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# Russia

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## 1. Introduction

Russia is the world's largest transcontinental country, spanning 11 time zones.<sup>1</sup> It has played and continues to play a crucial role in the global energy and resources market. Its economy is primarily built on the exploitation of natural resources: Russia has the world's largest natural gas reserves,<sup>2</sup> second-largest coal reserves and eighth-largest oil reserves.<sup>3</sup> However, where resource development is concerned, Russia can prove to be a risky venture for foreign investors. Over the decades, the dynamics of energy have changed and Russia has struggled to adapt to the increasing emphasis on efficiency and green technologies. Thus, on the whole, it is now being left behind.

However, Russia is opportunistic. In light of the move away from more polluting fossil fuels, natural gas and liquefied natural gas (LNG) have been promoted as 'bridge fuels' to wean nations off their reliance on fossil fuels and invest in the development of renewables (although this approach is somewhat controversial).<sup>4</sup> Due to its large gas reserves, Russia is only too happy to meet this increased demand. However, changing dynamics have forced Russia to focus more on security of supply and the preservation of its status as an energy power.<sup>5</sup> This has required it to encourage the growth of further investment opportunities; and as such, the focus is now more on the protection of international oil companies (IOCs) from the risks associated with unstable and developing states (which can range from political to monetary – that is, taxes and other arbitrary economic penalties). To protect developing states from exploitation by IOCs, protection is afforded through the development of a regulatory framework for production sharing agreements (PSAs). In general, some of the more attractive features of the PSA include the following:

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- 1 Organisation for Economic Co-operation and Development (OECD), "Russian Federation – OECD Data" (2021), <https://data.oecd.org/russian-federation.htm>.
  - 2 Statista, "Global Natural Gas Reserves by Country 2020" (2021), [www.statista.com/statistics/265329/countries-with-the-largest-natural-gas-reserves](http://www.statista.com/statistics/265329/countries-with-the-largest-natural-gas-reserves).
  - 3 OECD, "Energy – Crude Oil Production – OECD Data" (2021), <https://data.oecd.org/energy/crude-oil-production.htm>.
  - 4 T Powell, "Calling natural gas a 'bridge fuel' is alarmingly deceptive" (Sightline Institute, 2019).
  - 5 C Sørensen and E Klimenko, *Emerging Chinese-Russian Cooperation in the Arctic* (Stockholm International Peace Research Institute, 2017), p16.

- The risks associated with exploration are borne by the IOC;
- The costs are recovered during the cost oil phase of production;
- The profit oil is then shared between the company and the state; and
- Further benefits can be drawn from profits and tax.

Compared to other resource-dependent states, Russia was comparatively late in its adoption of a PSA regime. However, since the early 1990s, it has adopted a comprehensive set of laws to encourage the conclusion of PSAs between the state and investors. The PSA regime applies similar standards to those utilised across the sector and affords protection against legal and political risks in order to justify large-scale investments. It was thought that these developments would play a part in shaping Russia as an energy power – even more so in the present day.

However, modern Russia is very different from the Russia of the 1990s, when the PSA regime was conceived. Politics and priorities have changed, and exports of natural gas have decreased – Russia is now the world’s fourth-largest exporter of LNG. As it copes with changing dynamics and seeks to maintain its status as an energy power, Russia has welcomed the growing economic influence of China – in particular, in the form of the ‘Belt Road’ initiative and increased economic cooperation in the Arctic through projects such as Yamal LNG, designed to meet China’s growing energy demand, and to increase its energy mix and wean the state off its over-reliance on coal.<sup>6</sup> In November 2017, Novatek – one of the largest independent natural gas producers in Russia – signed a strategic cooperation agreement with the Chinese National Petroleum Company, which owns 20% of Yamal LNG. Production in 2019 was expected to be around 16.5 million tons;<sup>7</sup> however, it exceeded this by 11%, with 18.4 million tons of LNG produced.<sup>8</sup> Yamal LNG was not expected to operate at full capacity until late 2020; and although the outbreak of the COVID-19 pandemic and the stalemate between the Organization of the Petroleum Exporting Countries and Russia proved to be significant economic obstacles, it ultimately exceeded this goal.<sup>9</sup>

It would seem that overall, since the 1990s, the PSA has fallen out of favour in Russia. As it has been used in few projects to date, its relevance is dwindling. However, the PSA regime and its implementation serve as proof that Russia still has a unique ability to adapt to the changing dynamics of the industry.

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6 Yamal LNG shareholders include PAO NOVATEK (50.1%), Total (20%), CNPC (20%) and the Silk Road Fund (9.9%).

7 Novatek, “Novatek and the Silk Road Fund Conclude Framework Agreement on an acquisition of a stake in Yamal LNG” (2019), [www.novatek.ru/en/press/releases/index.php?id.4=984](http://www.novatek.ru/en/press/releases/index.php?id.4=984).

8 M Schuler, “Yamal LNG Crushes output capacity in 2019”, GCaptain (2020), <https://gcaptain.com/yamal-lng-crushes-output-capacity-in-2019/>.

9 A Cooper, “Energy Development in the Russian Arctic: Examining the Russian Energy Strategy and the Development of the Northern Sea Route in the Context of Geopolitical competition”, *Oil, Gas and Energy Law* (2021), [www.ogel.org/article.asp?key=3947](http://www.ogel.org/article.asp?key=3947).

## 2. **Scope and structure of the PSA**

In Russia, at its core, the exploitation of natural resources is based on the Constitution of the Russian Federation.<sup>10</sup> At least in theory, PSAs are one of the more favourable methods of regulating petroleum development. Nearly every country has a legal and administrative framework which regulates agreements such as PSAs.<sup>11</sup> In Russia, since the early 1990s, three main instruments have been developed which constitute the framework for the exploitation of natural resources (although the focus here is on the PSA):

- the Subsoil Law 1992;
- the PSA Law 1995; and
- the Law on the Gas Supply in the Russian Federation 1999.

The PSA Law is the main focus of this chapter, as it established a special regime for PSAs. In place since 1996, the law marked a leap forward for the former socialist economy.<sup>12</sup> This introduced a degree of legal certainty for foreign investors, which had historically viewed Russia as unstable due to its shifting political dynamics and ever-changing legislation. This was especially the case as the adoption of the PSA afforded more advantages to foreign investors than the previous method of regulation under mineral licences. Mineral licences in Russia were vulnerable because no protections were afforded against future changes in law, bureaucratic whim and political volatility. Because of how Russia regulates its petroleum activities, investors could find themselves caught in the crossfire both between the regions and within the state itself. Therefore, for foreign investors, insulation from this volatility made Russia a more attractive prospect.

However, there were substantial delays in the enactment of additional legislation and the state subsequently adopted what seemed to be an unfavourable approach to the PSA. Very few projects have since proceeded on production sharing terms. Since 1993, only the Sakhalin-1, Kharyaga and Sakhalin-2 PSAs have been agreed. In 1995, the law was harmonised and it was agreed that PSAs would be treated under Russian law as civil law contracts subject to a special statutory regime entered into between the Russian Federation and the investor(s). This was a significant step forward in the reform of the Russian energy markets, which are a vital part of the Russian economy. Still, even with this legislation in place and the potential clarity afforded by the adoption of the PSA regime, Russian PSAs have primarily been reserved for remote regions only and have thus been all but killed off, apart from the legacy fields.

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10 Specifically, Article 24 of the Russian Law on the Production Sharing Contracts.

11 Although there is no uniform approach, there are commonly agreed standards that are implemented in order to achieve a degree of protection for foreign investors.

12 T Walde and M Freidrich, "Russian Federation: Law on Production Sharing Agreements", *International Legal Material* 35(5) 1996.

### 3. Main features of the PSA

In Russia, the development of the PSA was influenced by international standards which are common throughout the sector. In essence, these aim to protect investors which are seeking assurances that any payments made to the state will not be subject to any arbitrary decisions or influences – that is, they will not be altered or amended in the future. However, these international norms were not exactly replicated in Russian law. Nevertheless, the PSAs concluded in Russia have some features to consider and lessons can be learned from them. The PSA Law contains three chapters comprising 26 articles; and while there are similarities with international standards, there are also certain unique features, some of which are tailored to the Russian environment. These changes must be taken into account by investing IOCs to ensure the feasibility of a venture.

A PSA is entered into between the IOC and the Russian Federation using the ‘one box, two key’ procedure.<sup>13</sup> This procedure was previously used for joint licensing under the Subsoil Law.<sup>14</sup> This is where the production sharing licence and the PSA diverge from international norms. Under the Russian PSA regime, once an agreement has been reached, the operator both obtains the mineral rights and has a contract with the government. This is defined under Article 2(1) of the PSA Law as follows:

*The production sharing agreement (hereinafter the agreement) shall be an agreement under which the Russian Federation shall grant to the subject of entrepreneurial activity (herein the investor), on a chargeable basis and for a specified period exclusions rights to prospect, explore for and extract mineral raw materials in the subsoil plot specified in the agreement and to perform operations connected therewith, where the investor shall determine all necessary terms and conditions connected with the subsoil use including terms and conditions of and procedure for sharing the extracted products between the parties to the agreement in accordance with the provisions of the present Law.*

This places an emphasis on civil law and thus reduces the PSA to a simple contract – the preferred option for investors, as opposed to the administrative approach, which is subject to wider governmental control and potential interference. This emphasis on civil law (while unclear) is favourable to foreign investors, even though it creates a ‘*lex specialis*’ with a claim for precedence over all past and future legislation.<sup>15</sup> Therefore, if there is any need for a claim to be made on the basis of the contract, for this to succeed, a degree of political agreement is still required, which can be difficult to achieve.<sup>16</sup> Section 1(1) of the general provisions specifies the areas in which the PSA Law will take

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13 Referring to the agreement on one hand, and then to the Russian authorities on the other.

14 Article 2-4 of the Subsoil Law.

15 With reference to Article 1(4) of the PSA Law.

16 Walde and Freidrich (n 12).

precedence in the event of any disagreements. This is an unusual characteristic within a contractual arrangement, which illustrates the dominance of the PSA Law insofar as the implementation, conclusion and termination of the agreement are concerned. This gives the added benefit of insulation from Russian administrative interference. Further, some protection is offered in the form of one of the 'safety nets' set out Article 1(4), which states that: "legal acts of the Russian Federation set rules other than those provided for by the present Law, the rules of the present Law shall apply to the domain of the regulation of relations specified in para. 1 of the present Article."

However, regardless of these contractual protections, Russia's energy politics can be difficult to navigate for foreign investors and the expectations can be very different from the realities of operating in the country. For all the benefits afforded at the international level, Russian PSAs are a very different beast from the international norm. Although the PSAs aim to protect investors, Russia has proved reluctant to completely relinquish its control and influence. For example, it still regards the Sakhalin-2 development as being detrimental to the Russian state.

Sakhalin-2 was one of the earliest PSAs to be concluded – the initial exploration phases were set at 25 years, which could have been extended if, upon further exploration, more economically viable discoveries were identified. This somewhat unusual extension feature is more reflective of the oil concession contracts to be found in Middle Eastern states. Further, all proceeds from oil and gas sales are treated as cost oil until the operator has received its capital investment and an internal rate of return. Thereafter, the operator (in the case of the Sakhalin-2 PSA, Sakhalin Energy Investment Company Ltd (SEIC)) receives 10% of the hydrocarbons for the following two years. Once these two years have elapsed, the Russian party to the agreement receives 50% of the hydrocarbons until SEIC has received 24% of the profits; thereafter, 70% of the hydrocarbons are shifted to the Russian party. These particular features showcase exactly why the Russian Federation has had a less than favourable view of PSAs. The architecture of the PSA is constructed in such a way that if there is any cost overrun, it will fall upon the state to address this issue. This is characteristic of Russia, in that the state and the PSA itself are still highly politicised. As such, the state can still push for more domestic involvement and investment without the necessary fair competition rules in place. This is further reflected in the domestic preference rule, which is highly questionable under existing international law.<sup>17</sup>

Since 2003, further amendments to the PSA legal framework have meant that this model is essentially restricted to use in remote regions, essentially relegating the value of the PSA within the Russian energy system because of the

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17 Specifically, the Energy Charter Treaty and the World Trade Organization Rules.

resulting economic detriment to the Russian state. However, in these circumstances, Russia can still benefit from transfers of technology: Russia still hopes to use the PSA as a means of generating investment in Russian companies throughout the production cycle. However, as the PSA will only be used in frontier situations, whether investors will still seek to venture into Russia remains to be seen.

#### **4. The role of the competent authority**

The Ministry of Natural Resources and Environment<sup>18</sup> is the executive body responsible for drafting and implementing government policy relating to natural resources (including water bodies, woodlands, flora and fauna). Where minerals and natural resources are concerned, it also implements government policies and develops regulations in the fuel and energy industry, including in relation to:

- oil and gas development;
- refining;
- trunk oil;
- oil products and gas pipelines;
- the development of hydrocarbons on the basis of PSAs; and
- petrochemicals.

Actual operations and development are overseen by the ministry; while environmental matters are overseen by the Federal Environmental, Industrial and Nuclear Supervision Service. There is a perception that the minister of energy has a certain degree of influence in this position, as the minister frequently features in the global media in relation to Russia's efforts to stabilise the global oil market and balance oil prices. However, the ministry's powers in relation to the oil and gas sector are limited primarily to controlling the fuel and energy balance of Russia and its regions, and overseeing the development of gas supply programmes and gasification plans.

#### **5. Analysis of the main clauses of the contract**

##### **5.1 Exploration, development and commercial discovery**

The exploration and development phases of the PSA state that the costs are borne by the foreign investor and are subsequently recovered from the cost oil. When the initial phases of development and exploration take place, the costs are recovered from the cost oil profits (which are usually taxed at a favourable rate). This is usually appropriate in developing states that lack a comprehensive tax system, but this is not the case for Russia. Russia has a comprehensive

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18 [www.mnr.gov.ru/en/](http://www.mnr.gov.ru/en/).



finance system; and investors are often invited to operate in fields which have proven reserves, which reduces the exploration costs.

Article 7(2) of the PSA provides that: “The investor, within the framework for the fulfilment of works under the agreement, shall have the right to construct facilities for the storage, processing and transportation of mineral raw material, the title to which shall be determined...” In this case, the fields will contain proven reserves and thus there will be no need for extensive exploration and commercial discovery works. Further, with reference to Article 7(2), any works carried out must be in line with general international practice. Primarily, when fields are developed, three main regulations must be adhered to:

- the Safety Regulations for the Oil and Gas Industry;<sup>19</sup>
- the Safety Regulations for Complex Offshore Oil and Gas Facilities;<sup>20</sup> and
- the Industrial Safety Regulations for Oil Processing Works.<sup>21</sup>

In terms of the standards that must be adhered to during these phases from a health and safety perspective, it is perhaps a stereotype that Russian health and safety standards are not strictly observed. However, in general, the provisions in the contracts have moved towards a risk-based system, resulting in stronger adherence to the standards outlined in the provisions. Further, the fines levied for breaches of health and safety standards can be quite steep.

*This is an extract from the chapter ‘Russia’ by Aaron M Cooper in Production Sharing Agreements: A Global Legal Handbook, published by Globe Law and Business.*

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19 Adopted by the Federal Service for Environmental, Technological and Nuclear Supervision in 2013.

20 Adopted by the Federal Environmental, Industrial and Nuclear Supervision Service in 2014.

21 Adopted by the Federal Mining and Industrial Inspectorate in 2016.