

# ClientInsight

2011 Legislative Year-in-Review

## Russia Energy & Natural Resources

This 2011 Legal Year-in-Review has been prepared by White & Case's Moscow Energy Team for our clients and friends to give you an overview of 2011's principal legislative developments affecting the Russian energy & natural resources sectors.

In this review ("Review") you will find spotlight articles covering:

- New Rules for the Wholesale Power (Capacity) Market in Russia;
- Recent Amendments to the Strategic Investments Law Affecting Subsoil Use; and
- The Kyoto Protocol: New Rules for Approving Joint Implementation Projects in Russia.

We have also included short updates on some additional legislative changes that occurred in the energy & natural resources sectors in 2011.

We hope you find this Review informative. We wish you and your company a very successful 2012.

### Spotlight Articles

#### Power

##### New Regulation on Russian Capacity Market

At the beginning of 2011, new rules relating to long-term capacity markets were launched in Russia; these rules were approved by Government Resolution No. 89, dated 24 February 2010 (the "Rules"). The adoption of these Rules is regarded as a significant development in the legislative basis of the Russian power sector, insofar as they give greater certainty to potential investors in new generation capacity.

##### Background

The Rules took effect as amendments to Government Resolution No. 643 approving wholesale market rules dated 24 October 2003. This Resolution was eventually replaced by Government Resolution No. 1172, dated 27 December 2010 on the same matter ("Wholesale Market Rules").

The Rules are among the key pieces of legislation relating to the final stages of liberalisation of the Russian power market.

### In This Review...

- New Rules for the Wholesale Power (Capacity) Market in Russia
- Recent Amendments to the Strategic Investments Law Effecting Subsoil Use
- The Kyoto Protocol: New Rules for Approving Joint Implementation Projects in Russia

For more information, please contact:

#### Igor Ostapets

Partner

[iostapets@whitecase.com](mailto:iostapets@whitecase.com)

#### Adam Smith

Counsel

[asmith@whitecase.com](mailto:asmith@whitecase.com)

White & Case LLC  
Tel + 7 495 787 3000  
Fax + 7 495 787 3001  
[whitecase.com](http://whitecase.com)

### Capacity Tenders

The centrepiece in the long-term capacity regime is a system of annual tenders for the procurement of capacity to meet expected demand for power in the coming years. The tender system, operated by the System Operator, is open to participants of the wholesale market in respect of both existing capacity and capacity yet to be constructed. With effect from 2012, capacity tenders will be performed annually before 1 December for the supply of capacity from 1 January in the fifth year after the date of the tender (so to give a four-year lead time for the completion of newly built projects, where relevant).

The quantity of capacity to be procured under the tender process is determined separately for each zone of free cross flow ("ZFC"), this being zones within which market participants can buy and sell capacity and is based on a forecast of demand for power for the first year of the period of supply covered by the tender adjusted upwards by applying a reserve coefficient.

Participants are able to submit bids in respect of all existing or planned generator blocks. The tender is conducted separately for each ZFC. Bids are selected by the System Operator normally on the basis of price (the capacity payment bid). As a result of this selection process, a single capacity price is established for each ZFC by reference to the marginal (most expensive) unit of capacity required to meet demand.

In addition to the regular annual tenders, it is possible for the System Operator to hold further annual tenders on shorter lead times in order to procure additional quantities of capacity where needed to adjust for changes in circumstances.

Generators which were not selected under the results of the capacity tenders will not receive capacity payments and will be able to sell electricity only. In this case an owner of such generating facility may decide to decommission it unless the facility is proved to be essential to system stability.

### Capacity entitled to payments independently of the tender system

Certain types of generators are entitled to capacity payments independently of the tender process. These include hydroelectric, nuclear generators and power stations whose position in the network renders them essential to system stability. The quantities of capacity provided by such generators in each ZFC are taken into account in determining how much capacity from other sources is required under the tender process.

### Agreements for the Delivery of Capacity

Apart from the tender, the Russian regime has also an additional measure to encourage the construction of new thermal generation capacity in the form of Agreements for Delivery Capacity ("ADCs") to be entered into with the existing thermal generators spun off from RAO UES (OGKs and T GKs).

### Buyer's Obligation to Buy Capacity

Buyers on the wholesale market must collectively meet the capacity payments due to all generators qualifying to receive them, including those selected through the tender, those guaranteed payment outside of the tender system and those delivering capacity under ADCs throughout various mechanisms by which the buyer can fulfil its capacity purchase obligation, in particular, including discussed above.

### Subsoil

#### Liberalization of rules for accessing the strategic subsoil sector in Russia

In November 2011, the Russian President signed into law significant amendments to Russian legislation on foreign investments. The amendments remove certain administrative barriers to foreign investors in Russia's national sensitive assets in order to prompt larger foreign investments, including in the natural resources sector. The amendments entered into force on 18 December 2011.

#### Background

In May 2008, the outgoing President Putin signed into law a new piece of legislation, Federal Law No. 57-FZ "On Foreign Investments into Entities Having Strategic Importance" ("Strategic Investments Law") and related amendments to Law No. 2395-1 "On Subsoil", which imposed restrictions on the exercise of foreign investments into sectors of strategic importance for the Russian economy and security and introduced special procedures for the acquisition of control over companies performing strategic activities, including geological studies of subsoil deposits, and/or exploration and production of natural resources of subsoil deposits of federal significance ("Strategic Deposits").

Although there is an official list of the deposits recognized as Strategic Deposits, the following subsoil plots are deemed to be Strategic Deposits, regardless of whether or not they have been included in such list:

those containing deposits of uranium, diamonds, extra pure raw quartz, rare earths of the yttrium group, nickel, cobalt, tantalum, niobium, beryllium, lithium and the platinum group of metals (irrespective of the amount of reserves contained therein);

those containing recoverable oil reserves of no less than 70 million tonnes; gas reserves of no less than 50 billion cubic metres; vein gold reserves of no less than 50 tonnes; and copper reserves of no less than 500,000 tonnes;

those located within the internal waters, territorial sea and on the continental shelf of the Russian Federation; or those for the use of which it is necessary to use land plots designated for defence or security purposes.

Under the Strategic Investments Law, any transaction entered into by a foreign investor (also meaning a group that includes such foreign investor) resulting in the establishment of "control" over a Russian company that has the right to develop the Strategic Deposit (the "Strategic Subsoil User"), requires prior consent of the Governmental Commission chaired by the Russian Prime Minister.

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## Effect of the Recent Amendments

### *Definition of "Control"*

Following the amendments to the Strategic Investments Law, the threshold used to define foreign "control" over the Strategic Subsoil User has been increased from 10% to 25%. It means that "control" will be considered established if a foreign investor:

directly or indirectly controls 25% or more of the voting shares (participatory interests) in the charter capital of the Strategic Subsoil User;

has the right to determine decisions of the Strategic Subsoil User, including determining the terms of its business operations;

has the right to appoint the sole executive body or 25% or more of the members of the collegiate executive body (management board) of the Strategic Subsoil User and/or has an unconditional ability to procure the election of more than 25% of the members of the board of directors (supervisory board) or other collegiate management body of the Strategic Subsoil User; or acts as a management company for the Strategic Subsoil User.

While foreign states, international organizations (except for international financial organizations established under international treaties to which Russia is a party) or organizations controlled by any of those (e.g., a state energy company) must still obtain consent of the Governmental Commission for the acquisition of more than 5% of the voting shares (participatory interests) in the Strategic Subsoil User, they are also allowed to acquire up to 25% (as opposed to previous threshold of 10% or more) of the voting shares in the Strategic Subsoil User.

### *Russian Beneficiaries*

Following the amendments, the Strategic Investments Law shall no longer apply to transactions between entities controlled by the Russian Federation or Russian citizens if such citizens are Russian tax residents and do not have double citizenship. Before the amendments entered into force, such entities were required to receive Governmental Commission consent if they were acting through their offshore holding structures. This long-awaited amendment removes excessive regulatory barriers to transactions performed by Russian investors and significantly reduces the number of transactions subject to approval by the Governmental Commission in general.

### *Additionally Issued Shares*

The amendments also explicitly exempt acquisition of shares (participatory interests) in the Strategic Subsoil User from the requirement to obtain consent of the Governmental Commission if, as a result of such transaction, a foreign investor's share in the Strategic Subsoil User's capital has not actually increased (e.g., additional share issue).

## Kyoto Protocol

### New procedure for approving Joint Implementation projects in Russia

The approval process for joint implementation projects ("JI Projects") in Russia, carried out in accordance with Article 6 of the Kyoto Protocol to the United Nations Framework Convention on Climate Change has been changed for the third time since 2007. To make full use of the possibilities offered by the JI mechanism before the end of the first compliance period of the Kyoto Protocol (2008-2012), on 15 September 2011 the Russian Government issued Resolution No. 780 with the intention of simplifying the procedure of reviewing and approving JI Projects in Russia ("Resolution").

The new legal framework no longer provides for a lengthy tender procedure for approving JI Projects. Instead of a tender, carbon units are to be issued on an ongoing basis. The new rules also imply that there will be no more emission reduction units ("ERUs") limit for JI Projects registration but only the aggregate amount of ERUs set for the first compliance period. In particular, under the Resolution the maximum amount of ERUs that can be generated from JI Projects until the end of 2012 is 300 million tons of equivalent carbon dioxide.

The new procedure is not only administrated by Sberbank and the Ministry of Economic Development ("MED") but also involves the participation of the Ministry of Natural Resources and Environment ("MNR"). While the approval of the JI Projects selected by Sberbank is awarded by MED, MNR monitors JI Projects' implementation process (previously this was MED's responsibility). In certain cases listed in the Resolution, MNR has the right to request MED to annul the approval of the JI Project.

The Resolution also, for the first time officially requires the investors until 2020 to reinvest the revenue earned from the implementation of the JI Project into projects to improve energy and ecological efficiency. Such intentions shall be reflected in an investment declaration, which shall be submitted along with other documentation required for the application.

In addition, new rules expand Sberbank's authority in relation to the implementation of JI Projects. In particular, under the Resolution, Sberbank shall act as a third party to the agreement for the transfer of ERUs, generated from the JI Project, from an investor to a foreign purchaser. ERUs are transferred against payments on the carbon accounts of a foreign purchaser providing cash compensation to be credited to the investor's income and its account with Sberbank.

## Legislative Update Briefs

### Subsoil

On 25 January 2011 the MNR issued Order No. 16 amending the procedure for reviewing applications for a short-term (less than one year) right to subsoil use which was previously envisaged by MNR Order No. 22 dated 22 January 2005. Pursuant to the Law "On Subsoil", the right of a subsoil user can be terminated before the term of its subsoil license expires. In this case, the Federal Agency for Subsoil Use ("Rosnedra") may decide to grant a short-term right of subsoil use to a new operator on the basis of an application. The Order now also authorizes Rosnedra's territorial departments to adopt such decisions. In addition, Rosnedra will have no right to request additional documents from an applicant to clarify data reflected in the application.

On 14 February 2011 MNR issued Order No. 33 amending the procedure for the use of state geological information on subsoil, envisaged by MNR Order No. 340, dated 12 December 2005. Payments for the use of geological information were abolished starting from 1 January 2011. The Order specifies that subsoil users may submit the application for obtaining such information not only to Rosnedra and its territorial departments, but also to subordinate organizations (provided that the applicant is aware which organization disposes of such information). The list of such organizations is available on Rosnedra's official website ([www.rosnedra.com](http://www.rosnedra.com)).

On 5 April 2011 the President signed Federal Law No. 45-FZ amending the Law "On Subsoil" in relation to the production of commonly occurring natural resources ("CONRs"). The Law simplifies the procedure for the production of CONRs and underground waters. Under the Law, subsoil users conducting exploration and production of natural resources or geological study, exploration and production of natural resources under a combined license, have the right to produce CNRs and underground waters for their needs, in accordance with the approved technical project, not only within mining allotments but also within geological allotments. Before the amendments entered into force, subsoil users could produce CONRs and underground waters within granted mining allotments. Furthermore, the subsoil use rights for the production of CONRs beyond such mining allotments could be only granted on the basis of an auction.

On 14 June 2011 the President signed Federal Law No. 137-FZ amending the Forest Code in relation to subsoil use in protection forests. Before the amendments, the placement of facilities of capital construction, except linear facilities (e.g., pipelines) and hydrotechnical facilities within protection forests was prohibited. At the same time the use of protection forests for subsoil operations was allowed. However, mining excavations and drilling wells, necessary for conducting subsoil operations, are recognized as facilities of capital construction. For these purposes, the amendments allow the placement of mining excavations and drilling wells, in particular in forests within water protection zones and within forest protection belts along bodies of water which belong to a sub-category of protection forests.

On 30 November 2011 the President signed Federal Law No. 364-FZ amending the Law "On Subsoil" in relation to subsoil plots of local importance. According to the Law "On Subsoil", the powers for allocation of subsoil plots of local importance fall under the joint jurisdiction of federal and regional authorities. However, the criteria for allocation and the procedure for granting such plots have not been established. The amendments specify that subsoil plots of local importance include subsoil plots containing CONRs and those used for the construction and use of underground facilities of local importance not related to the production of natural resources. The amendments also authorize regional authorities to grant such plots for use provided a prior approval of Rosnedra or its territorial departments is obtained.

### Energy

On 17 February 2011 the Government issued Resolution No. 90 approving the procedure for accessing trunk oil pipelines in Russia by oil production facilities aimed at ensuring non-discriminatory access. In particular, access is granted on the basis of an application, submitted by a company to the owner of the pipeline, to issue technical terms required for granting access. If the company meets these technical terms, the parties will sign an agreement which grants access. The Resolution also approves the procedure for maintaining a register of companies involved in oil production which is maintained by the Ministry of Energy.

On 29 March 2011 the Government issued Resolution No. 218 establishing the rules for accessing trunk pipelines for the transportation of oil and refined products. The rules represent a slightly updated version of the existing procedure to ensure oil producers non-discriminatory access to the trunk pipelines controlled by natural monopolies for the transportation of oil (petroleum products). Access is granted on the basis of an agreement between the monopolies and the consumers. In cases where the pipeline network has limited capacity, oil (petroleum products) supply is to be assured to the domestic market first and only then for exports. In addition, upon the monopolies' consent consumers are entitled to revise the agreed oil supply volumes and transfer (assign) their access rights to legal entities specified in the Resolution.

On 4 May 2011 the President signed Federal Law No. 99-FZ "On Licensing of Certain Types of Activities" which replaced Federal Law No. 128-FZ, dated 8 August 2001 on the same matter. The Law is noted particularly for establishing a new uniform procedure for the licensing of certain types of activities including the procedure for filing applications, the adoption of decisions on the issuing of licenses, as well as organizing licensing control. It also reduces a list of activities subject to licensing. In addition, under the Law licenses are issued for an indefinite term, including certain operating licenses in the energy sector (e.g., a license for conducting a mining survey) whereas, according to prior regulation, licenses could not be issued for a term of less than five years. Newly issued licenses will be valid indefinitely, while licenses issued prior to the entry of the Law into force for activities listed in the Law will, from the date of its enactment, become valid for an indefinite term. Licenses issued before the entry of the Law into force should be re-issued upon their expiration date if the description of the licensed activity changed. Re-issued licenses will also be valid for an indefinite term.

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On 21 July 2011 the President signed Federal Law No. 256-FZ "On Safety of Fuel and Energy Complex Facilities". The Law establishes the legal framework to ensure the safety of fuel and energy complex facilities in Russia, except for nuclear energy facilities, to prevent illegal interference. The particular focus is on linear facilities (e.g. pipelines) and the gas supply system. The Law also defines the powers of the relevant federal and regional authorities in this sphere as well as the rights, obligations and liability of legal entities which own or possess such facilities.

On 3 December 2011 the President signed Federal Law No. 382-FZ "On the State Information System of the Fuel and Energy Complex". This Law sets out a legal framework for the establishment and use of a state information system of the fuel and energy complex ("FEC"). The system aims at assuring an information exchange between state authorities and energy companies in order to develop an efficient state policy and legal framework for regulating the FEC. The operator of the information system is the Ministry of Energy. The Law, in particular, lists information energy companies must submit for such purposes including information on the quality of energy resources, volumes of their production and transportation, tariffs and prices, environmental aspects of the companies' operation, etc. Breach of this rule entails liability. The detailed procedure for the establishment and use of the information system of FEC, submission of this information to the system and access to such information will be established by the Government.

## Energy efficiency

On 25 April 2011 the Government issued Resolution No. 318 on the enforcement of organizations' compliance with legislative requirements on energy saving and energy efficiency. Pursuant to the Federal Law "On Energy Saving and Increasing Energy Efficiency", the Resolution establishes the procedure for implementing state control over organizations' compliance with legislative requirements on energy saving and increasing energy efficiency. State control is executed by means of scheduled and non-scheduled inspections carried out by the relevant federal or regional authorities. The Resolution sets out the procedure for conducting such inspections and the legal framework for their performance.

## Electric Power

On 6 December 2011 the President signed Federal Law No. 394-FZ amending the Federal Law "On the Electric Power Industry". The Law aims to improve mechanisms for the state regulation of prices of electric power (capacity) on the wholesale power (capacity) market. In particular, it specifies a procedure for calculating payments for electric power (capacity) by OJSC "Administrator of the Trading System of the Wholesale Electricity Market". The Law also specifies a regime for tariff regulation, including within "non-pricing" zones, for imports and exports of electric power (capacity). In addition, the Law specifies a procedure for cooperation between JSC Federal Grid Company of the Unified Energy System ("JSC FGC UES"), the manager of the unified national (all-Russia) power grid ("UNPG") and companies owning or possessing facilities forming part of the UNPG. The Law establishes JSC FGC UES's pre-emptive right to purchase such facilities if the owners decide to sell them, and defines the procedure for the exercise of such right.

## Environmental

On 22 December 2010 the MNR issued Order No. 558 amending the procedure for the development and approval of draft plans reflecting proposed volumes for waste generation and limits for their disposal. Following the recent legislative amendments, certain powers of the Federal Service on Ecological, Technological and Nuclear Supervision in relation to waste management have been transferred to the Federal Service for Supervision of Natural Resources Use ("Rosprirodnadzor"). The Order introduces the respective amendments to Order of the MNR No. 50, dated 25 February 2010, providing that Rosprirodnadzor is now the state body authorized to approve the respective draft plans and limits for waste disposal.

On 31 December 2010 the Ministry of Natural Resources issued Order No. 579 approving the procedure for identifying sources of air pollution subject to state registration and emission level approval pursuant to the Law on Air Protection. These sources are identified on the basis of an inventory of air pollution in relation to existing industrial facilities and on the basis of project documentation in relation to industrial facilities being put into operation and (or) under reconstruction. A list of air polluting substances subject to state registration and emission level approval is also established.

On 10 June 2011 the Federal Forestry Agency issued Order No. 223 approving the rules for the use of forest for (re) construction and the use of linear facilities. Following recent amendments to the Forest Code, the Order represents an updated version of the rules for using the forest for construction, reconstruction and use of electric power transmission lines, communication lines, roads, pipelines and other linear facilities approved by Order of the Ministry of Agriculture No. 28, dated 5 February 2011. The rules specify obligations of legal entities which own or possess such linear facilities to ensure their safe use and operation.

On 21 November 2011 the President signed Federal Law No. 331-FZ on the establishment of a unified state ecological monitoring system. The Law primarily amends the Federal Law "On Environmental Protection" with the intent to increase effectiveness of the state ecological monitoring management in Russia. The Law proposes to establish a unified monitoring system to include all existing types of monitoring in the sphere of environmental protection (e.g., air, forest, land, subsoil, radiation conditions). Information support for the system will be achieved by introducing a unified state monitoring database. The database will contain information on the state of the environment and the results of state control and registration of facilities adversely affecting it. This information may then be provided to legal entities for the purposes of planning and performance of their business activities.