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Status of legislation for foreign investment in the Russian petroleum sector and on the continental shelf

12 April the Federation Council passed the new Law on Foreign Investment in Strategic Sectors in its final version¹ and another law detailing corresponding changes in other laws, including the Law on Mineral resources (LM), the Law on the Continental shelf, the Law on Foreign Investment, and others. Together they comprise a revised framework for foreign investment in the petroleum industry and on the Russian continental shelf. This note² is based on a reading of the law text (reference to concrete chapters and paragraphs in brackets) plus comments obtained from officials in Moscow.

The Law on Strategic Sectors is general and wide-ranging, addressing foreign ownership in strategic sectors of the economy, which are listed (more than 40). The mineral sector is singled out for stricter regulations than the general norm and comprise “geological studying of underground resources and (or) exploration and exploitation of minerals” (6-39).

- A distinction is made between foreign government controlled and foreign private investors. Organisations controlled by foreign states are not allowed to control economic subjects with strategic significance for the defence and security of Russia (hereafter referred to as ‘strategic enterprises’ (2-2). Such organisations must have advance approval to obtain more than five per cent of a strategic subject engaged in geological studying of, exploration or production of mineral resources of *federal significance* (2-3).
- ‘Federal significance’ is defined in an amendment to the Law on Mineral Resources. It includes oil fields with reserves more than 70 mill. tons, gas fields with reserves over 50 BCM, and *all resources on the continental shelf*. (LM 2)
- This clause does not apply if the Russian Federation owns or indirectly controls more than fifty per cent of the strategic enterprise in question (2-7).

¹ Full name: “On the order of realisation of foreign investments in economic enterprises having strategic significance for securing the defence of the country and the security of the state”

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- For private foreign companies the law is more ‘liberal’. They may individually or as a group control up to ten percent of a strategic enterprise engaged in use of mineral resources of federal significance, without being affected by the law (3-3). To obtain more than ten percent they need advance approval from the designated federal agency (4-1).
- Many Russian companies may be severely affected by the new law. Indirectly the law says that if a foreign investor or a group of foreign investors directly or indirectly controls more than ten per cent of the shares in a Russian company in the minerals sector, then the Russian company is by definition controlled by foreign investors and becomes a ‘foreign investor’ itself under this law (3-3) It seems, however, that if the shares are distributed between unrelated investors foreigners may own up to 20 per cent combined without this happening. But this is not clearly spelled out in the law.
- A state controlled company, which is defined as a company with a more than fifty percent state share, may have foreign owners holding more than twenty per cent of the shares without changing status vis-à-vis the law.
- Applications for the right to obtain shares and influence above the limits stipulated by the Law shall be directed to the designated government agency (for the sector, apparently). A “Government commission for control of realisation of foreign investments in the Russian federation”, headed by the Prime minister will be set up and make the final decision (8-6). The commission can accept or decline an application, or lay down special requirements, e.g. that mineral resources from fields of federal significance shall be processed on the territory of Russia. (12-1).
- The commission is going to have its own staff, but may be attached to the Federal anti-monopoly service.
- The Law does not have retroactive power, but foreign owners in strategic enterprises must register their holdings within three months after the Law’s entry into force (16-3).
- If a company with a foreign investor, holding a combined license for geological study, exploration and exploitation, in the course of geological study discovers a field of federal significance, the Russian government may deny the company right to further exploration and exploitation. Compensation will be paid according to unspecified principles. (LM 2)
- Only companies established according to Russian law may be users of mineral resources of strategic significance. On the continental shelf only companies established according to Russian law and which have more than five year experience working on the continental shelf and where the Russian Federation holds more than fifty per cent of the shares can (from now on) be mineral users (LM 9). In addition, the Minister of Natural Resources has announced that blocs on the continental shelf will be divided between Gazprom and Rosneft according to their expected ‘profile’ – oil or gas (Kommersant, 17.4.08).

Summing up: An explicit goal of the new legislation is to increase the predictability for foreign investors. And to some extent it codifies regulations which already have been applied informally.

The new law is said to be based on a 'permission principle'. There are few absolute prohibitions. Indeed the new law gives considerable discretion to the executive branch, and a liberal-minded government could, based on the law, give foreign investors significant roles in exploration and extraction of hydrocarbons. The implementation of the law remains to be seen, but the tone in the law and the present dominant discourse points in a different direction.

Furthermore the new legislation has important implications for the general development of the petroleum sector in Russia. It

- Removes competition on the continental shelf
- Further increases the privileged position of Gazprom and Rosneft
- Complicates the operations of private Russian oil companies, notably Lukoil and TNK-BP
- Introduces a new layer of bureaucracy.

The specific limitations on foreign investment now introduced are a result of a long tug-of-war between the 'security' bloc, which is suspicious of all foreign activity in Russia, and the 'economic bloc' who wants to encourage foreign investment. A first reading of the law suggests that the former has had the stronger influence. But the provisions of the law remain controversial. While most of the parliamentarians applauded the law, in its recommendations the Federation Council's committee on industrial policy warned that "an excessively strict control of [foreign investment] could reduce business activity in Russia and lead to a reduction of foreign investment in a number of sectors". The committee could not see why a number of activities, including usage of mineral resources of federal significance should be termed 'strategic'. It also argued that the provisions counteract the state's policy of attracting foreign investment and that it has a negative impact on Russia's image.

In the words of a senior official in Moscow: "Revisions can not be ruled out".