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Abstract

Russia is currently engaged in a major overhaul of legislation governing the subsoil. The new legal framework will confirm the recent centralisation of authority over subsoil use and initiate the transition from a licensing regime to a regime based on civil law agreements between the state and investors. A civil law regime could provide investors with much more favourable conditions, but its success depends on the nature of the secondary legislation still to be drafted and on progress in strengthening judicial impartiality and independence.

The views expressed in this briefing note are those of the author alone and do not necessarily reflect those of the OECD or its member states.

Re-Writing Russia's Subsoil Law: From Sovereignty to Civil Law?

The Russian Federation is currently engaged in a major overhaul of legislation governing the subsoil, which will alter substantially the legal basis on which the country's enormous natural resources are exploited. Given its impact on such crucial sectors as oil, gas, diamonds, gold and other metals, this process is potentially of tremendous importance. While the new legislative framework will in no way compromise the basic constitutional principle which stipulates that the subsoil is state property, it will greatly alter the institutions and procedures whereby the state exercises its rights as owner. The changes envisaged are many and concern the whole range of issues covered by the 1992 federal law 'On the subsoil' ('*O nedrakh*'), but two broad priorities stand out. First, the powers of Russia's regions in matters pertaining to the exploitation of most subsoil resources have already been substantially curtailed, with far greater authority concentrated at federal level. Secondly, the government is now preparing to move from a system of licences for subsoil use to a legal regime based on civil law agreements between the state and companies engaged in resource extraction. The issue of regional power was largely resolved in amendments to the 1992 subsoil law approved in August 2004, which entered into force on 1 January 2005[1]. The transition from licences to leases is to be legislated this year. This note examines these two concerns in turn, before briefly examining some of the other important changes being set in train.

Centralisation drive

The August 2004 amendments to the subsoil law involve a fundamental revision of the constitutional compromise adopted in the 1990s in the field of resource use. Article 72.1 of the 1993 constitution assigns 'matters of possession, use and disposition of land, subsoil, water and other natural resources' to the joint competence of the federation and its constituent provinces, territories and autonomous districts (the so-called 'subjects of the federation'). The constitution does not specify what such 'joint competence' means in practice, but during the 1990s, it came to be almost synonymous with the so-called 'two-key' principle, whereby both federal and

[1] Some provisions concerning payments for resource use are to enter into force at a later date.

regional governments had to approve licences awarded to (or removed from) companies. The amended subsoil law (art. 1.1), however, effectively declares that the practical meaning of joint competence will be defined by *federal* law. This, of course, must be seen in the context of the larger drive to extend federal authority over the regions since 2000. The dual-key compromise was in no small measure a product of the political struggles of the 1990s and, in particular, of then President Boris Yeltsin's need to secure the political support of regional elites. His successor, Vladimir Putin, has reversed many of Yeltsin's concessions to the regions in an effort to re-establish a strong central authority. Moreover, federal officials insist that the dual-key principle is unfair – it gives a handful of regional authorities tremendous power over the exploitation of resources that are meant to belong to the nation as a whole – and that it is both inefficient and open to corruption.

Under the revised article 10.1, licences for resource use are awarded by a tender/auction commission formed by the federal Ministry for Natural Resources (MPR). The law states only that a representative or representatives of the region in which the resources are located will be 'included' in the commission. There will no longer be any requirement for separate approval of licences by regional executives. This will apply to new exploration and production licences, as well as to exploration-only licences and to the conversion of existing exploration licences to production licences upon commercial discovery[2]. While the law defines certain requirements for the composition of auction commissions, it does not specify the *number* of regional representatives to be included on them.

The adjustment to the regime for awarding licences also entails changes in the destination of certain types of payments[3]. The tender/auction fee, the licence fee and the payment for geological information now go to the federal budget. The 'regular payments for subsoil use' (covering the prospecting, exploration and appraisal stages) will now be set for each field by the MPR within the limits set out in the amended law (rather than by the regional governments based on federal proposals). However, the amendments do not affect the federal/regional allocation of these fees, nor do the amendments change the arrangements for sharing bonus

[2] See also article 13.1 of the amended subsoil law (hereafter, ASL) for details. The regime described above applies only to deposits on land. For marine deposits (including inland water ways, territorial waters and the continental shelf), the decision remains, as previously, entirely in the hands of the federal authorities.
[3] See articles ASL 40–42 for details.

payments, the natural-resource extraction tax or the profit tax. Since these have recently been revised in favour of the centre anyway, there was little reason for Moscow to adjust them[4].

Other changes to the centre-regional balance are less dramatic but still noteworthy. Local authorities (municipalities and rural districts) have lost their one more or less significant power over the exploitation of subsoil resources: the right to restrict subsoil use in or near populated areas or industrial, transport or communications zones if this could threaten human life or health, economic interests or the environment. This power now rests with the federal authorities. However, the MPR draft of the new subsoil law vests this power in whatever organ issued the licence or concluded the contract for resource exploitation. If this provision reaches the statute books unchanged, the relevant authority will most often be the MPR, but it will in certain circumstances be the relevant regional authority, because the regions retain their authority over land and roads, and over 'widespread mineral deposits' such as sand, clay and gravel. Under the current draft, their jurisdiction would at least extend to the health and environmental impacts of projects in these spheres.

The implications of these changes for resource-rich regions are substantial. Hitherto, the regions have used their role in the awarding of licences to secure investments in transport and social infrastructure. While there has undoubtedly been some corruption, the old arrangements do seem to have benefited the populations of resource-producing regions. The fact that licences for exploration (5 years) and production (20 years) have usually been awarded by tender, not by auction, has allowed the regions to press for the financing of roads, schools, hospitals, jobs, environmental programmes, etc as. Their role in licensing decisions also enabled regions to shape their own industrial policies: some tended to protect the interests of favoured local producers, while others sought to diversify the range of companies operating on their territories and thus to discriminate *against* locally dominant players. Advocates of greater centralisation point out that such behaviour created significant incentives for powerful resource-sector companies to get deeply involved in regional politics, often pouring enormous resources into gubernatorial elections and on occasion even securing the election of company executives as

[4] The NDPI split is 85.6/14.4 in favour of the centre or 81.6/13.4/5.0 in so-called 'complex federal subjects' (those in which one subject of the federation exists within another and there are thus two federal subjects with a claim on resource revenues). The NDPI for gas is entirely federal, as are export tariffs on hydrocarbons. The profit tax is split as per Tax Code article 284 – 20.83% to the centre, 70.83% to the regions and 8.3% to local governments.

regional chief executives[5]. Federal officials argue, moreover, that the cumbersome and often untransparent nature of the dual-key licensing process made it both inefficient and open to corruption, while complicating efforts to monitor adherence to licence terms. Overall, the federal authorities insist that the changes will not disadvantage the regions, since a more streamlined set of procedures should accelerate the development of resource projects and increase the number of resource sites in production.

As noted above, the most recent changes to the subsoil law are part of a broader drive to centralise economic power. They will reinforce the incentives for companies to concentrate their lobbying efforts in Moscow. One should not, however, underestimate the regions' ability to make use of their remaining authority to influence resource-extraction companies. They still have considerable power over issues such as land allotments and local infrastructure provision. Moreover, it is already clear that regional officials will continue to play a key role in auction and tenders, simply because it is they who possess much of the expertise needed to draw up the relevant documentation, not their colleagues in Moscow[6].

Enhancing stability and predictability

While the focus of the August amendments was on the division of powers between the centre and the regions, they introduced one other set of changes that are of particular significance. The amended text of article 10 states that licences 'shall be extended' by application of the licence-holder 'on condition of the absence of violations of licence terms'. This replaces the previous version's stipulation that licences 'may be extended… on condition of compliance with the agreed licence use terms'. The substitution of 'shall' for 'may' and the somewhat more explicit formulation of the criterion for extension ('absence of violations' has been taken to imply a 'presumption of innocence' – if no violations have been raised, then the licensee is entitled to renewal) are both regarded as steps to reduce bureaucratic discretion and increase investors'

[5] Yukos executive Boris Zolotarev was elected governor of the Evenk Autonomous District (AO) in 2000; in 2001, Yukos won the licence for the Yurubcheno-Takhomskoe field there. Norilsk Nickel manager Aleksandr Khloponin was elected to head, first, the Taimyr AO and then, in 2002, Krasnoyarsk Krai. Komi Republic President Spiridonov lost his bid for re-election in 2002 to an opponent financed by Lukoil. The defeat of Spiridonov, who had opposed Lukoil's drive to dominate Komi's oil sector, allowed Lukoil to consolidate its corporate interests in Komi.

[6] It is important to remember that defining the tender/auction terms will involve such basic decisions as delineating the boundaries of the relevant blocs, which are more likely to be done at regional level, even under the new regime.

certainty concerning licence renewal. While the grounds for early termination of licences in article 20 are broadened, they are also clarified[7].

These changes to the licensing regime reflect a larger concern with reducing the considerable scope for bureaucratic arbitrariness that has always existed since the subsoil law was adopted in 1992. However, revisions to the licensing arrangements are merely the beginning. The MPR draft of the new subsoil law envisages a transition from the present, essentially administrative, regime based on licensing to one based on civil law agreements. The former, which is essentially based on the state's *sovereign* rights over the subsoil, leaves far greater scope for arbitrary state action than the latter, which is based on *property* rights and under which the state will enter into agreements with investors on the basis of legal equality. The crucial point is that the courts will henceforth play a much more important role in resolving conflicts between investors and the state, while the powers of bureaucrats should be substantially curtailed. In an effort to ensure a smooth transition, the MPR draft includes a range of changes designed to make the licensing regime more stable and transparent[8], but it explicitly states that these provisions apply only to licences awarded *before* the law enters into force. All new rights over subsoil resources will be based on civil law contracts concluded under the provisions of chapter 5 of the draft law.

While investors are still pressing for some clarifications and revisions to the draft, the transition should be good news for companies involved in resource extraction. The licensing regime in its current form posed serious problems for investors, mainly because it leaves so much discretionary power in the hands of officials. Prior to the changes adopted last year, a licence could be revoked if the licensee failed to fulfil any 'significant terms' of the agreement, but the law failed to specify what a significant term might be. While actual revocations were rare (in part because of the dual-key principle), the threat of licence withdrawal has been used by the authorities to pressure companies, and periodic licence-compliance 'campaigns' by the MPR have proved unsettling. The more general problem, which even the August amendments have not fully rectified, is that the licensing regime leaves investors with little scope for turning to any third party in the event of a dispute with the state over the meaning of licence terms or the fact of compliance.

[7] Among other things, article 20 states explicitly that any transfer of a licence in violation of rules governing transfers (set out in article 17.1) is grounds for termination of rights.

Under the draft of the law put forward by the MPR at the end of 2004, subsoil exploitation rights (to prospect, explore or extract) will be awarded on the basis of auctions. This may change: it was previously expected that the legislation would propose both auctions and tenders, and the latter may yet reappear as the new law makes its way through the government and the Federal Assembly. The MPR thinks tenders are more corruptible, because there is greater scope for discretion in judging among competing bids, and, even if tenders are ultimately included in the law, the MPR recommendations will probably give priority now to auctions. The only references in the draft at present concern tenders for *licences* (i.e. tenders conducted prior to the entry into force of the draft). Only auctions are discussed in connection with the right to conclude contracts with the state. The law does provide for the awarding of rights without auctions, and this has prompted some critics to express concern that rights to exploit large deposits would still be awarded in an non-competitive fashion, on the basis of political or bureaucratic discretion. However, the MPR draft outlines fairly restrictive conditions for the awarding of licences or contracts without auctions. With respect to hydrocarbons, this will mainly concern the award of temporary (up to one year) rights where the previous user's rights have been terminated early. It also applies to the right of those who have made new discoveries to develop the resources they have found[9].

The draft law also provides for the turnover of subsoil-use rights. There can be no turnover of resource deposits themselves – the subsoil is inalienable state property – but the rights to explore and develop them may be sold, used as collateral or transferred by other means set out in the law. There are some provisions already for licence transfers, but the draft law is both clearer and more permissive. It does, however, allow the state to restrict the range of persons or entities allowed to participate in the turnover of subsoil-use rights. What is not entirely clear is whether and to what extent the state will have the right to regulate, or even veto, such transfers of rights. Nor is it clear what state body will exercise any such power: it has been suggested that it would rest with the body that concluded the original contract, but this might put the negotiating parties onto a highly unequal footing. Amongst the amendments proposed for the draft is an explicit statement that the only restrictions on the assignment and pledge provisions in the law are those specifically listed therein.

[8] These are found in chapter 6 of the draft.
[9] See DL articles 70–77.

A final step towards making the system more predictable for investors concerns the shift to awarding exploration and production rights together. One of the major impediments to encouraging exploration activities in Russian minerals sectors has been the lack of any assurance that those making commercially significant discoveries would be entitled to develop them, or even to receive any compensation for their efforts. Under the MPR draft, the right to produce from such a deposit would be conferred automatically, provided that the entity had financed the bulk of the exploration work, whether from its own capital or borrowed funds. The question of conversion would arise only where most of the exploration work had been financed from the budget. This change will probably mean little in mature producing regions. In practice, those making new finds usually *do* win the exploitation rights, but that is because the major companies tend to explore in their own areas of operation, where they are likely to be at an advantage in any competition for a production licence[10]. Where the new law may have a real impact is in encouraging prospecting in regions where resource extraction is not already taking place on a large scale.

It remains to be seen what changes this framework will undergo as it makes its passage towards the statute books. A number of analysts have suggested that Russian companies may object to the new arrangements and lobby for the restoration of a greater degree of bureaucratic discretion. While the major Russian resource-extraction companies certainly have no desire to fall victim to bureaucratic whim, they may well calculate that, on balance, they are better able to defend their interests within the bureaucracy than their foreign rivals or smaller domestic companies. The licensing system is in any case more familiar, and companies are not likely to rush to convert their licences into leases. Russian companies are also likely to be sceptical of the benefits that civil law agreements will bring them, fearing that the courts will in any case construe the law in favour of the state when conflicts arise. However, slippage here is likely to be limited, as President Vladimir Putin himself has stated explicitly on a number of occasions that he wishes to minimise bureaucratic involvement in the award and administration of rights to the subsoil. The much more likely outcome is simply that the Russian companies will make the transition to the new regime gradually, perhaps shifting a few fields to the leasing system early on, to see how it works, while leaving most under licences.

[10] There is more to this than mere 'local knowledge'. Control of the local infrastructure may be even more important: while competition laws forbid the most flagrant anti-competitive behaviours, there remain many ways for companies to make life difficult for unwelcome interlopers who are reliant on their infrastructure.

In theory, at least, the contract-based system implies the legal equality of the parties and much greater reliance on the courts. It also offers investors far greater transparency and stability, since it will be possible to void such contracts only by agreement of both parties or by a court decision. The draft law, moreover, specifies the contractual conditions that are conditions, which might provide a basis for the court to void the contract at the request of one side or the other, and those that are warranties. Similar provisions apply to contract stability – changes may made by mutual agreement or court order – and to early contract termination. Article 80 includes *force majeure* clause stipulating that the courts will decide, at the request of the resource user, if a 'fundamental change in circumstances' has occurred that would necessitate revision or abrogation of the contract. However, there is no assurance that the subsoil use contracts will continue to apply irrespective of subsequent changes in primary and secondary legislation, nor does the draft include changes in the tax or regulatory regimes among the grounds on which a subsoil user may invoke *force majeure* to request that the courts amend or cancel a contract. The stability clauses in the MPR draft are thus rather weaker than they look at first sight.

Other changes

The MPR draft envisages a number of other changes, some of which relate closely to the two major priorities above. The MPR draft would preserve the authorities' existing right to conduct 'open' or 'closed' auctions. In particular, Natural Resources Minister Yuri Trutnev has indicated that the MPR would exercise its authority to conduct 'closed national auctions', effectively barring the participation of foreign entities when auctioning the rights to some deposits. The ministry has confirmed that, in 2005 at least, only majority Russian-owned entities are to be permitted to bid for licences to develop large deposits. The draft law specifically provides for such restrictions on national security grounds. However, it is far from clear what all this might mean in practice, since the draft is not wholly clear as to what would constitute a foreign participant – the exclusion of Russian subsidiaries of foreign companies is a real possibility, but it is not clear what the position would be with respect to predominantly Russian-owned entities in which non-residents held stakes[11]. However, while this is undoubtedly a concern for many investors, the draft (in contrast to some recent ministerial statements) strongly suggests that

[11] Article 9.2 states explicitly that, with specified exceptions, foreign individuals and entities cannot be resource users. However, Russian-registered entities that are owned by non-residents can do so, except where the law provides otherwise. The point is that the state insists that any foreign participation in resource sectors be through structures created – and taxed – under Russian law.

open auctions are to be the norm and, indeed, the MPR has resisted pressure from some Russian oil companies to introduce tougher criteria for participation, seeing such proposals as an attempt by the larger Russian companies to limit competition. Competition may, however, be limited by the draft law's retention of provisions in the August 2004 amendments that would require auctions to be conducted with 45 days' notice and results to be announced within 30 days of the auctions being conducted. Hitherto, the applicable time limits have been three months' notice for small fields and six for larger ones. There is real concern that smaller companies and foreign firms, being less well connected in the administration and/or less familiar with the fields in question would not be able to assess the deposits on offer and prepare their bids with such short lead times.

Conclusion

Assuming the law is properly administered by the courts, it should mark a big step forward compared to its predecessor. Its major weaknesses concern what is still missing from the draft rather than what is there. The auction process, for example, is not outlined in much detail, nor is the nature of the contracts to be concluded with auction winners. It is not clear, for example, whether auction participants will be required to demonstrate in advance their ability to fulfil the obligations of the subsoil use agreement or whether they will even be allowed adequate time to review and recommend changes to the subsoil use agreement being put forward at auction. Nor is there any explicit commitment to allowing agreements to be extended automatically if the subsoil user is able to present geological and economic evidence in support of an extension of the project's life. Foreign investors are seeking an explicit statement that their rights under the law are identical to those of subsoil users not associated with foreign investors except as and when differences are explicitly set out in the law.

This list of omissions could, of course, be extended. Each unresolved issue appears to leave a bit more discretion to the ministry, despite the fact that one of the avowed aims of the law is to reduce bureaucrats' power over resource use. Critics have suggested that the MPR is simply trying to cling to as much of its old authority as possible. Moreover, the liberalising concept at the heart of the law – the move to a system of civil law contracts – is at odds with the more *étatiste* direction of much recent policy. However, consultations on the draft are continuing and the real impact of the law will depend in no small measure on the extent to which these issues are

addressed as the draft makes its way through the government and the Federal Assembly, as well as on the nature of the normative acts adopted pursuant to it. A great deal will also depend on the quality of the courts. In the absence of substantial further progress in strengthening judicial impartiality and independence, the change to a leasing regime may mean little in practical terms.

Author

William Tompson is Senior Economist for South-east Europe and the Newly Independent States in the Economics Department of the OECD. He is on leave from Birkbeck College, University of London, where is Professor of Politics, and he is an associate fellow of the Royal Institute of International Affairs.