

# Oil & Gas NewsWire

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## Welcome to the Inaugural Issue of Chadbourne & Parke's Oil & Gas NewsWire!

Dear Reader,

Chadbourne & Parke is an international law firm with a long and diverse history of representing clients in the oil & gas industry. The six articles in this first edition of the *Oil & Gas NewsWire* reflect the breadth of this experience and the seriousness with which Chadbourne attorneys treat the legal developments that impact our clients' investments. Read further, and you will find that in these pages:

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## Welcome

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- **Jaroslawa Johnson**, the managing partner of Chadbourne's Kyiv office, and **Yevhen Fedorchenko**, an associate in Kyiv, walk us through Ukraine's harmonization of its energy legislation with EU energy law and policy concerning energy efficiency and security, thus paving the way for greater investment in Ukraine's gas industry and its effective linkage with the European energy system.
- **Victor Mokrousov**, an international partner in our Almaty office, and **Alexandra Neovius**, an associate in London, analyze how the key changes in Kazakhstan's new Subsoil Law differ from the previous regulatory regime in terms of stabilization, the pre-emptive right of the state, and stricter local content requirements, and the impact these changes will have upon oil & gas investors.

We hope you will find these articles informative and useful. Please give us your feedback—and for those of you not already on our mailing list who wish to receive this publication on a regular basis, please let us know. We welcome the opportunity to share our ideas pertaining to the globally significant and commercially vital legal developments which impact upon oil & gas investment throughout the world.

*Kenneth E. Mack*

PARTNER, HEAD OF OIL & GAS PRACTICE GROUP

# China Develops Unconventional Gas Potential

*By Chris Flood*

A recent upsurge in activity in China's unconventional gas sector is providing opportunities for Chinese and foreign oil & gas players both within China and overseas. The implications of these new developments are significant for companies active in the unconventional gas sector. In addition, considerable increases in domestic unconventional gas production may result in more limited opportunities in the coming years for LNG suppliers to secure long-term supply contracts with China, according to a recent report.

Since late 2009, Chinese, American and European oil firms have announced a number of new partnerships aimed at exploiting China's vast, but undeveloped, unconventional gas resources. In some cases, the development of these resources is occurring directly, through joint exploration and development projects, and in others, it is occurring indirectly by way of technological cooperation in overseas projects.

In both cases, the objective of the Chinese partners has been to team with international firms with experience in developing technologically demanding unconventional gas projects. Through this type of cooperation, the Chinese firms hope to jumpstart the development of the domestic industry, which is expected to grow from its current fledgling state to play a significant role in China's energy future.

The following are examples of some of the recent transactions:

- In March 2010, Shell signed a 30-year production sharing contract with China National Petroleum Corporation (CNPC) to develop tight gas and shale gas in two separate 4,000-square-kilometer blocks in Sichuan province. Shell is already involved with PetroChina, CNPC's overseas-listed subsidiary, in a tight gas block in Changbei, Shaanxi province, that is currently in production.
- In July, PetroChina announced that it had agreed to cooperate with BP in developing a coalbed methane (CBM) project in the Tuha basin located in Xingjiang Uighur Autonomous Region. BP has also reportedly been discussing cooperation with Sinopec on shale gas in Guizhou and Jiangsu provinces.

- Also in July, media reports indicated that ExxonMobil was in talks with PetroChina to jointly explore and develop a tight gas block in the Erdos basin. In September, Chevron CEO John Watson confirmed talks were underway with Sinopec to develop shale gas in China. Other Western majors involved in domestic Chinese unconventional gas development have included Total and ConocoPhillips, and more cooperation can be expected as China prepares to auction six new shale gas exploration blocks to domestic producers this month.
- In terms of Chinese oil companies' efforts to acquire experience in overseas shale gas projects, this November, CNOOC Ltd., the overseas-listed subsidiary of China National Offshore Oil Corporation, closed a US\$2.16 billion investment in a Texas shale gas project operated by Chesapeake Energy. In addition, in June 2010, CNPC signed a heads of agreement with EnCana to jointly develop shale gas reserves in British Columbia. As with the CNOOC-Chesapeake Energy joint venture, the partnership will involve EnCana acting as operator of the projects, with CNPC providing financing and acquiring technological know-how in return.
- In another international move to acquire technology, Shell and PetroChina made a successful US\$3.2 billion joint bid in March 2010 for Australia's Arrow Energy, a developer of coal seam gas assets. PetroChina has indicated it intends to use Arrow's institutional capability in developing unconventional gas in Australia and apply it to projects in China. More recently in Australia, China National Offshore Oil Corporation this month announced an investment in a series of coal seam gas blocks in its first overseas onshore unconventional gas investment to date.

## Market Development

A series of interrelated factors has acted as a catalyst for this recent development of the unconventional gas sector in China, including surging domestic demand for natural gas resulting from rapid development, increased concern within the Chinese government over energy security and a new emphasis on reducing the carbon intensity of energy sources. Demand has outstripped supply by so much that recent years have seen disruptive winter gas shortages, and more shortages are predicted until a more reliable supply of gas is made available.

Despite the current periodic regional shortages, the Chinese government is reportedly considering increasing the proportion of total energy consumption accounted for by natural gas from

the current 4%, to 8% by 2015 and 10% by 2020. This translates into overall demand of 200 billion cubic meters (bcm) by 2020, which will put significant additional pressure on producers to increase domestic supply. In terms of targets on the supply side, China's Ministry of Land and Resources (MLR) has set a deadline of 2020 for the identification of 50 to 80 shale gas prospects and 20 to 30 exploration blocks.

This increase in natural gas consumption is expected to be partially offset by an increase in natural gas imports by estimates ranging from 33% to 50% by 2020. However, Chinese policymakers are mindful of the broader policy goal of strengthening China's energy security and these projected increases are creating a strong incentive among them to secure long-term natural gas supplies from overseas and increase investment in and development of China's domestic unconventional gas resources, which are estimated to be at least five times larger than its conventional gas reserves, or 30 trillion cubic meters, according to some estimates. In a recent report, consultancy Wood Mackenzie estimates that by 2030, gas from unconventional domestic sources will account for 25% of total Chinese gas supply.

To achieve its overall consumption goals, China has been actively acquiring long-term gas supply commitments from a variety of countries, including Australia, Indonesia, Turkmenistan and Qatar, and more such commitments are reportedly in the works. It has also invested heavily to strengthen natural gas transportation and distribution links such as pipelines and LNG terminals.

Compared with ensuring access to overseas natural gas supplies, however, the development of China's domestic unconventional resources is at a very early stage, despite its enormous potential. By way of illustration, CNPC has forecast that by 2020, CBM will account for about 20 to 30 bcm of domestic supply and that shale gas will account for 2 bcm. By comparison, only approximately 2 bcm of CBM is expected to be produced this year domestically and no shale gas deposits are currently in commercial production. Similarly, the MLR has targeted increasing unconventional gas consumption from 5 bcm in 2010 to 10 bcm in 2015 and 20 bcm in 2020, despite evidence that actual levels will fall well short of the 2010 target.

## Domestic Barriers and Solutions

Domestic barriers to the development of unconventional gas supply have included below-market natural gas price caps, which remained until recently at

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## China Gas Potential

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approximately a 33% discount to the import cost of LNG. In addition, an inflexible adjustment mechanism resulted in only two price adjustments in the five years prior to 2010.

As discussed above, another significant historical barrier has been the absence of homegrown technological know-how in exploiting unconventional gas resources. This has been the main reason behind the linkages being formed between Chinese and foreign developers in recent months.

Other barriers to the development of a domestic market include the lack of clarity in subsoil rights between coal miners and gas drillers, an unpredictable approval process to obtain land use rights and environmental permits, and limited access to existing pipeline capacity.

The Chinese government has shown it has placed a high priority on addressing these barriers and has begun making reforms necessary to make the unconventional gas market attractive to both domestic and foreign players.

It took steps to eliminate the domestic technological deficit in late 2009, when Chinese President Hu Jintao and his U.S. counterpart Barack Obama signed an agreement establishing the U.S.-China Shale Gas Resource Initiative. The initiative is aimed at providing China with the benefit of American technical know-how backed by its considerable experience with, and accumulated expertise in, unconventional gas development. The initiative is also aimed at increasing investment in China's shale gas sector through the U.S.-China Oil and Gas Industry Forum, in addition to ad hoc study tours and workshops. Also in the area of technological development, China announced in August the establishment of the first national shale gas research center, to be centered at the MLR.

In June 2010, the Chinese government went part of the way toward addressing pricing concerns by implementing a one-time natural gas price increase of 25%. The increase was adopted so that domestic prices better reflect global pricing, though not as accurately as the market-based pricing system lobbied for by the Chinese oil & gas firms. The new pricing remains below China's import cost for higher-priced gas imported from locations such as Turkmenistan. It is being viewed as a compromise between the government's desire for low prices to placate consumers, and the reality that participants in the domestic gas exploration and development sector must be incentivized. Nonetheless, it is expected to have a positive effect on investment in natural gas projects.

More recently, in early November, an official at the National Development and Reform Commission, China's principal economic planning body, announced that drafting has been completed on a set of long-anticipated policies aimed at supporting increased shale gas production. According to the official, the policies will include a subsidy of no less than RMB 0.33 (about US\$0.05) per cubic meter of shale gas produced. It is expected that additional details on the initiative will be made available shortly and that the policies will be implemented in the coming months.Ⓢ

## UK Bribery Act Makes Business a Bit Slippery for Oil & Gas Industry

*By Heidi A. Lawson and Elizabeth Kurpis*

On November 4, 2010, U.S.-based Panalpina, Inc. (and its parent Panalpina World Transport Holding Ltd.) (Panalpina), a Swiss freight forwarding company, along with six other companies in the oil & gas industry, settled Foreign Corrupt Practices Act (the FCPA)<sup>1</sup> charges with the Department of Justice and the Securities and Exchange Commission (SEC). As a result of the settlement, the companies are required to pay US\$236.5 million in criminal fines, civil disgorgement, interest and penalties. Panalpina, which admitted to bribing government officials in seven nations, will pay US\$70.5 million of that total amount for their FCPA violations and US\$11.3 million in disgorgement of profits it derived from the bribery scheme.

Panalpina and other companies in the oil & gas industry are not unique when it comes to Department of Justice and SEC actions. Extractive industries have historically made up a large percentage of bribery prosecutions under the FCPA, amounting to about 20% of such prosecutions since its enactment.<sup>2</sup> Now, there is another new law coming into force: the UK Bribery Act 2010 (the Bribery Act). The Bribery Act, which has a much broader jurisdictional span than the FCPA, is attracting the attention of boards of directors around the world. Due to the

<sup>1</sup> The FCPA is the U.S. statute dealing with bribery, which is enforced by the Department of Justice and the SEC.

<sup>2</sup> Global Enforcement Report, TRACE International 2010.

global nature of the oil & gas industry and the complexity of the various contractual arrangements with governments, joint venture partners, suppliers and other contractors, the Bribery Act presents another challenge and will require management to focus on updating internal policies and procedures to ensure compliance.

Coming into force in spring 2011, with unlimited penalties and much longer prison sentences, the Bribery Act will raise the standard for anti-bribery policies above that of the FCPA. A company, which carries on any part of its business in the UK, could be prosecuted for failure to prevent bribery even where

the bribery takes place wholly outside the UK and the benefit or advantage to the company is intended to accrue outside the UK. The Bribery Act does not define what constitutes “or part of a business” and until that is clarified in the courts, a company should exercise caution. A representative office or UK agent may be sufficient to engage the Bribery Act. The company’s only statutory defense would be to prove the existence of adequate systems and controls. A comparison of the main differences between the FCPA and the Bribery Act is summarized below.

FCPA	UK BRIBERY ACT
<p>Prohibits the (1) bribery of a foreign official, international organization official, political party or party official or candidate for public office and (2) failure to maintain books, records and accounts.</p>	<p>Prohibits the (1) offering, promising or giving a financial or other advantage, (2) requesting, agreeing to receive or accepting a financial or other advantage, (3) offering, promising or giving a financial or other advantage or (4) bribery of another person by a person associated with the organization.</p>
<p>Those liable for the first offense include issuers (and their officers, directors, agents and employees), U.S. domestic concerns (i.e., citizens, corporate and businesses in the U.S.) and persons acting within the U.S. Those liable for the second offense include issuers with securities listed in the U.S..</p>	<p>Those liable for the first three offenses include a person committing the relevant act or omission in the UK or a person committing the act or omission overseas where the person has a “close connection to the UK”.<sup>3</sup> Those liable for the fourth offense include any UK corporate or partnership (or foreign corporate or partnership which carries on a business or part of a business in the UK) in respect of acts or omissions taking place in the UK or elsewhere.</p>
<p>With regard to the first offense, the payment must be made for the purpose of influencing that official to assist in obtaining or retaining business or in directing business to a particular person to secure an improper advantage. With regard to the second offense, the requisite proof of intent is knowingly falsifying any book, record or account or knowingly circumventing or failing to implement an internal system of accounting controls.</p>	<p>With regard to the first offense, one must have the intention to induce a person to perform improperly a relevant function or activity or reward them for doing so or know or believe that the acceptance of the advantage itself constitutes improper performance of a relevant function or activity. With regard to the second offense, one must have the intention that a “relevant function or activity” should be performed improperly.<sup>4</sup> With regard to the third offense, one must have the intention to obtain or retain business or an advantage in the conduct of business. With regard to the fourth offense, the associated person must intend to obtain or retain business for the corporate or to obtain or retain an advantage in the conduct of business for the corporate.</p>

<sup>3</sup> “Close connection to the UK” includes, among others, a British citizen; a British overseas territories citizen; a UK resident; and a UK body corporate.

<sup>4</sup> Note, however, that no proof of intention is required where the request, agreement or acceptance is itself improper performance by

the recipient or the request, agreement or acceptance is a reward for or in anticipation of the relevant improper performance.

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## UK Bribery Act

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FCPA	UK BRIBERY ACT
<p>Defenses include whether the payment was (a) a reasonable and bona fide expenditure (such as travel and lodging expenses) directly related to the promotion, demonstration or explanation of products or services or the execution or performance of a contract with a foreign government or its agency; (b) a facilitating or expediting routine governmental action; or (c) permitted by local written law.</p>	<p>Defenses include for the third offense whether the foreign official is permitted by the written law applicable to him to be influenced by the offer, promise or gift, and for the fourth offense, whether the corporate is able to prove that it had adequate procedures designed to prevent persons associated with it from undertaking such conduct. There are no defenses for the first and second offenses.</p>
<p>Penalties for the first offense include a criminal fine for entities up to US\$2 million, for individuals up to US\$250,000 and up to five years' imprisonment, and civil penalties up to US\$10,000 per violation. Penalties may also include debarment from contracting with the federal government. Penalties include for the second offense a criminal fine for entities up to US\$25 million, for individuals up to US\$5 million and up to 20 years' imprisonment, and civil penalties up to US\$500,000 for entities and US\$100,000 for individuals. Penalties may also include being barred from serving as an officer/director of a public company.</p>	<p>Penalties include for the first, second and third offenses an unlimited fine and/or a maximum 10 years' imprisonment, and for the fourth offense, an unlimited fine.</p>

Another critical issue for the oil & gas industry is the idea that a company may be subject to liability as a result of a violation made by an "associated" person. This broadly defined term embraces any person or third party who performs services for or on behalf of the business, determined by what they actually do and not the capacity in which they do it. Many third parties are likely to fall under this definition. Therefore, this will be of particular concern to the oil & gas sector due to its use of numerous partnering arrangements.

As noted above, there is a defense against prosecution where a company can prove it had adequate procedures in place. The government is required under the Bribery Act to issue guidance on what comprises adequate procedures, which will likely be published in early 2011. In the interim, companies may want to revisit their current policies and procedures in light of the preliminary guidance issued by the Ministry of Justice. The guidance emphasizes the need for a top level commitment by management, and a focus on six main principles, as summarized below:

- 1. Risk Assessment:** The commercial organization should regularly and comprehensively assess the nature and extent of the risks relating to bribery to which it is exposed.
- 2. Top Level Commitment:** The top level management of a commercial organization (be it a board of directors, the owners or any other equivalent body or person) should be committed to preventing bribery. They should establish a culture within the organization in which bribery is never acceptable, and take steps to ensure that the organization's policy to operate without bribery is clearly communicated to all levels of management, the workforce and any relevant external actors.
- 3. Due Diligence:** The commercial organization should have due diligence policies and procedures which cover all parties to a business relationship, including the organization's supply chain, agents and intermediaries, all forms of joint venture and similar relationships and all markets in which the commercial organization does business.

**4. Clear, Practical and Accessible Policies and Procedures:** The commercial organization's policies and procedures to prevent bribery being committed on its behalf should be clear, practical, accessible and enforceable. Policies and procedures should take account of the roles of the whole workforce from the owners or board of directors to all employees, and all people and entities over which the commercial organization has control.

**5. Effective Implementation:** The commercial organization needs to effectively implement its anti-bribery policies and procedures and ensure they are embedded throughout the organization. The process should ensure that the development of policies and procedures reflect the practical business issues that an organization's management and workforce face when seeking to conduct business without bribery.

**6. Monitoring and Review:** The commercial organization should institute monitoring and review mechanisms to ensure compliance with relevant policies and procedures and identify any issues as they arise. The organization should implement improvements where appropriate.

The oil & gas industry must be very proactive in the area of bribery prevention. Internal ongoing education will be key in order to raise awareness and create the appropriate corporate culture. ©

## Mobil v. Venezuela: ICSID Tribunal's Decision Highlights the Importance of Early BIT Planning; Holds that Venezuela's Investment Law Does Not Provide a Basis for ICSID Arbitration

By Ignacio Suárez Anzorena and Marcelo Blackburn

The arbitral tribunal's ruling in *Mobil Corporation and Others v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/07/27, June 10, 2010) powerfully demonstrates the importance of early bilateral investment treaty (BIT) planning to protect foreign investment. The Claimants had inserted a Netherlands entity into their ownership structure for the specific purpose of obtain-

ing the protection of a BIT between the Netherlands and Venezuela. The tribunal held that this corporate planning was legitimate and provided a proper basis for jurisdiction over claims that arose after the Claimants' corporate restructuring. In so doing, the tribunal distinguished prospective claims from those that arose before the restructuring and over which it did not have jurisdiction. The Claimants' BIT planning proved to be the crucial factor in establishing a basis for ICSID jurisdiction in light of the tribunal's determination that Article 22 of the Venezuelan Law on the Promotion and Protection of Investments (Article 22) did not provide a basis for ICSID jurisdiction. The *Mobil* ruling is thus a vivid object lesson for investors in how just a little BIT planning can significantly reduce their expropriation risk.

### Background

Mobil Corporation and several of its subsidiaries (Mobil) began investing in the exploration and production of petroleum in Venezuela during the "Apertura Petrolera" policy in the 1990s. In 2004, Venezuela began levying a series of rate and tax increases on private petroleum interests that culminated in a January 8, 2007 decree that nationalized Mobil's petroleum investments. During late 2005 and 2006, after Mobil had become subject to some of the rate and tax increases, but before its investments had been nationalized, Mobil restructured its corporate structure so that a holding company organized under the laws of the Netherlands, Venezuela Holdings B.V., was inserted into Mobil's chain of ownership as the indirect owner of Mobil's Venezuelan petroleum investments.

### Venezuela's Challenge to ICSID Jurisdiction

On September 6, 2007, Mobil submitted to ICSID a request for arbitration against Venezuela asserting, among other claims, that the compensation offered by Venezuela for Mobil's nationalized petroleum investments was insufficient. Venezuela challenged both of Mobil's grounds for ICSID jurisdiction. First, it argued that Article 22 did not provide a clear and unambiguous consent to arbitrate the dispute, as is required by the ICSID Convention. Second, it argued that the Netherlands-Venezuela BIT could not provide a basis for ICSID jurisdiction because the BIT did not apply to Venezuela Holdings B.V.'s non-Dutch subsidiaries or to indirectly held investments and, that even if it did, the creation of a Dutch "corporation of convenience" in anticipation of litigation against Venezuela solely to gain access to ICSID jurisdiction was an "abuse of right." / continued page 8

## Mobil v. Venezuela

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### Article 22 Does Not Provide a Basis for ICSID Arbitration

The tribunal found that Article 22 did not contain an unambiguous consent to ICSID arbitration. Article 22 provides that disputes to which bilateral investment treaties, the Convention Establishing the Multilateral Investment Guarantee Agency (MIGA) or ICSID apply “shall be submitted to international arbitration according to the terms of the respective treaty or agreement, if it so provides.” The tribunal interpreted the last clause, “if it so provides,” as having two potential meanings: “if the treaty or agreement provides for international arbitration,” or “if the treaty or agreement provides for mandatory submis-

of one of Article 22’s drafters, the tribunal concluded that there was insufficient evidence of an intent to provide “consent to ICSID arbitration in the absence of a BIT.”

### Mobil’s BIT Planning Was “Perfectly Legitimate”

The arbitrators relied on a straightforward textual analysis of the BIT text to reject Venezuela’s arguments that the BIT did not apply to non-Dutch subsidiaries or to indirectly held investments. However, Venezuela’s argument that Mobil’s restructuring to create a Dutch holding company constituted an “abuse of right” warranted more discussion.

The tribunal stated that “abuse of right is to be determined in each case, taking into account all the circumstances of the case,” and noted that different tribunals used “different criteria to determine in each case whether or not there has been abuse

**The *Mobil* decision serves as a reminder of the importance of timely BIT planning, particularly in light of the tribunal’s decision to exercise jurisdiction only as to issues that arose after Mobil was protected by the BIT.**

sion of disputes to international arbitration.” Because both meanings were grammatically possible, the tribunal considered other factors.

The tribunal first rejected Venezuela’s claim that Venezuelan legal principles were “highly relevant and must be taken into account” in interpreting Article 22. Based on its review of ICSID case law, the tribunal concluded that Article 22 “must accordingly be interpreted according to the ICSID Convention itself and to the rules of international law governing unilateral declarations of states.” The tribunal also rejected Mobil’s invocation of the *effet utile* doctrine, which holds that every clause should be interpreted as meaningful, concluding that “the principle of *effet utile* must not be taken into account in the interpretation of States’ unilateral declarations.”

Instead, the tribunal determined that Article 22 should be interpreted in light of its context and purpose. After reviewing the policy evolution represented by Article 22 and the comments

of right.” Ultimately, the tribunal said, “the question is to give effect to the object and purpose of the ICSID Convention and to preserve its integrity.” In Mobil’s case, the tribunal found that “the main, if not the sole purpose of the restructuring was to protect Mobil investments from adverse Venezuelan measures in getting access to ICSID arbitration through the Dutch-Venezuela BIT.” However, whether the restructuring was “legitimate corporate planning” as contended by Mobil, or “abuse of right” as submitted by Venezuela, depended on the circumstances under which it happened.

The arbitrators considered it important that Mobil notified Venezuela of the restructuring, even though it was under no obligation to seek approval of the restructuring, and that Venezuela did not object to the restructuring at that time. The tribunal also considered Mobil’s relatively limited additional investment in its Venezuelan operations around the time of the restructuring but decided that no adverse inference could be

drawn from that fact because ongoing operations provided sufficient funding. The tribunal concluded that protection of investments by gaining access to ICSID arbitration through the BIT “was a perfectly legitimate goal as far as it concerned future disputes.”

Exercise of jurisdiction was limited to disputes arising after BIT protection applied, because a restructuring to obtain BIT protection for pending disputes would be “an abusive manipulation of the system of international investment protection under the ICSID Convention and the BITs.” Thus the tribunal held that it could not exercise jurisdiction over any dispute arising before the corporate reorganizations took place, including Mobil’s disputes concerning the rate and tax increases in 2004 and 2005.

### Conclusion

While the limitations imposed by a specific BIT must of course be taken into consideration, the *Mobil* decision serves as a reminder of the importance of timely BIT planning, particularly in light of the tribunal’s decision to exercise jurisdiction only as to issues that arose after Mobil was protected by the BIT. Investors would be well advised to consider whether additional BIT planning to protect their foreign investments is warranted. ☺

# Russia Looking to Amend Its Subsoil Law

By Ivan Kozhemiakov

In August 2010 Russia’s Ministry of Natural Resources published a draft law seeking to introduce significant amendments to the Law on Subsoil. If approved, the amendments may become effective in early 2011. This article discusses certain key elements of the draft law.

### Contents of a Subsoil Use License

The draft law proposes that license agreements (currently optional) would no longer be entered into between the license holder and the licensing authority, and that all the terms relevant to the use of a particular subsoil block would be reflected in the license itself. A license would need to stipulate the following additional terms:

- timelines for the preparation of technical project documentation;
- types and minimum volumes of exploration / geological study work, with a breakdown by year and with an indication of timelines (in relation to exploration licenses); and
- a timeline for the start-up of production (for production licenses).

While the above terms are not unusual, and the draft law simply clarifies that the text of the license would need to contain relevant terms, the draft law calls for an additional license term. Specifically, if the conditions of the tender for the grant of the relevant subsoil use right impose processing obligations on the subsoil user, the license must include a timeline for the commissioning of processing facilities and an indication of the minimum volume of processed production.

In addition, the draft law allows for the issuance of one license to cover a group of subsoil blocks in the event that it is economically efficient to combine activities at such blocks.

### Mechanism for Amending License Terms

The draft law proposes a mechanism for the amendment of license terms at the initiative of the subsoil user, including in the following cases:

- a significant decrease in the consumption of the relevant mineral resources caused by circumstances outside the subsoil user’s control, and related delay in the commissioning of facilities;
- material change of circumstances (relative to the circumstances prevailing at the time the license was granted);
- necessity to complete exploration or production beyond the expiry of the term of the license, provided that no violations were committed; and
- necessity to modify the boundaries of the subsoil block.

If enacted, the draft law may enable subsoil users to obtain extensions to license terms in certain circumstances and to temporarily reduce production levels (below the levels required under the terms of the license) pending reductions in market demand for oil. The draft law also allows a subsoil user to decrease production for technical or economic reasons, in line with the specific project’s technical documentation.

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## Russia to Amend Subsoil Law

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### Tender and Auction Procedures

The rules applicable to tenders and auctions—the two main mechanisms for granting subsoil use rights—are clarified by the draft law. Key proposed changes include the following:

- tender conditions may impose additional criteria relating to the extent of the processing of the mineral resources on the territory of the Russian Federation and the timeline for the implementation of the relevant investment project designed to allow for such processing;
- a single participant in an auction or tender can be announced the winner of the auction (currently such a possibility exists with respect to tenders only);
- a clarification to the effect that the sole criterion (currently the “main criterion”) for determining the winner of an auction is the amount offered for the subsoil use right; and
- in determining the winner of a tender, “interests of national security” are to be taken into account (the criterion of “interests of national security” seems to afford the authorities wider discretion to refuse to grant the relevant subsoil use rights to a foreign investor or entities with foreign investment, compared to the currently applicable criterion of “ensuring defense and security of the state”).

As a related matter, modifications to the list of grounds for a refusal to consider a bid (in the context of an auction or tender) have been proposed. Specifically, proof that the bidder has or will have the relevant specialists and technical means to perform the relevant work would no longer be required. This change, if implemented, may enable non-industry investors to take part in auctions or tenders for the grant of subsoil use rights. Further, bids from bidders who have had their subsoil use licenses revoked two or more times for certain specified causes over the course of a five-year period preceding the bid would not be accepted.

### Restrictions on License Transfers

Modifications are proposed to the provisions of the Subsoil Law allowing for transfers of subsoil use licenses in certain cases. In particular, it is proposed that (currently allowed) license transfers to a Russian legal entity affiliated with the existing subsoil

user, being its direct or indirect parent or subsidiary with a majority direct or indirect share of at least 50%, would not be permitted if the existing user is in breach of license terms and such breach has not been rectified in the time frame provided.

### Revocation, Suspension or Limitation of a License

The draft law specifies with greater clarity the grounds for license revocation, suspension or limitation. The rationale for the changes is to ensure transparency and to combat corruption. Specifically, the following would apply:

#### Grounds for License Revocation

The authorities may revoke a license if the subsoil user:

- exceeds the timeline for the preparation of technical project documentation by more than six months;
- breaches the license terms in respect of the types and minimum volumes of exploration / geological study work (with a breakdown by year and with an indication of timelines);
- breaches the license terms in respect of the start-up of production;
- defaults upon subsoil use payments;
- breaches the conditions for the use and filing of geological information;
- breaches any processing obligations;
- breaches the requirements imposed by the technical project documentation or allows above-norm losses, mineral dilution/impooverishment or selective working of the deposit;
- repeatedly breaches (i.e. two times or more) the license terms (other than those summarized in the first and second bullets above) or the requirements of subsoil legislation, including in respect of rational use and protection of the subsoil; or
- fails to submit information as required by subsoil legislation or submits inaccurate information.

The authorities may also revoke the license:

- upon the liquidation of the subsoil user;
- at the subsoil user's request;

- if the Government determines that a threat to state defense and security exists and takes a decision to revoke a license (or not to issue a production license) in cases where a subsoil user which is a foreign investor or an entity with foreign investments discovers (as part of geological study activities) a subsoil deposit of federal significance (e.g. in respect of oil, a deposit containing reserves of 70 million tons or more).

According to the draft law, the procedure for license revocation involves sending a notice to the subsoil user setting a time period for the rectification of the relevant breach. Such time period may not be less than three months, and may not exceed 12 months from the date of receipt of the above notice. A subsoil user willing to voluntarily terminate the license must give six months prior notice of the proposed termination date.

#### Grounds for License Suspension

The draft law provides for the possibility of suspension (as opposed to revocation) of a license in the event of:

- a direct threat to the life or health of people working or living in the impact zone of the relevant subsoil use activities; or
- emergency situations (natural disasters, military action, etc.).
- Suspension may entitle the subsoil user to an extension of the license term if the subsoil user had not been at fault in respect of the occurrence that caused the suspension.

#### Grounds for License Limitation

Pursuant to the draft law, a temporary or permanent limitation may be imposed in respect of specific activities relating to subsoil use if conducting such activities has led or may lead to a threat to the life and health of people, a negative impact upon the subsoil and the environment or if the relevant activity is carried out prior to the receipt of the required documents and permits. Where such limitation is put in place, the license remains in effect, save for the specific limitations imposed. ☺

# Energy Security: Cooperation Between Ukraine and The European Union

*By Jaroslawa Johnson and Yevhen Fedorchenko*

Energy efficiency and security is a strong prerequisite to an attractive investment climate and growth of a country's economy. Ukraine is seeking to follow this standard in its partnership with the European Union in the EU's move towards the introduction of an energy-efficient economy and a secure energy supply. Ukraine's recent progress in harmonizing some of its legislation with EU energy law and policy has been reached at an international level, but still a great deal remains to be done for the internal regulation of the energy market. Future improvements to Ukrainian energy law will most likely follow the example of the EU.

## Early Cooperation with the EU

*The Memorandum of Understanding on Energy* signed in September 2005 (the Energy MOU) is the basic document establishing the framework for cooperation between Ukraine and the EU in the energy sector. It enumerates the main actions which Ukraine must take in order to facilitate its transition to an energy efficient economy and to join the EU's energy market. These include the following:

- reforming electricity tariffs and gas pricing;
- developing alternative pricing structures to ease the impact of reforms on vulnerable customers;
- reducing unregulated losses;
- reducing electricity network losses, in particular transmission losses due to the poor technical condition of the network;
- increasing energy efficiency in order to better meet industry and consumer demand;
- implementing measures to ensure full payment for electricity and gas;

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- diversifying supply, including from renewable energy sources, while maintaining a free market framework; and
- optimizing the energy mix and focusing on renewable sources in electricity generation with the aim of increasing efficiency, environmental safety, operational reliability, and security of supply.

The Energy MOU created a platform for further institutional and legal reforms. At the same time, the EU is focusing on adopting a consistent sustainable energy policy with its partners all over the world, including the United States, India, Brazil, China, Russia, Norway, OPEC countries and Algeria. Ukraine's leaders recognize that Ukraine would benefit from managing its energy policy in such a way as to keep pace with modern challenges by engaging in institutional cooperation with the EU.

parliament, Ukraine will be obliged to implement substantive rules of EU law in the area of energy and environment, as well as elements of EU competition regulation.

Once the Treaty is ratified, Ukraine will be obliged to increase its use of renewable energy and improve energy efficiency, as well as tackle issues arising due to climate change. As was indicated in the official press release by Energy Community members on the accession of Ukraine, Ukraine has a binding obligation to implement core EU energy law and thereby put in place a sound and transparent market structure. It is hoped that this will also benefit the investment climate and financial stability of Ukraine

Article 3 of the Treaty establishes a three-tier structure for mutual integration of the parties with subsequent commitments: extension of the *acquis communautaire* (the *acquis*—the law of the EU); development of the mechanism for operation of Network Energy markets; and creation of a Single

**Ukraine's Gas Market Act calls for the liberalization of the gas market; separation of supply and production activities from network operations; market access; and increased powers and independence for the Ukrainian energy regulator.**

### Accession to the Energy Community Treaty

Ukraine's recent accession to full membership of the Energy Community, an institutional mechanism created by the EU in 2005—2006 to strengthen the South Eastern European energy market, promote reform and encourage investment,<sup>1</sup> is evidence of its commitment and successes in the energy sphere to date. On September 24, 2010, Yuriy Boyko, Minister of Fuel and Energy of Ukraine, and Fatmir Besimi, Minister of Economy of the Former Yugoslav Republic of Macedonia (currently presiding over the Energy Community), signed the accession protocol which finalized Ukraine's process of transition from observer to full member. By acceding to the Energy Community Treaty (the Treaty) and following ratification of the Treaty by Ukraine's

Energy Market. Due to the Treaty requirements and the terms of the accession protocol, Ukraine is still obliged to implement a significant amount of the EU rules on energy and related areas in the course of several years up to 2018, starting from the date of its accession.

This gradual implementation will include legislation in the following areas to be implemented by January 1, 2012:

- common rules for the internal market in natural gas (*Directive 2003/55/EC*);
- conditions for access to natural gas transmission networks (*Regulation No. 1775/2005*);
- measures to safeguard security of natural gas supplies (*Directive 2004/67/EC*);

<sup>1</sup> The members of the Energy Community are the European Union, Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Moldova, Montenegro, Serbia and the United Nations Interim Administration Mission in Kosovo pursuant to *United Nations Security Council Resolution 1244*.

- common rules for the internal electricity market (*Directive 2003/54/EC*);
- conditions for access to the network for cross-border electricity transactions (*Regulation No. 1228/2003 and Commission Decision 2006/770/EC amending the Annex to Regulation No. 1228/2003*); and
- measures to safeguard the security of electricity supplies and infrastructure investment (*Directive 2005/89/EC*).

Other rules also relating to sustainable development, protection of the environment and energy efficiency must also be implemented by specified deadlines.

Although problematic legal issues may very well arise from the large-scale adoption of such a large number of EU rules within a short time, this is the price Ukraine will have to pay in order to access the benefits of the Energy Community and promote investment in Ukraine's energy market. The official position of the Energy Community members, as presented on December 18, 2009 at Zagreb during approval of the future accession of Ukraine and Moldova to the Energy Community is that Ukraine will benefit from effective accession when and if its laws at this stage of integration comply with the EU *acquis* requirements—and in particular with the initial standards applicable to Ukraine which are set forth in *Directive 2003/55/EC* and *Regulation 1775/2005* (the Gas Directive and the Gas Regulation, respectively).

### Ukrainian Legislative Initiatives

In line with the requirements of the Gas Directive and the Gas Regulation, in July 2010 the President of Ukraine signed the *Act On Principles of the Functioning of the Natural Gas Market of Ukraine* (the Gas Market Act). The Gas Market Act calls for the liberalization and opening of the gas market; separation of supply and production activities from network operations; market access, including to the Gas Transportation System and storage facilities; and increasing the powers and independence of the National Electricity Regulatory Commission (NERC), Ukraine's principal energy regulator, in relation to the gas market.

The Gas Market Act follows the rules set out in the Gas Directive with regard to the free choice of natural gas suppliers (subject to relevant contractual relationships). The legislation strives to create a free market for natural gas supply based on the principles of fair competition and transparency. Enterprises operating in the field of natural gas supply are permitted to

enter the Ukrainian market in order to provide services, but must comply with the licensing requirements stipulated by the Gas Market Act. A consumer choosing a gas supplier from among those present on the market is entitled to receive information on the availability of natural gas at the disposal of such supplier and its qualitative characteristics. The requirements of licensing and active participation of the consumer in the formation of a pool of market players should improve the quality of the services delivered.

The Gas Market Act has endorsed the principle of unbundling transmission, distribution, supply and storage of natural gas which was introduced by the Gas Directive. According to the Gas Market Act, all of the above-mentioned activities must be separated in order to create competition in the energy market and avoid state monopolies. This approach has been applied in the EU energy sector over the past decade in order to eliminate state involvement in the operation of the internal market.

Under the Gas Market Act, transmission operators are prohibited from extracting or supplying natural gas, whereas distribution operators are not allowed to undertake extraction, supply, storage or transmission of natural gas. This principle of unbundling transmission, supply and distribution is also related to the vertically integrated enterprises operating in the market of natural gas supply. The Gas Market Act requires legal and organizational separation from other activities by such enterprises, although the Act makes it clear that the principle of unbundling will not affect small enterprises.

The Gas Market Act also introduces the principle of the NERC. The NERC is mainly authorized to perform licensing of enterprises entering the market, supervising their activities and imposing sanctions stipulated by the law, and distributing funds received from consumers. The Gas Market Act emphasizes that the NERC is independent from all levels of the executive authorities as well as from commercial entities, although in practice the government does influence activities falling within its competence. The actual independence of the NERC following enactment of the Gas Market Act will need to be assessed over time.

### Conclusion

Ukraine's accession to the Energy Community Treaty provides the legal basis for future harmonization of Ukrainian energy law with that of the EU. The European experience is already being implemented in the new Gas Market Act with regard to supplies of natural gas. It is likely that amendments to other key laws concerning oil and renewable energy

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will also be adopted soon. The new rules calling for privatization of the production, transmission and distribution services delivered in the Ukrainian market should be viewed favorably by foreign investors. ☺

# Kazakhstan's New Subsoil Law

*By Victor Mokrousov and Alexandra Neovius*

Kazakhstan has adopted a new Subsoil Law<sup>1</sup> in mid-2010 which gives the government a stronger hand in its dealings with investors and replaces the previous Subsoil Law and the Petroleum Law. This article outlines the key changes from the previous regime and comments on some of the implications of these changes for investors in the oil & gas and other extractive industries in Kazakhstan.

## Existing Licenses and Contracts

Existing subsoil use licenses and contracts remain valid. However, a number of provisions of the new law have retroactive effect—associated gas processing and utilization, project documentation for production contracts, and local content requirements. These are discussed further below.

## Stabilization

Although the relevant provisions of the new law are worded in a similar way to those in the previous Subsoil Law and the Petroleum Law, the actual stabilization protection offered is significantly narrower. The threshold for stabilization protection to apply is where changes in law “worsen the results of commercial activity of a subsoil user.”

As was the case previously, stabilization does not apply to changes in law in relation to national security, defense, environmental safety and healthcare. However, the new law also provides explicitly, for the first time, that stabilization does not apply in respect of changes to tax and customs legislation. This is consistent with the general trend in Kazakhstan's fiscal regime in recent years, which culminated in the new Tax Code in

2009. Under the Tax Code, only production-sharing agreements entered into prior to January 1, 2009 and subsoil use contracts specifically approved by the President retain stabilized fiscal regimes. While the Tax Code specifically addresses taxes and other mandatory payments to the state budget, it is unclear at this stage whether the customs legislation will do so in respect of customs duties and fees.

## Grants of Rights and Types of Contracts

The procedure for granting subsoil use rights remains broadly similar under the new law. The acquisition of rights by direct negotiations is only available to the National Company (i.e. KazMunaiGas), to companies which have made commercial discoveries under exploration contracts, and in situations where a second competitive tender has been held involving a single bidder. All other grants must follow a competitive tender process in which the selection criteria focus on the level of the signature bonus and the proposed social and infrastructure spending commitments.

Combined exploration and production contracts are abolished by the new law, except when specifically approved by a decision of the government if the project involves a property of “strategic significance and/or a complex geological structure” (Article 61.4). Exploration contracts may be signed for a period of up to six years, with a one-off extension of up to two years available for offshore properties. The law previously permitted two extensions of two years each for both on-shore and off-shore properties. Production contracts will be available for up to 25 years generally with up to 45 years available for “major and unique” deposits (Article 67.4).

## Transfers of Interests and the Pre-emptive Right

The requirement to obtain the consent of the competent body for transfers of direct interests in subsoil use contracts and equity interests in subsoil users has been expanded to explicitly cover a broader range of transactions, including transfers by succession, initial public offerings by parent entities of subsoil users, and transfers higher up in the corporate chain.

The new law also clarifies the types of transfers of direct and equity interests which are exempt from the consent requirement—sales of securities on a recognized exchange, transfers between 99% commonly owned affiliates (except where the transferee is registered in a tax haven jurisdiction), and transfers of less than 0.1% of shares.

The scope of transfers triggering the pre-emptive right of the

<sup>1</sup> Law of the Republic of Kazakhstan on Subsoil and Subsoil Use No. 291-IV, dated June 26, 2010.

state to acquire interests in subsoil users or parent entities (formerly contained in Article 71, now Article 12) has not changed. However, free-of-charge transfers now trigger the pre-emptive right.

These amendments were generally anticipated and do not represent a fundamental change of the government's position. Indeed, the greater clarity provided by a specific application procedure in relation to consents and pre-emptive right waivers (Article 37) is to be welcomed. However, the time frame set out in the law for the consent and waiver procedure is now over three months (previously a month and a half), adding potentially significant delays.

### Termination of Contracts

The state may unilaterally terminate a subsoil use contract when:

- (i) a subsoil user has failed to cure breaches of its contract

as do certain treaties to which Kazakhstan is a party. However, this provision of the law is seen as an attempt to limit investors' ability to draw the Republic into international arbitration.

### Project Documents and Gas Processing and Utilization

As a prerequisite to entering into a production contract, subsoil users must prepare "project documents" containing the technical and commercial parameters of exploration, appraisal and development of a particular asset. Existing holders of subsoil use rights must ensure that project documents are prepared and approved by the competent body within 12 months from the date of enactment of the new law (i.e. by early July 2011). Similarly, work programs based on the approved project documents must be submitted for approval within 18 months of enactment.

**The amendments to the pre-emptive right triggers do not represent a fundamental change of the government's position, but the increased procedural time frame adds potentially significant delays.**

- following two notifications from the competent body;
- (ii) a transfer of a direct interest in a contract or an equity interest was made without consent;
- (iii) a subsoil user does not agree to amend its contract "to restore the economic interests" of the state (Article 71.3); or
- (iv) there is a threat to national security.

Aside from item (i) these bases for unilateral termination are largely unchanged from the previous Subsoil Law.

### Dispute Resolution

The new law provides that where the parties cannot resolve a dispute by negotiation, they "shall be entitled [to do so] in accordance with the laws of the Republic of Kazakhstan and international treaties ratified by the Republic of Kazakhstan" (Article 128.2). Kazakhstan law generally permits international arbitration,

At this stage, there is limited guidance in the law as to the content of the project documents. One point which is clear is that the project documents must include a "section" on processing/utilization of associated gas (Article 86.6). New production and combined exploration/production contracts must provide for processing and utilization. For existing contracts, subsoil users are required to enter into a separate agreement with the competent body which will become an attachment to the subsoil use contract. Flaring is generally prohibited, except in certain emergency or testing situations.

### Local content

In line with the government's policy of legislating to increase the Kazakhstan content of goods and services used in the oil & gas sector, the new law imposes stringent requirements in relation to procurement activities by subsoil users. Depending upon the exact provisions of a particular

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## Kazakhstan's New Subsoil Law

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contract, some subsoil users may be exempt from the statutory requirements. However, the transitional provisions in Article 129 instruct all subsoil users “to be guided by the requirements” of the new law. This indicates that subsoil users will be expected to comply with the statutory regime rather than the specifics of their contracts, unless able to prove that doing so would “worsen the results of [their] commercial activity.”

### Conclusion

Although the new Subsoil Law gives greater power to the government in the regulation of extractive industries, it does not represent a fundamental shift in Kazakhstan's policy. Limited fiscal stabilization, the pre-emptive right of the state, strict local content requirements—these changes occurred in Kazakhstan law over the past several years. However, the new law solidifies these changes and applies them broadly, limiting stabilization protection available to existing investors. ☺

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