

Client Update

Top 10 Legal Developments of 2017 in Regulation of Russian Subsoil Use

This client update outlines the most significant recent changes and trends in the regulation of Russian subsoil use.

As a recurring theme of the legislative changes of 2017, one can point to the continuing restriction on foreign participation in the most important spheres related to the extraction of minerals. In particular, measures have been taken to de-offshorize the use of subsoil sites of federal significance and to restrict the use in the oil & gas sector of marine vessels that belong to foreign entities.

In addition, certain legislative provisions have been clarified for the benefit of state-owned production companies:

- a number of tax incentives have been introduced in the oil & gas sector;
- the right to extract associated minerals has been clarified; and
- the right to sell produced gas for production and export of LNG at non-regulated prices has been provided.

Based on the latest legislative initiatives, the most relevant regulatory trends include:

- a change in the taxation of hydrocarbon production;
- the encouragement of geological survey of the subsoil (including its financing by private entities);
- an increase in the effectiveness of tenders/auctions for the right to use subsoil sites; and
- the enhancement of the legal framework for joint field development.

RECENT DEVELOPMENTS IN REGULATION OF SUBSOIL USE

De-offshorization of Subsoil Use

On July 1, 2017, amendments to Federal Law No. 57-FZ on the Procedure for Foreign Investments in the Legal Entities of Strategic Importance for Russian National Defense and National Security, dated April 29, 2008 ("Law No. 57-FZ") came into force. The amendments were aimed at implementing the state policy, announced in early 2016, on restricting

offshore participation in the subsoil use sector and stimulation of the repatriation of capital previously transferred from Russia.

In terms of subsoil use, these amendments relate to the participation of offshore companies in companies that are users of subsoil sites of federal significance (the “strategic subsoil users”) and limit the ability of offshore companies to gain control over strategic subsoil users or their main production assets.

According to the new revision of the Law No. 57-FZ, offshore companies and organizations under their control:

- may directly or indirectly acquire more than 5% of the voting shares (participation interests) of a 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 main 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 company.

An offshore company is a legal entity registered in an offshore zone. Offshore zones are states (territories) that provide preferential tax treatment and/or do not require or provide information disclosure when conducting financial transactions.

The list of offshore zones is approved by the Russian Ministry of Finance and currently includes, *inter alia*, the British Virgin Islands, Bahamas, Bermuda, Belize, Monaco, the Cayman Islands, Panama, the Seychelles, the Isle of Man, Guernsey, and Jersey. Cyprus, Malta, and Hong Kong were excluded from this list (Hong Kong was just excluded from the list on January 1, 2018).

Restriction on the Use of Ships That Belong to Foreign Parties in the Oil & Gas Sector

According to the new version of the Russian Merchant Shipping Code (the “MSC”), the following types of activities may be carried out exclusively by ships sailing under the State Flag of the Russian Federation:

- from February 1, 2018: storage of oil and oil products, natural gas (including LNG), gas condensate and coal on a ship in the water area of the Northern Sea Route; and
- from December 30, 2018: marine transportation of oil, natural gas (including LNG), gas condensate and coal produced in the territory of the Russian Federation and/or in the territory under the jurisdiction of the Russian Federation, including on the Russian continental shelf, and loaded on ships in the water area of the Northern Sea Route, to the first point of unloading or reloading.

According to the MSC, the ships, the owners or charterers of which are Russian legal entities or individuals, or state or municipal bodies, may sail under the State Flag of the Russian Federation.

This restriction does not apply to transportation (storage) contracts entered into before the above mentioned dates, or to international treaties of the Russian Federation, providing for the use of ships sailing under other flags.

The restriction on the use of ships sailing under foreign flags is intended to support Russian shipping (shipping, shipbuilding, and ship repair companies), taking into account, in particular, the prospects of Russian LNG projects. Previously, the Russian President V. V. Putin stated that in the future such restrictions could be extended to other water areas (in addition to the Northern Sea Route).

In addition, unless otherwise provided by international treaties of the Russian Federation, the MSC, or the decisions of the Russian Government adopted in accordance with them, from February 1, 2018, the following types of activities, *inter alia*, shall be carried out by ships sailing under the State Flag of the Russian Federation:

- the transport of goods, passengers and their luggage and/or towing (i) in the inland sea waters and/or the territorial sea of the Russian Federation without crossing the state border of the Russian Federation; (ii) from the inland sea waters and/or the territorial sea of the Russian Federation into the inland sea waters and/or the territorial sea of the Russian Federation that includes crossing of the state border of the Russian Federation; (iii) from the inland sea waters and/or the territorial sea of the Russian Federation to artificial islands, installations, and fixtures (the “artificial facilities”) located in the exclusive economic zone and/or on the Russian continental shelf, and vice versa; and (iv) between the artificial facilities located in the exclusive economic zone and/or on the Russian continental shelf; and
- marine resource studies, exploration and development of mineral resources of the seabed and its subsoil in the inland sea waters and/or the territorial sea of the Russian Federation, in the exclusive economic zone, and on the Russian continental shelf.

Establishment of Tax Incentives in the Oil & Gas Sector

Introduction of Tax Deductions for MET in the Production of Oil & Gas Condensate

Starting January 1, 2018, tax deductions for mineral extraction tax (“MET”) apply to the production of (i) oil in the subsoil site located entirely within the boundaries of the Nizhnevartovsk region of the Khanty-Mansiisk Autonomous District-Yugra and (ii) gas condensate from all types of hydrocarbon deposits.

The tax deduction for MET in the production of oil applies provided that (i) the license for the relevant site has been issued before January 1, 2016; and (ii) the initial recoverable oil reserves of this site, as of January 1, 2016, amounted to 450 million tons or more. Currently, only the Samotlor field of Rosneft satisfies the conditions for granting such a deduction.

The tax deduction for MET in the production of oil will apply for 10 years (from January 1, 2018 to December 31, 2027), during which the cumulative reduction of the MET will amount to approx. USD 6.25 billion (approx. USD 625 million a year).

The introduction of this deduction is part of the initiatives to support the development of oil fields that have a high degree of water cut. In the future, the program for granting MET privileges to highly watered fields may be extended to other subsoil sites.

The tax deduction for MET in the production of gas condensate applies when the following conditions are simultaneously met:

- the produced gas condensate is directed for processing on technological equipment that belongs to a Russian company;
- a wide fraction of light hydrocarbons is recovered from the produced gas condensate on such equipment during processing; and
- the fact of recovery of a wide fraction of light hydrocarbons from the produced gas condensate is documented.

The Russian Tax Code provides a formula for determining the size of the deduction, depending on the volume of the gas condensate directed for processing and the recovery factor of a wide fraction of light hydrocarbons. The period of application of the tax deduction for MET in the production of gas condensate is not limited.

Lowering the MET Rate on Gas for Gazprom's Joint Ventures

Starting January 1, 2018, for the owner of the Unified Gas Supply System (Gazprom) and/or organizations in which it directly or indirectly participates, there is an actual reduction of the MET rate on gas produced from hydrocarbon deposits with a minimum depth of over 3,300 meters. The rate is reduced to the level of the MET rate applicable to the production from such deposits by independent gas producers. According to the drafters, the reduction in the MET is due to the need to preserve the interest of foreign investors in the development of the Achimov deposits in Russia.

Additional Clarification of the Right to Extract Associated Minerals

Since July 4, 2016, Law of the Russian Federation No. 2395-1 on Subsoil, dated February 21, 1992 (the "Subsoil Law") has provided for the right to extract associated minerals not specified in the subsoil use license (except for associated waters, hydrocarbons and common minerals). However, this right is enjoyed only by the subsoil users, more than 50% of whose voting shares (participation interests) are directly or indirectly owned by the state, as well as their subsidiaries.

Resolution of the Russian Government No. 963, dated August 12, 2017, specifies that these subsoil users may extract associated minerals that simultaneously meet the following criteria:

- these minerals (i) occur in the subsoil together with the main minerals specified in the license, (ii) are contained in the production and processing waste and/or (iii) are contained in temporarily unused production products;

- they are impossible and/or economically inexpedient to independently extract (develop); and
- their estimated value during production does not exceed 10% of the total value of all minerals in the relevant subsoil site.

The production of associated minerals is possible only after obtaining the report of the state expert reserves review and amending the license accordingly (including the levels of production of associated minerals).

Balancing the Interests of Extraction Companies and LNG Producers

Starting January 1, 2018, Gazprom and its affiliated entities may sell their produced natural gas to entities that produce LNG and export it from Russia at non-regulated prices. Previously, state regulation of gas prices in the domestic market also applied to gas sales to Russian LNG producers.

Corresponding changes were introduced by Resolution of the Russian Government No. 1663 on Certain Issues of Gas Sales in the Russian Federation, dated December 27, 2017, and were intended to balance the business interests of these gas suppliers and LNG producers that export LNG at non-regulated prices.

Possibility of Repeated Increases of Subsoil Site

Since May 30, 2017, subsoil users have had the right to repeatedly increase their subsoil sites. Corresponding amendments were made to Regulations on the Establishment and Modification of the Boundaries of Subsoil Sites Granted for Use (approved by Decree of the Russian Government No. 429, dated May 3, 2012). Prior to this, the boundaries of a subsoil site could only be changed once, except for their reduction.

Under the new rules, the boundaries of a subsoil site may be many times:

- *increased* in the case of (i) the presence of technological needs to extend the site boundaries without an increase in mineral reserves; (ii) the accession of the underlying subsoil layer, containing the minerals that are recorded on the balance sheet and are part of the same deposit; (iii) the accession of a subsoil layer (with the exception of the underlying subsoil layer) containing the minerals that are recorded on the balance sheet and are part of the same deposit, provided that the total volume of all the reserves, added as a result of multiple changes to the site boundaries, does not exceed 20% of the reserves which are recorded on the balance sheet of this deposit; or (iv) fulfillment of obligations under international treaties of the Russian Federation;
- *decreased* in the case of (i) the abandonment of a part of the site with a lack of prospective geological objects; (ii) the allocation of a subsoil site, containing the deposit discovered with its own (including borrowed) funds by a subsoil user from the site provided for geological survey; or (iii) fulfillment of obligations under international treaties of the Russian Federation.

MAIN TRENDS IN REGULATION OF SUBSOIL USE

Change in Procedure for Taxation of Hydrocarbon Production

Draft Law No. 325651-7 (submitted to the Russian parliament (the “State Duma”) on November 28, 2017; it is under consideration in the first reading) fundamentally changes the approach to the taxation of hydrocarbon production, by introducing a new type of tax in addition to the MET – the additional income tax on hydrocarbon production (the “AIT”). Unlike the MET, which is levied on the amount of the extracted minerals, the AIT is expected to be levied on the income earned after the project passes the break-even point. The Draft Law is planned to be adopted in 2018, with the new taxation procedure coming into effect in 2019.

Initially, the AIT is expected to be applied to the following:

- deposits with a degree of depletion of oil reserves of less than 0.05, 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 Krai), Yamalo-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); and
- deposits in Western Siberia within certain geographical coordinates (in the Tyumen region, KhMAO-Yugra, Komi, Yamal) with a certain degree of depletion and recoverable reserves.

Users of the sites of the first two groups will have the right to refuse to switch to the AIT. In the future, a new tax may be levied on other hydrocarbon deposits.

The AIT at a rate of 50% will be levied on additional income earned from hydrocarbon production for a calendar year after the project passes the break-even point (additional income is determined as the difference between estimated income and the amount of expenses for oil production and transportation and the estimated export duty).

Incentivization of Geological Survey

Simplification of Obtaining Subsoil Sites in the Inland Sea Waters and the Territorial Sea of the Russian Federation for Geological Survey

Draft Law No. 223906-7 (adopted by the State Duma in the first reading on October 20, 2017; it was not considered in the second reading) provides for the allocation of subsoil sites of federal significance in the inland sea waters and the territorial sea of the Russian Federation for geological survey on the basis of the Decision of the Russian Government without holding auctions.

At present, subsoil sites of federal significance are allocated on the basis of the Decision of the Russian Government based on the results of an auction (i) for exploration and development or (ii) for geological survey, exploration and development (under a combined license).

The Draft Law is aimed at incentivizing private investments in geological survey of the subsoil in the inland sea waters and the territorial sea of the Russian Federation, which have been studied much less than the subsoil of the land and the continental shelf.

Ensuring Compliance with Established Deadlines for Geological Survey

In the beginning of October 2017, the Russian Ministry of Natural Resources submitted to the Russian Government a draft law that would increase the rate of regular payment for the use of the subsoil (up to a hundred times the maximum regular payment rate) in the event that the subsoil user exceeds the time frame for geological survey. The draft law has not yet been submitted to the State Duma.

The proposed changes do not apply to cases of exceeding the time frame for search and evaluation of hydrocarbon deposits on the continental shelf and the exclusive economic zone of the Russian Federation or territories under the jurisdiction of the Russian Federation.

According to the Subsoil Law, the time limits for geological survey are from 5 to 10 years, depending on the location of the subsoil site.

Consideration for Discovery of a New Deposit and Reimbursement for Related Expenses at the Expense of Subsoil Users

On October 20, 2017, Draft Law No. 297648-7 was submitted to the State Duma. The Bill provides for the payment of consideration for the discovery of a previously unknown deposit that has commercial value and reimbursement for the related expenses.

The recipients of consideration and reimbursement may be parties that have conducted the geological survey using private funds (not under a government contract) and that (i) abandoned exploration and development, or (ii) did not obtain the right for exploration and development. It is assumed that the payments will be made by the subsoil users to whom the relevant deposit will be provided for exploration and development.

Currently, the legislation provides for only limited government payments to entities that have discovered the deposit as follows: (i) the remuneration of individuals (contractors or employees of geological exploration companies) that participated in the discovery of the deposit using public funds; (ii) reimbursement of expenses incurred on the discovery of a deposit that belongs to subsoil sites of federal significance, and the amount of a one-time payment for this subsoil site, as well as remuneration of an entity which has not obtained this site for exploration and development; and (iii) the payment of the price of work under a state contract for geological survey of subsoil.

However, on December 5, 2017, the Draft Law was returned to the drafters due to the lack of the Russian Government's approval, which is required for the draft laws that change the financial obligations of the state.

Increasing Effectiveness of Tenders/Auctions for the Right to Use Subsoil Sites

Restriction of Dishonest Participation in Tenders/Auctions

In July 2017, the Russian Ministry of Natural Resources submitted to the Russian Government a draft law aimed at improving the procedure for tenders and auctions for the right to use the subsoil. The bill has not yet been submitted to the State Duma of the Russian Federation. The proposed changes are intended to exclude cases when unfair bidders, during tenders/auctions for the right to use subsoil sites, announce an overestimated amount of a one-time payment for the use of the subsoil, without intent to pay it, in order to disrupt the provision of subsoil sites.

It is proposed to determine the winner of a tender based on the largest proposed one-time payment for the right to use a subsoil site; provided that the bids of two or more participants in the tender are deemed equivalent according to the main criteria (scientific, technical, socio-economic, and time criteria, the effectiveness of protecting the subsoil and the environment, and ensuring national defense and national security).

In the event that the winner of the tender/auction fails to pay the final amount of the one-time payment set by the results of the tender/auction, the winner will be considered the participant of the tender/auction, whose bid was next in amount of the one-time payment (in the case of a tender, only the bids equivalent according to the main criteria are considered).

The winners of tenders/auctions who have not made a one-time payment are proposed to be included in the public register of unfair participants in tenders/auctions for the right to use the subsoil. An entity will not be allowed to participate in a tender/auction, if this register contains information on it or its participants (shareholders), CEO or members of the collegial executive body.

Issuance of License to the Sole Participant of a Tender/auction

According to Draft Law No. 288750-7, amending the Subsoil Law (submitted to the State Duma on October 17, 2017, the date of consideration is not determined), if a tender or a repeated auction for a subsoil site that is not a subsoil site of federal significance is recognized as failed due to the presence of only one proper bidder, the license is issued to such bidder.

This change is aimed at ensuring the interests of the state as the owner of the subsoil, since the recognition of the tender/auction as failed and the holding of a new auction requires a considerable amount of time (up to a year), during which the prospective subsoil site remains in the unallocated fund, and the state does not receive the corresponding revenues.

At present, the Subsoil Law contains only a discretionary rule, in the case when a tender is recognized as failed due to the receipt of an application of only one bidder, allowing the state to issue a license to that bidder.

Enhancement of the Legal Framework for Joint Development of Hydrocarbon Deposits

In August 2017, the Russian Ministry of Natural Resources prepared an updated version of the Draft Law on the Specifics of Joint Activities in Developing Hydrocarbon Deposits and on Amending the Subsoil Law (not yet submitted to the State Duma).

For the purposes of joint development of hydrocarbon deposits, the Draft Law provides for two types of the existing simple (*non-corporate*) partnership agreement — the mining partnership agreement (the “MPA”) and the joint investment agreement (the “JIA”).

Under the MPA, the subsoil user (the license holder) and the operator jointly develop the subsoil site in accordance with the license and distribute among themselves the produced hydrocarbons and associated minerals or sales proceeds.

The JIA determines the procedure for (i) the operations by one of the parties to the JIA (managing partner) as an operator under the MPA on behalf of itself and in their joint interests, (ii) the distribution between the parties to the JIA of the minerals or sales proceeds received by the managing partner, and (iii) joint financing of the managing partner’s operations under the MPA.

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Please do not hesitate to contact us with any questions.

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