of a set of tax incentives;
- exemption for a certain period of time from customs export duties⁴ for certain types of hydrocarbons exported from Russia and obtained/produced from the development of a number of Offshore Deposits; and
- enhancement of the legal regime governing the creation, operation and use of Shelf Facilities.⁵

Furthermore, for taxation purposes and purposes of regulating the creation, operation and use of Shelf Facilities, Law No. 268-FZ supplements existing Russian law by adding new concepts and clarifying existing concepts.

STATE INCENTIVIZATION OF HYDROCARBON EXTRACTION

Law No. 268-FZ was drawn up in pursuance of the 2011 Parliamentary Recommendations for the drafting of amendments to Russian legislation aimed at, *inter alia*, **enhancing the economic effectiveness and investment appeal of projects for the development of new deposits**.⁶ These amendments were first broached in 2008-2010 by the Russian Government, which had repeatedly identified a need to create and develop major new centers for the production of hydrocarbons (including Offshore Deposits) over the next few decades and to provide incentives to attract private investors to them to ensure that domestic and international demand for hydrocarbons could be met in a sustainable and cost-effective manner, given the expected fall in production in the traditional oil and gas production regions of Western Siberia in 2015-2030.⁷ It was the belief of the Russian

⁴ Customs export duty is hereinafter referred to as “export duty”.

⁵ Artificial islands, installations, or fixtures on the Russian continental shelf (together hereinafter “Shelf Facilities”).

⁶ See Explanatory Note to Draft Bill No. 577558-5, which became Law No. 268-FZ (the “Draft Bill”), prepared by the State Duma (the “Duma”) Budget and Taxes Committee (“Explanatory Note”). The Parliamentary Recommendations were drawn up following parliamentary hearings on the topic “Legislative Support for the Development of the Gas Industry”, which took place on May 30, 2011 with the participation of Duma deputies, members of the Federation Council, representatives of federal executive bodies (“FEB”) and executive and parliamentary/legislative bodies of constituent entities of the Russian Federation, , representatives of scientific research institutions, as well as commercial entities and non-profit organizations (the “2011 Parliamentary Recommendations”).

⁷ See Strategy for the Development of the Geological Industry of the Russian Federation to 2030, approved by Resolution No. 1039-r of the Russian Government dated June 21, 2010 (the “Development Strategy”).

Government that these objectives could be implemented by **enhancing the subsoil legislative and regulatory framework** and **introducing economic incentive mechanisms**.⁸

During 2012 – 2013 (when the Draft Bill was being considered in the Duma) the Russian Government continued to make statements proposing to increase the resource base of the Russian oil and gas industry⁹ and raise the investment appeal of Shelf Projects.¹⁰ Such initiatives included, for example, classifying Shelf Projects according to four categories of difficulty,¹¹ exempting hydrocarbons extracted at Offshore Deposits from export duty, introducing tax incentives, etc.

As indicated above, the changes envisaged by Law No. 268-FZ are aimed at providing tax and customs duty incentives for the production of hydrocarbons at Offshore Deposits, and enhancement of the legal regime governing the creation, operation and use of Shelf Facilities; however, they do not embody all of the legislative initiatives included in the 2011 Parliamentary Recommendations and Russian Governmental regulations, or those initially included in the Draft Bill.¹² Below we provide a brief review of the changes to Russian law set forth in Law No. 268-FZ.

INTRODUCTION OF NEW AND CLARIFICATION OF EXISTING CONCEPTS

Law No. 268-FZ has augmented the Continental Shelf Law, adding definitions of the concepts of “artificial islands”¹³ and “installations and fixtures”¹⁴ used in the latter, thereby

⁸ See Concept of the Long Term Socio-Economic Development of the Russian Federation for the Period to 2020 (approved by Resolution No. 1662-r of the Russian Government dated November 17, 2008), the Energy Strategy of the Russian Federation for the Period to 2030 (approved by Resolution No. 1715-r of the Russian Government dated November 13, 2009), and the Development Strategy.

⁹ This included developing existing submarginal deposits, as well as deposits in new regions with extreme climatic and environmental conditions and a lack of infrastructure.

¹⁰ See Resolution No. 443-r of the Russian Government dated April 12, 2012 (“Resolution No. 443-r”) and the Governmental Program entitled “Energy Efficiency and the Development of the Energy Industry” (approved by Resolution No. 512-r of the Russian Government dated April 3, 2013).

¹¹ Based on technological and geological complexity, climatic and environmental conditions, ice conditions, sea depth, remoteness from shore, and availability of onshore infrastructure.

¹² The 2011 Parliamentary Recommendations, Russian Governmental regulations, and the Draft Bill (as tabled for consideration by the Duma) contain a broad range of legislative initiatives in the field of tax and customs law, as well as legislation on subsoil, the continental shelf, the Russian national border, and merchant shipping (including the introduction of special customs procedures and simplification of border, customs and other types of control procedures for the implementation of Shelf Projects, exemption from customs import duties for equipment imported to carry out the Shelf Projects, inclusion of some Shelf Projects in the Russian International Register of Vessels, and extension of the list of vessels that may sail under the state flag of the Russian Federation).

¹³ Artificial islands are objects fixed at their location on the Russian continental shelf in accordance with their design documentation (artificial constructed fixtures), with an aggradational, earthfill, piled and/or other non-floating substructure rising above the surface of the water at maximum tide.

clarifying exactly what facilities may be regarded as Shelf Facilities (for the purposes of regulating their creation, operation and use) and what territories fall under the jurisdiction of the Russian Federation (for the purposes of applying tax law).¹⁵

The Tax Code has been supplemented by a number of concepts for the purposes of taxation of hydrocarbon production, the most significant of which are “activities related to hydrocarbon production at a New Offshore Deposit”¹⁶ and “operator of a New Offshore Deposit.”

The Tax Code (as amended by Law No. 268-FZ) defines **activities related to hydrocarbon production at a New Offshore Deposit**,¹⁷ as activities that include one or more of the following types of activities:

- prospecting and evaluation of a New Offshore Deposit at a subsoil site;¹⁸
- conceptual and front-end engineering and design, as well as development of a New Offshore Deposit;¹⁹
- exploration and commercial development of a New Offshore Deposit and activities related to the sale of hydrocarbons extracted at such New Offshore Deposit (including storage and delivery of the hydrocarbons to customers);

¹⁴ Installations and fixtures are fixed and floating/mobile drilling rigs/platforms, offshore floating/mobile drilling rigs/platforms, offshore floating/mobile platforms, offshore fixed platforms and other objects fixed or floating at their location on the Russian continental shelf in accordance with their design documentation, as well as underwater fixtures (including wells).

¹⁵ Pursuant to Article 11, paragraph 2 of the Tax Code, Russian territories and other territories falling under the jurisdiction of the Russian Federation include Russian territories, as well as artificial islands, installations and fixtures over which the Russian Federation has jurisdiction in accordance with Russian law and the provisions of international law.

¹⁶ The Tax Code (as amended by Law No. 268-FZ) defines a new Offshore Deposit as an Offshore Deposit at which commercial hydrocarbon production will commence in the period from January 1, 2016 (including any Offshore Deposit in respect of which the date of commencement of commercial hydrocarbon production has not been determined as at January 1, 2016) (“New Offshore Deposit”). Further, **the date of commencement of commercial hydrocarbon production** is deemed the date on which the state balance of reserves of mineral resources is drawn up, in accordance with which the level of reserve depletion of at least one type of hydrocarbon resource (other than affiliated gas) first exceeds 1%.

¹⁷ Activities related to hydrocarbon production at a New Offshore Deposit, hereinafter “Activities at a New Offshore Deposit”.

¹⁸ Including activities aimed at the creation, bringing to a state of preparedness for use/operation, technical servicing, repair, reconstruction, modernization, technical upgrading, decommissioning, dismantling, abandonment (and other capital works) of Shelf Facilities, as well as other property necessary for prospecting and evaluation of a New Offshore Deposit.

¹⁹ Including activities aimed at the erection/construction, creation/fabrication, bringing to a state of preparedness for use/operation, technical servicing, repair, reconstruction, modernization, technical upgrading (and other capital works) of Shelf Facilities, as well as other facilities for the development of a New Offshore Deposit.

- production of LNG²⁰ from natural fuel gas (including affiliated gas) extracted at a New Offshore Deposit, and activities related to the sale of such LNG (including storage and delivery of the LNG to customers);
- processing of gas condensate extracted at a New Offshore Deposit resulting in stable condensate and a wide light hydrocarbon fraction, and activities related to the sale of such stable condensate and wide light hydrocarbon fraction (including storage and delivery of these products to customers);
- transportation of natural fuel gas (including affiliated gas) and/or gas condensate extracted at the New Offshore Deposit to the respective LNG plant and/or gas condensate processing facility.

Therefore, for tax assessment purposes Activities at a New Offshore Deposit may be deemed to be activities at any stage of the oil and gas industry: upstream (exploration, prospecting, extraction, interfield transportation), midstream (primary distillation, storage and transportation), and downstream (high conversion, sale). It is more common for Russian subsoil law to refer to the concept of “activities in connection with subsoil use,”²¹ which is understood to mean, in the first instance, the upstream stage, *i.e.*, activities directly related to subsoil use within the boundaries of a subsoil site that may also be performed by contractors engaged by the Subsoil User (prospecting and evaluation of deposits, exploration, extraction from the subsoil and storage of mineral resources, etc.).

The Operator of a New Offshore Deposit²² is defined as an organization that **simultaneously** meets the following criteria:

- it has the **direct or indirect** equity participation of (i) a Subsoil User²³ that is using a subsoil site within the boundaries of which it is proposed to conduct the prospecting, evaluation, exploration and/or development of a New Offshore Deposit, or (ii) an organization that is a related person²⁴ with respect to the Subsoil User;

²⁰ Liquefied natural gas (“LNG”).

²¹ *See, e.g.*, Articles 7 and 9 of Law of the Russian Federation No. 2395-1 on Subsoil dated February 21, 1992 (the “Subsoil Law”).

²² The Operator of a New Offshore Deposit is hereinafter referred to as the “Operator”.

²³ An organization holding a license for use of the subsoil site (“Subsoil User” and “License”, respectively).

²⁴ Pursuant to Article 20, paragraph 1 of the Tax Code, for tax purposes related persons are deemed to be organizations whose relations are such that they may exert influence on the conditions or economic results of their activity or the activity of persons they represent, namely, if one organization directly and/or indirectly participates in the other organization, and the aggregate share of such participation amounts to more than 20%. The proportion of the indirect participation of one organization in the other through a series of other organizations is determined by multiplying the shares of direct participation by the organizations in this series by one another.

- it carries out **at least one** of the types of Activities at a New Offshore Deposit using its own resources and/or hired contractors;
- it carries out Activities at a New Offshore Deposit on the basis of an agreement entered into with the relevant Subsoil User, and such agreement provides for a fee to be paid to the Operator in an amount depending on, *inter alia*, the volume of hydrocarbons produced and/or revenues earned from the sale of such hydrocarbons (the “Operator Agreement”).

It is worth noting that Law No. 268-FZ does not contain any requirements or restrictions concerning the Operator’s country of incorporation, or the percentage share of the Subsoil User or organization that is a related party of the Subsoil User in the Operator.

However, **for the purposes of the Tax Code** (as amended by Law No. 268-FZ) two or more Operators are not permitted to carry out Activities at a New Offshore Deposit simultaneously at one and the same New Offshore Deposit. This means that several Operators may carry out such Activities at one and the same New Offshore Deposit, but the provisions of the Tax Code relating to Operators (see the following section of this Client Update) will apply to only one of them.

There is a practical example of a legal entity having been created that meets the criteria of an Operator, and of such Operator entering into an agreement similar to an Operator Agreement for the purposes of carrying out work on the Russian continental shelf.²⁵ However, provisions on such Operators and Operator Agreements have only now appeared in Russian legislation.

Furthermore, Law No. 268-FZ will bring Russian legislation into line with international practice by expressly providing for the execution of Operator Agreements with exposure for subsoil use at Offshore Deposits (as noted above, the Operator’s fee under the Operator Agreement may be linked to the volume of hydrocarbons extracted and/or revenues earned from the sale of such hydrocarbons).

In addition, the introduction to Russian legislation of provisions on Operators and Operator Agreements, as well as Activities at a New Offshore Deposit will, in the event of a challenge, serve as further evidence that in carrying out work at a subsoil site (at the

²⁵ In February 2008, OJSC Gazprom (Russia), Total S.A. (France) and StatoilHydro ASA (Norway) created a Swiss SPV called Shtokman Development AG to develop the Shtokman gas condensate field on the Russian continental shelf. Shtokman Development AG signed an operator contract with LLC Sevmorneftegaz (a 100% subsidiary of OJSC Gazprom now known as LLC Gazprom Neft Shelf), which was the Subsoil User at the relevant subsoil site of the Shtokman gas condensate field (in 2013, the License for the Shtokman gas condensate field was transferred to OJSC Gazprom).

upstream stage) an Operator (or a contractor) has not been involved in an unlawful transfer of the right to the use of a subsoil site.²⁶

TAX INCENTIVES

On **January 1, 2014** the changes to the Tax Code contained in Law No. 268-FZ will come into force which, in the first instance, envisage a whole system of tax measures relating to hydrocarbon production at New Offshore Deposits, as well as a number of new rules regarding production at all Offshore Deposits.

System of Measures Regulating Production at New Offshore Deposits

The special regulation applies to:

- Subsoil Users at New Offshore Deposits; and
- Operators.

Some of the more significant measures aimed at regulating the production of hydrocarbons at New Offshore Deposits include the following.

Profits Tax

- New rules are introduced to determine the tax base for Subsoil Users and Operators that provide for separate record-keeping (separate from other types of activities and separate for each New Offshore Deposit) and broaden the scope of specific types of expenses that may be deducted from taxable income.²⁷
- Subsoil Users and Operators now have the right to earlier recognition of expenses for the development of natural resources incurred in carrying out Activities at a New Offshore Deposit.²⁸ In the event that the right to subsoil use is terminated, one third of the expenses incurred for the development of natural resources may be allocated to a New Offshore Deposit at another subsoil site.

²⁶ In violation of Article 17.1 of the Subsoil Law.

²⁷ Such as expenses for the creation of provision for future costs in connection with the termination of Activities at New Offshore Deposits, and expenses for the transportation of such hydrocarbon resources and their processed products ("Products"). Given the uncertainty about whether to allocate expenses to a special or general tax base, a solution might be to lock in one or other method in the tax policy or obtain clarification on the procedure for allocation of expenses from the taxation authorities.

²⁸ From the 1st day of the month in which the taxpayer adopts the decision to allocate expenses to Activities at a New Offshore Deposit, but not before the date that the first New Offshore Deposit is designated, or from the date of the decision to terminate work at the subsoil site. The date that a New Offshore Deposit is designated at a subsoil site is deemed to be the date of the first approval in the duly prescribed manner of the respective field development flow process diagram.

- There is provision for special depreciation rates (so-called “accelerated depreciation”) to be applied to depreciable capital assets used exclusively to carry out Activities at a New Offshore Deposit (but not together with other scale-up factors that would otherwise be applicable).
- Subsoil Users and Operators are now entitled to carry forward any losses for an indefinite period, rather than 10 years (as a general rule).
- The profits tax rate remains at 20%, but it is envisaged that the whole tax amount is paid to the federal budget in full. This means that any reduction in the rate of tax may only be granted by federal law.

Mineral Extraction Tax

- Law No. 268-FZ introduces a system of tiered rates depending on the particular New Offshore Deposit at which hydrocarbons are extracted. For deposits that lie wholly in the Sea of Azov or at least 50% within the Baltic Sea the rate is 30%.²⁹ The rate is set at 15%³⁰ for hydrocarbons extracted at deposits with 50% or more of their area in the Black Sea (at a depth less than 100 meters), in the Russian sector of the Caspian Sea bed, the Pechora or White Seas, and the southern part of the Sea of Okhotsk (south of 55 degrees North latitude), including the Sakhalin Island shelf. The rate for deposits with 50% or more of their area in the Black Sea (at a depth of 100 meters or more), the northern part of the Sea of Okhotsk and the southern part of the Barents Sea (south of 72 degrees North latitude) will be 10%.³¹ For New Offshore Deposits with 50% or more of their area in the Kara Sea, the northern part of the Barents Sea, and the Eastern Arctic (Laptev Sea, East Siberian Sea, Chukchi Sea, Bering Sea) the rate is set at 5%.³²
- Reduced rates will apply for natural fuel gas produced at certain New Offshore Deposits: 1.3% (for gas produced at certain New Offshore Deposits with 50% or more of their area in the Black Sea (at a depth of 100 meters or more), the northern part of the Sea of Okhotsk and the southern part of the Barents Sea (south of 72 degrees North latitude) and 1% (for gas produced at certain New Offshore Deposits with 50% or more of their area in the Kara Sea, the northern part of the Barents Sea, and the Eastern Arctic

²⁹ The rate will apply for 60 calendar months, commencing from the month following the month in which commercial production begins, but not later than March 31, 2022.

³⁰ The rate will apply for 84 calendar months, commencing from the month following the month in which commercial production begins, but not later than March 31, 2032.

³¹ The rate will apply for 120 calendar months, commencing from the month following the month in which commercial production begins, but not later than March 31, 2037.

³² The rate will apply for 180 calendar months, commencing from the month following the month in which commercial production begins, but not later than March 31, 2042.

(Laptev Sea, East Siberian Sea, Chukchi Sea, or Bering Sea). These rates apply for the same periods as for other types of hydrocarbon resources.

- A zero tax rate is envisaged until the cumulative volume of oil extraction reaches 35 million tonnes at subsoil sites that lie to the north of the Arctic Circle wholly or partially within the boundaries of inland seas and territorial waters and on the Russian continental shelf. The period of development of the reserves of the subsoil site must not exceed seven years (inclusive), commencing from January 1, 2015. The license must have been issued by January 1, 2009, and the level of reserve depletion as at January 1, 2015 must be less than or equal to 0.05.

Tax Administration

- It is anticipated that special requirements may be put in place by the Russian Ministry of Finance for the tax registration of Subsoil Users and Operators, possibly similar to those for major taxpayers (so far no such requirements have been introduced).
- Subsoil Users and Operators are required to file tax returns for profits tax for each separate deposit, and they are also under an obligation to notify the tax authorities on an annual basis of the sum of the expenses incurred for the development of natural resources, of New Offshore Deposits designated in the last completed tax period, of each decision made to allocate expenses for the development of natural resources to Activities at a New Offshore Deposit, and of any decisions taken in the last completed tax period on termination of work.

Control of Transfer Pricing

- The Tax Code expressly views as controlled transactions those transactions that are between Operators or Subsoil Users that treat their income and expenditure in accordance with special rules laid down for such taxpayers, on the one hand, and any other taxpayers (or Operators or Subsoil Users that apply general rules), on the other hand.
- With the introduction of the new provisions to the Tax Code, transactions between Subsoil Users and Operators performed in carrying out Activities at a New Offshore Deposit in relation to one and the same New Offshore Deposit will in all cases be exempt from transfer pricing control.

Changes Pertaining to All Offshore Deposits

Value Added Tax

- A 0% rate will apply to the sale of hydrocarbons extracted at Offshore Deposits, as well as the Products of such hydrocarbons exported abroad from the continental shelf, the Russian exclusive zone, or the Russian sector of the Caspian Sea bed.
- Services involving the carriage and/or transportation of hydrocarbons from departure points situated on the Russian continental shelf and/or in its exclusive economic zone or the Russian portion/Russian sector of the Caspian Sea bed to a destination point situated outside Russian territory and other territories under Russian jurisdiction are equated to international carriage and are hence subject to a 0% rate.
- Criteria have been introduced for determining the place of sale of hydrocarbons extracted at an Offshore Deposit or their Products: the shipment and transportation criteria apply here not only to Russian territory, but also to the continental shelf, the exclusive economic zone and the Russian portion of the Caspian Sea bed. This means that the shipment/sale of hydrocarbons from these new territories is equated to the sale of hydrocarbons on Russian territory and will, in principle, be deemed subject to Russian value added tax.
- Similarly, for the purposes of determining where services have been rendered, the territory within which services are deemed to have been rendered in Russia has also been extended to include the continental shelf, the exclusive economic zone and the Russian portion of the Caspian Sea bed. In addition, the list of services to which this rule applies has been supplemented to include services for regional geological survey, geological survey and exploration of Offshore Deposits.³³

Profits Tax

- It is expressly provided that the costs of voluntary insurance aimed at funding actions included in an oil and petroleum product spill prevention and clean-up plan may be allocated to expenses.
- Also included in other expenses related to production and sale that may be deducted are the expenses of a New Subsoil User in the form of reimbursement of expenses for the development of mineral resources to the previous Subsoil User (incurred upon receipt of the same).

³³ Including the geological survey of subsoil and replacement of mineral reserves, geophysical well logging, geological exploration works and seismic surveys, exploratory drilling, monitoring of the state of the subsoil, and aerial surveys.

Mineral Extraction Tax

- A zero rate is temporarily envisaged for hydrocarbons (other than oil extracted from New Offshore Deposits) extracted from a hydrocarbon reservoir at a subsoil site that lies wholly within the boundaries of the inland seas and/or territorial waters, on the Russian continental shelf or in the Russian portion of the Caspian Sea bed, *provided* that either (i) the level of reserve depletion³⁴ of each type of hydrocarbon resource (other than affiliated gas) extracted at the respective reservoir as at January 1, 2016 is less than 0.1%, or (ii) as at January 1, 2016, such reserves have not been included in the state register of mineral reserves. The exemption is valid until the end of the fiscal period in which the respective field development flow process diagram for the offshore hydrocarbon deposit within the boundaries of which the relevant reservoir(s) lie(s) was first approved, but not longer than 60 months commencing from the first day of the month following the month when any type of hydrocarbon resource from the respective reservoir was first included in the state register of mineral reserves.

Property Tax

- Property, including leased property, is not subject to corporate property tax, *provided* that it is (i) situated within the inland seas and/or territorial waters of the Russian Federation, the continental shelf of the Russian Federation, an exclusive economic zone of the Russian Federation or the Russian portion / Russian sector of the Caspian Sea bed (or outside these territories, but *provided* that it is used for its intended purpose at least 90 days per year), and (ii) used in activities for the development of Offshore Deposits, including geological survey, exploration, and conduct of preparatory work.

Transport Tax

- The transport tax exemption is for offshore fixed and floating platforms, offshore mobile drilling rigs, and drilling vessels.

EXEMPTION FROM EXPORT DUTY FOR CERTAIN TYPES OF HYDROCARBONS

On **December 31, 2013**, the amendments to the Customs Duties Law introduced by Law No. 268-FZ will take effect, in accordance with which **certain types of hydrocarbons**

³⁴ The **level of reserve depletion** of each type of hydrocarbon resource (other than affiliated gas) extracted from a hydrocarbon reservoir is calculated by the taxpayer based on information from the state register of mineral reserves as the quotient resulting from the division of the amount of such hydrocarbon resource extracted from the relevant hydrocarbon reservoir (including extraction losses) by the initial reserves of the relevant reservoir. The initial reserves of natural fuel gas (excluding affiliated gas) or gas condensate, duly confirmed and including any growth or write down of reserves, are defined as the sum of Category A, B, C1 and C2 reserves of gas or gas condensate and the amount extracted since the commencement of development at the respective hydrocarbon reservoir.

exported from Russia and obtained/produced in the course of the development of a number of Offshore Deposits (both new and old) **will be exempted from export duty for a certain period.**³⁵

The period of exemption from export duty depends on the complexity of the Shelf Project and, for an Offshore Deposit that is not a New Offshore Deposit, also on the level of reserve depletion.

Law No. 268-FZ stipulates that the Russian Government will have to establish a procedure to ascertain that hydrocarbons have been obtained/produced in the course of the development of a:

- New Offshore Deposit; or
- Offshore Deposit that is not a New Offshore Deposit (subject to the condition that the level of reserve depletion³⁶ of such deposit as at January 1, 2015 is less than 5%).

Information on the respective Offshore Deposits and types of hydrocarbons exempted from export duty, with a breakdown by location of Offshore Deposits, is provided in the **Annex** to this Client Update.

CHANGES TO THE CONTINENTAL SHELF LAW

On **October 1, 2013** the **amendments to the Continental Shelf Law** introduced by Law No. 268-FZ took effect, including the following:

- It is expressly provided that in addition to creating, operating and using Shelf Facilities, a Subsoil User may also engage a Provider³⁷ for these purposes on a contractual basis.³⁸ In doing so the Subsoil User must procure that the Provider comply with the terms of such contract, and the Provider must ensure that the Subsoil User has free access to the Shelf Facilities.

³⁵ These amendments were not originally in the Draft Bill, but were included prior to consideration of the Draft Bill by the Duma in the second reading.

³⁶ The level of reserve depletion of each type of hydrocarbon resource (other than affiliated gas) extracted at Offshore Deposits is calculated in the manner stipulated by Article 11.1, paragraph 2 of the Tax Code (added to the Tax Code by Law No. 268-FZ).

³⁷ The Provider may either be a Russian or a foreign entity. Based on the definition of Activities at a New Offshore Deposit, the Provider may be the Operator.

³⁸ The Russian Government must select an FEB with which Subsoil Users will have to file information on Providers creating, operating and using Shelf Facilities, and set forth a procedure for the filing of such information.

- It is established that any Provider so engaged may (as may the Subsoil User) create, operate or use Shelf Facilities if there is provision for their creation in (i) the License of the respective Subsoil User, and (ii) the project documentation for works related to use of the respective subsoil site on the Russian continental shelf. In such case the Provider (as the Subsoil User) is not required to obtain a permit for the creation, operation and use of Shelf Facilities.³⁹ The Subsoil User is prohibited from engaging 2 or more Providers (carrying out the respective works or providing services without obtaining a permit) simultaneously to carry out works or provide services for the creation, operation and use of Shelf Facilities on one and the same subsoil site.
- It is stated that Shelf Facilities must be created in accordance with design documentation as provided for by (i) Russian legislation on subsoil,⁴⁰ and (ii) urban development legislation, taking into account special aspects of the Continental Shelf Law and the regulatory acts adopted in accordance therewith. One such special aspect is, for example, the fact that some Shelf Facilities correspond in their construction more to a seaborne vessel than a capital construction facility, pursuant to which their creation under urban development legislation is problematic.
- It is envisaged that if a License grants a Subsoil User the right to perform drilling operations, a Provider engaged for this purpose may (as may the Subsoil User) carry out drilling at the respective subsoil site of the continental shelf without obtaining a permit to carry out such work. Such work must be carried out in accordance with the Subsoil User's Project Documentation.
- It has been clarified that safety zones around Shelf Facilities⁴¹ should be established from the moment work commences on their creation (or installation) on the continental shelf (or from the moment other similar operations commence). A provision has also

³⁹ Previously, anyone that did not have a License in respect of the relevant subsoil site on the continental shelf was required to obtain a permit for the creation, operation and use of Shelf Facilities, which was issued after a lengthy approvals process with the FEB in accordance with Article 18 of the Continental Shelf Law.

⁴⁰ In accordance with **Russian legislation on subsoil**, project documentation includes the technical project for development of the mineral resource deposit and other project documentation to carry out work in connection with use of the subsoil site (see paragraph 1 of the Regulations approved by Decree No. 118 of the Russian Government dated March 3, 2010) (the "Subsoil User's Project Documentation"). Under **urban development legislation**, project documentation constitutes documentation containing materials in the form of text and in the form of maps/diagrams and defining architectural, functional, technological, structural and engineering concepts and plans to enable the construction and reconstruction of **capital construction facilities and parts thereof** and capital repairs (see Article 48, paragraph 2 of the Town Planning Code of the Russian Federation).

⁴¹ Safety zones are provided for in Article 16, paragraph 4 of the Continental Shelf Law.

been added making it mandatory to liquidate such zones after the Shelf Facilities are demolished.⁴²

- It is established that Shelf Facilities and the rights thereto are subject to registration.⁴³
- The obligations of persons undertaking the creation, operation and use of Shelf Facilities have been clarified.⁴⁴
- However, in its final version Law No. 268-FZ does not contain the proposal to allow proprietary rights to Shelf Facilities (or parts thereof) to be transferred under transactions between persons with a right to create, operate or use them.⁴⁵

* * *

We would be happy to answer any questions you may have.

November 1, 2013

⁴² As indicated in the Explanatory Note, the provisions of the Continental Shelf Law on safety zones around Shelf Facilities were supplemented in order to bring it into line with the UN Convention on the Law of the Sea (UNCLOS) (The Russian Government must establish the procedure for such registration concluded in Montego Bay on December 10, 1982).

⁴³ The Russian Government must establish the procedure for such registration.

⁴⁴ Among other things, the procedure and timing for demolition of abandoned or unused Shelf Facilities by those that have created them have been clarified.

⁴⁵ Pursuant to Article 20 of the Continental Shelf Law, it is prohibited to transfer Shelf Facilities to other persons in violation of granted permits and Licenses. It was originally envisaged that the Draft Bill would repeal this prohibition.

ANNEX: HYDROCARBONS EXEMPT FROM EXPORT DUTY

No.	Location of Offshore Deposit		Category of Offshore Deposit	Category of Difficulty of Shelf Project ⁴⁶	Type of Hydrocarbon Exempt from Export Duty	Term of Incentive/Exemption from Export Duty ⁴⁷
	Sea	Characteristics of Offshore Location ⁴⁸ / Conditions				
<i>Arctic Ocean</i>						
1.	Barents Sea	50% (or more) of its area in the southern part of the Barents Sea (south of 72 degrees North latitude)	new offshore	III	<ul style="list-style-type: none"> ■ crude oil;⁴⁹ ■ natural gas condensate; ■ LNG; ■ gas in gaseous state; ■ wide light hydrocarbon fraction 	March 31, 2042
		50% (or more) of its area in the northern part of the Barents Sea (at or north of 72 degrees North latitude)	new offshore	IV		
2.	White Sea	50% (or more) of its area in the White Sea	new offshore	II	<ul style="list-style-type: none"> ■ crude oil; ■ natural gas condensate; ■ LNG; ■ gas in gaseous state; ■ wide light hydrocarbon fraction 	March 31, 2032
3.	Kara Sea	50% (or more) of its area in the Kara Sea	new offshore	IV	<ul style="list-style-type: none"> ■ crude oil; ■ natural gas condensate; ■ LNG; ■ gas in gaseous state; ■ wide light hydrocarbon fraction 	March 31, 2042

⁴⁶ Category I – basic level of difficulty, Category II – advanced level of difficulty, Category III – high level of difficulty, Category IV – arctic level of difficulty (in accordance with Resolution No. 443-r). No category of difficulty for the Russian portion / Russian sector of the Caspian Sea bed has been determined.

⁴⁷ Exemption from export duty is valid until the date given in the Table, inclusive, other than any such exemption in respect of Offshore Deposits that are not new, which is valid until January 1, 2021 (not inclusive).

⁴⁸ According to Article 11.1, paragraph 1, subparagraph 4 of the Tax Code (added to the Tax Code by Law No. 268-FZ), the Offshore Deposits indicated in this Annex must be situated wholly within the boundaries of the inland seas and/or territorial waters of the Russian Federation and/or the continental shelf of the Russian Federation or the Russian portion / Russian sector of the Caspian Sea bed.

⁴⁹ Hereinafter (including in respect of an Offshore Deposit that is not new) including oil/gas condensate mixture obtained as a result of the technological aspects of transporting crude oil and stable gas condensate by pipeline.

No.	Location of Offshore Deposit		Category of Offshore Deposit	Category of Difficulty of Shelf Project ⁴⁶	Type of Hydrocarbon Exempt from Export Duty	Term of Incentive/Exemption from Export Duty ⁴⁷
	Sea	Characteristics of Offshore Location ⁴⁸ / Conditions				
4.	Pechora Sea	50% (or more) of its area in the Pechora Sea	new offshore	II	<ul style="list-style-type: none"> ■ crude oil; ■ natural gas condensate; ■ LNG; ■ gas in gaseous state; ■ wide light hydrocarbon fraction 	March 31, 2032
5.	Eastern Arctic (Laptev Sea, East Siberian Sea, Chukchi Sea, Bering Sea)	50% (or more) of its area in these Eastern Arctic seas	new offshore	IV	<ul style="list-style-type: none"> ■ crude oil; ■ natural gas condensate; ■ LNG; ■ gas in gaseous state; ■ wide light hydrocarbon fraction 	March 31, 2042
<i>Pacific Ocean</i>						
6.	Sea of Okhotsk	50% (or more) of its area in the southern part of the Sea of Okhotsk (south of 55 degrees North latitude)	new offshore	II	<ul style="list-style-type: none"> ■ crude oil; ■ natural gas condensate; ■ LNG; ■ gas in gaseous state; ■ wide light hydrocarbon fraction 	March 31, 2032
		50% (or more) of its area in the northern part of the Sea of Okhotsk (at or north of 55 degrees North latitude)	new offshore	III		March 31, 2042
		<ul style="list-style-type: none"> ■ 50% (or more) of its area in the southern part of the Sea of Okhotsk (south of 55 degrees North latitude); and ■ level of reserve depletion of each type of hydrocarbon resource (other than affiliated gas) extracted at such deposit as at January 1, 2015 is less than 5%.⁵⁰ 	offshore, not new	II	<ul style="list-style-type: none"> ■ crude oil; ■ natural gas condensate; ■ LNG 	January 1, 2021

⁵⁰ The level of reserve depletion of each type of hydrocarbon resource (other than affiliated gas) extracted at such Offshore Deposits is calculated in the manner stipulated by Article 11.1, paragraph 2 of the Tax Code (added to the Tax Code by Law No. 268-FZ).

No.	Location of Offshore Deposit		Category of Offshore Deposit	Category of Difficulty of Shelf Project ⁴⁶	Type of Hydrocarbon Exempt from Export Duty	Term of Incentive/Exemption from Export Duty ⁴⁷
	Sea	Characteristics of Offshore Location ⁴⁸ / Conditions				
<i>Atlantic Ocean</i>						
7.	Sea of Azov	all in the Sea of Azov	new offshore	I	<ul style="list-style-type: none"> ■ crude oil; ■ natural gas condensate; ■ LNG; ■ gas in gaseous state; ■ wide light hydrocarbon fraction 	March 31, 2032
8.	Baltic Sea	50% (or more) of its area in the Baltic Sea	new offshore	I		
9.	Black Sea	<ul style="list-style-type: none"> ■ 50% (or more) of its area in the Black Sea ■ depth up to 100 meters, inclusive 	new offshore	II		
		<ul style="list-style-type: none"> ■ 50% (or more) of its area in the Black Sea ■ depth over 100 meters 	new offshore	III	March 31, 2042	
<i>Inland seas</i>						
10.	Russian portion / Russian sector of the Caspian Sea bed	50% (or more) of its area in the Russian portion / Russian sector of the Caspian Sea bed	new offshore	-	<ul style="list-style-type: none"> ■ crude oil; ■ natural gas condensate; ■ LNG; ■ gas in gaseous state; ■ wide light hydrocarbon fraction 	March 31, 2032