

On 30 June 2022, the Russian Federation issued Presidential Decree No. 416, which asserts governmental control over the Sakhalin-II oil and gas export facility.

Russia’s issuance of Decree No. 416 comes directly on the heels of various market events that have intensified existing global gas market tensions. In recent weeks, the market has been forced to react to, and absorb the effects of: (i) a fire at the Freeport LNG facility in the United States (causing major LNG supply disruptions, anticipated to last until later this year);¹ (ii) a sharp reduction of Russian gas supplies to Europe;² (iii) a further anticipated curtailment of Russian supplies due to maintenance on the Nord Stream 1 pipeline;³ (iv) significant ongoing heat waves in Japan and Europe increasing energy demand; (v) the impact of sanctions on Russian shipping vessels; and (vi) rising spot market prices. While the long-term effects of Decree No. 416 remain unknown at this time, in the near term at least, Decree No. 416 can be anticipated to exacerbate these and other prevailing market pressures. This is likely to create additional uncertainty and concerns for market participants who continue to grapple with severe price volatility and concerns regarding supply.

What is the purpose of Decree No. 416?

In broad terms, Decree No.416 takes the ownership of the Sakhalin Energy Investment Company Ltd (“**Sakhalin Energy**”), a consortium of international investors created to develop the Sakhalin-II oil and gas project in Yuzhno-Sakhalinsk, Russia, and transfers it to a newly formed Russian LLC created by the Russian government. The newly created Russian LLC replaces and assumes the rights and obligations of the existing project company, Sakhalin Energy.⁴

Shares in the Russian LLC are then transferred to Gazprom Sakhalin Holding Limited Liability Company in proportion to the number of shares Gazprom owns in the original Sakhalin Energy. The remaining shares in the Russian LLC correspond to foreign investors’ ownership in Sakhalin Energy.

Under the terms of the Decree, existing shareholders are afforded a period of one month to notify the Russian government as to whether or not they wish to continue as stakeholders in the newly created LLC entity.

Once those confirmations are provided, the Russian Government will then verify the documents submitted; this is to decide whether to accept or to refuse the transfer of shares in the new LLC to the relevant existing shareholder of Sakhalin Energy. If approved, the Russian Government will retain the right to conduct financial, environmental, technological and other audits of the activities of foreign legal entities associated with the implementation of the production sharing agreement signed by Sakhalin Energy and the Russian Government in 1994, and any damages would be assessed in that regard.

If the transfer of shares in the new LLC to existing Sakhalin Energy shareholders were to be refused, the share value will be appraised by the Russian government. The shares would then be sold, with cash proceeds from the sale being deposited into a special Russian “C-type” bank account in the name of the Sakhalin Energy shareholder. A shareholder in Sakhalin Energy cannot access the funds until the Russian government has completed the financial, environmental, technological and other audits of the activities of foreign legal entities associated with the 1994 Sakhalin Energy production sharing agreement. The Russian government will then assess any damages and debit them from the cash proceeds held in the relevant Russian “C-type” bank account of the Sakhalin Energy shareholder.

What are the possible impacts of Decree No. 416?

The impact of Decree No. 416 will likely resonate most closely with LNG buyers and investors in the Asian markets, in particular in Japan and South Korea. Shell was quick to voice its intended departure from its 27.5% share in the Sakhalin-II project in February this year,⁵ but it remains a shareholder in Sakhalin Energy at present; a decision will need to be made by Shell as to whether or not to request the transfer of its stake to the newly created Russian LLC. Decree No. 416 also has obvious and direct relevance for the Japanese trading houses Mitsui and Mitsubishi, who hold respective stakes of 12.5% and 10% in the project. The asset transfer, share sale, cash proceeds and damages assessment procedures outlined in Decree No. 416 have clear implications for all stakeholders.

1 “Factbox: Freeport LNG plant shutdown and main buyers at risk,” Reuters, 14 June 2022

2 “Russian gas to Europe falls short as heatwave drives demand,” Reuters, 17 June 2022.

3 “Europe on edge as Nord Stream Russian gas link enters shutdown,” Reuters, 11 July 2022.

4 An unofficial translation of Decree No. 416 is appended to this bulletin, which sets out the specific elements of the new legislation.

5 See, e.g., “Shell intends to exit equity partnerships held with Gazprom entities,” dated 28 February 2022, at <https://www.shell.com/media/news-and-mediareleases/2022/shell-intends-to-exit-equity-partnerships-held-with-gazprom-entities.html> (announcing Shell’s intention to exit from its stake in the Sakhalin II LNG facility).

At the time of writing, no official response has been provided by either Mitsui or Mitsubishi with regards to their ongoing participation in Sakhalin. Undoubtedly, Japanese demand for Russian gas imports will need to be delicately balanced against rising reputational concerns and the potential impact of the terms of the Decree. While Japan has previously publicly condemned Russia's invasion of Ukraine and endorsed sanctions as a member of the G7, it remains heavily reliant on imported Russian energy: 10% of its annual LNG imports are from Russia alone.⁶ Its reliance on those supplies remaining stable and affordable on a long-term basis is critical, especially in today's market.

There are also potential legal ramifications at play, not just for the shareholders of Sakhalin Energy but also for downstream buyers of Sakhalin gas. Due to the change in ownership of Sakhalin Energy required by Decree No. 416, long-term contracts between buyers and Sakhalin Energy will need to be considered. These will either need to be novated or otherwise account for the transfer of shares, rights and obligations from Sakhalin Energy to the newly created Russian LLC. Impacted buyers managing these ongoing concerns will therefore need to finalise these contractual arrangements with their new counterparty moving forward.

While Sakhalin has particular importance for the various Japanese gas companies and power utilities who purchase significant volumes of LNG from Sakhalin II under long-term contracts, they are not alone. South Korea represents another major import market for Russian LNG. Buyers in these markets will be eager to understand and mitigate against any possible operational disruptions that may flow from the Decree in due course. As these authors previously noted, recent sanction regimes have created operational doubts on the usage of particular Russian DES vessels used to supply LNG cargoes to the Japanese and South Korean markets,⁷ prompting concerns regarding possible consequential impacts on production at Sakhalin II. These concerns may be compounded by Shell's departure, not only as a shareholder, but also as an experienced and reliable operator of the project.

At the same time, the contractual formalisation process between Sakhalin and its buyers may represent an opportunity to commence dialogue regarding how best to manage the smooth operation of deliveries under the specific contract in the future. In particular, those discussions will be guided by the specific delivery, destination and volume flexibility provisions in the given contract.

It will also be important for buyers to mitigate the impact of possible supply disruptions through optimisation management measures in their fuel generation stack within their portfolios. For example, certain Japanese power utilities may find relief from Japanese Prime Minister Fumio Kishida's confirmation at the G7 summit in Germany on 28 June that the Japanese government will seek to restart nuclear reactors where possible in an effort to supply electricity to the struggling power grid in the country.⁸

However, other smaller gas companies (i.e., without nuclear capability and with limited alternative fuel capacity) may need to focus on operational discussions with the new LLC entity in order to secure supply reliability. Possible options in this regard may include delivery mode changes, advanced deliveries in the summer months to assist with rising temperatures, and other annual delivery programme amendments where possible.

On this last point, a solid grasp of the terms of the contract will be crucial for commencing dialogue on how best to address and confront this new development. This includes a possible discussion of operational amendments to help promote the parties' future contractual compliance in a rapidly evolving legal and political landscape. The scale of the communications required will likely vary from buyer to buyer, based on its exposure to Sakhalin II LNG deliveries in its portfolio, and the transition of its new working relationship with the LLC entity.

Please feel free to contact the authors directly if you have any questions regarding the content of this piece.

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6 Reuters: <https://www.reuters.com/business/energy/russia-decree-sakhalin-2-project-knocks-mitsui-mitsubishi-shares-2022-07-01/>

7 <https://www.squirepattonboggs.com/en/insights/publications/2022/06/the-asia-lng-market-ongoing-impact-of-the-russia-ukraine-conflict>

8 <https://asia.nikkei.com/Business/Energy/Japan-heat-wave-PM-calls-for-maximum-nuclear-power-use>

Unofficial Translation of Decree No. 416

Decree of the President of the Russian Federation

On application of special economic measures in the fuel and energy field in connection with unfriendly actions of some foreign states and international organisations

In view of unfriendly [treatment] and actions of the United States of America and foreign states and international organisations allied to it that contradict international law, which are aimed at imposing restrictive measures against nationals of the Russian Federation and Russian legal entities, in order to protect the national interests of the Russian Federation, and in accordance with the Federal Laws dated December 30, 2006, No. 281-FZ "On Special Economic Measures and compulsory measures," dated December 28, 2010 No. 390-FZ "On Security," and dated June 4, 2018 No. 127-FZ "On measures of influence (counteraction) to unfriendly actions of the United States of America and other foreign states," I hereby decree:

1. Establish that due to the threat of natural and man-made emergencies, threat to human life and safety, threat to the national interests and economic security of the Russian Federation, arising as a result of the violation by certain foreign legal entities and individuals of their obligations related to the implementation of the Agreement on the Development of the Piltun-Astokhskoye and Lunskeye oil and gas fields on terms of Production Sharing Agreement dated June 22, 1994 (hereinafter referred to as the "**Agreement**"), the following special economic measures shall be applied to these foreign persons and individuals under their control:
 - a. The Government of the Russian Federation creates a Russian Limited Liability Company, to which, on the basis of this Decree, all rights and obligations of Sakhalin Energy Investment Company Ltd (hereinafter the "**Company**") are assigned. The said Limited Liability Company ("LLC") shall be created in accordance with the procedure established by the Government of the Russian Federation. LLC shall carry out its activities in accordance with the Agreement. The Government of the Russian Federation is not a founder (participant) of LLC;
 - b. The Company's property created under the Agreement is subject to immediate transfer to the ownership of the Russian Federation (due to the proper fulfilment by the Russian Federation of its obligations to finance its creation) with its simultaneous transfer to LLC for free use for a period determined by the Agreement;
 - c. Other than provided for in subparagraph "b" of this section, the property of the Company is subject to immediate transfer to the ownership of LLC;
 - d. Shares in the authorised capital of LLC are owned by:

Gazprom Sakhalin Holding Limited Liability Company in proportion to the number of shares it owns in the authorised capital of the Company;
 - e. LLC in proportion to the number of shares owned in the authorised capital of the Company by other shareholders. These shares shall be transferred to persons determined in accordance with this Decree. Until the time of transfer of the shares of LLC to these persons, their shares shall be managed by the Government of the Russian Federation in accordance with this Decree;
 - e. within one month of the establishment of LLC, the shareholders of the Company specified in the third paragraph of subparagraph "d" of this section shall submit to the Government of the Russian Federation notifications of consent to accept the ownership of shares in the authorised capital of LLC in proportion to the number of shares each of them owns in the authorised capital of the Company. The notifications of consent shall be accompanied by documents confirming the rights of such shareholders of the Company to the relevant number of shares in the Company;
 - f. upon receipt of a notification from among the notifications referred to in subparagraph "e" of this section, the Government of the Russian Federation within 3 days:

verifies the documents submitted in accordance with subparagraph "e" of this section;

makes a decision on the transfer of a share in the authorised capital of LLC to the relevant shareholder of the Company in proportion to the number of shares in the authorised capital owned by such shareholder of the Company or refuses the transfer of such share;
 - g. a share that the Government of the Russian Federation decided to transfer is immediately transferred to the person in whose favour, in accordance with the third paragraph of subparagraph "f" of this section, the decision on such transfer was made, whereupon its management by the Government of the Russian Federation is terminated.
 - h. the share in the authorised capital of LLC, the transfer of which, in accordance with subparagraphs "f" and "g" of this section, was not carried out to a shareholder in the Company, shall be subject to appraisal by the Government of the Russian Federation and shall be sold in accordance with the procedure established by the Government of the Russian Federation to a Russian legal entity that meets the criteria defined in this Decree. Such appraisal and sale of the share shall be carried out by the Government of the Russian Federation within four months from the date of the decision to refuse the transfer of the share in accordance with the third paragraph of subparagraph "e" of this section or, if such decision to refuse the transfer of the share was not made (including due to non-submission of the notification provided for in subparagraph "e" of this section, or its submission in violation of the established deadline), within four months from the day following the date of expiry of the period provided for in subparagraph "e" of this section;

- i. Cash proceeds from the sale of shares in the authorised capital of LLC, the transfer of which in accordance with subparagraphs “f” and “g” of this section was not carried out to a shareholder of the Company, shall be credited by the purchaser of such share to a “C-type” account opened by LLC in the name of such shareholder of the Company in accordance with Decree of the President of the Russian Federation No. 95 dated March 5, 2022 “On Temporary Order of Carrying out Obligations to Certain Foreign Creditors.” A shareholder of the Company shall not be entitled to dispose of the aforementioned funds until completion of the procedures provided for in subparagraphs “j” to “l” of this section.
 - j. The Government of the Russian Federation shall conduct financial, environmental, technological and other audits of the activities of foreign legal entities (their branches) and/or individuals associated with the implementation of the Agreement. The list of persons whose activities are audited shall be approved by the Government of the Russian Federation;
 - k. based on the results of the audit conducted in accordance with subparagraph “j” of this section, the Government of the Russian Federation establishes the amount of the damage caused and determines the persons to be liable for its reimbursement who are obliged to compensate for it;
 - l. funds in the amount equal to the amount of the damage caused are deducted from the type “C” account opened in the name of the shareholder of the Company, associated with foreign legal entities (their branches) and/or persons on whom, in accordance with subparagraph “k,” the obligation to compensate damages in favour of the Company rests.
2. The Government of the Russian Federation shall appoint as the manager of LLC the current or last appointed head of the Russian branch of the Company, who shall perform the functions of the sole executive body of LLC from the date of establishment of LLC until the date of election of the sole executive body of LLC. If the head of the Company’s branch does not agree with his/her appointment as the manager of LLC, the Government of the Russian Federation shall appoint another person as the manager of LLC. No later than 10 days from the date of transfer of ownership of all shares owned by LLC to the persons determined in accordance with this Decree, the general meeting of shareholders of LLC shall elect a sole executive body of LLC. Operational activity of LLC shall be carried out in accordance with the terms of the Agreement.
 3. The manager of LLC is obliged to transfer all employees of the Company (its Russian branch and representative office) to LLC.
 4. When establishing LLC, the Government of the Russian Federation approves its charter, which shall remain in effect until the date of approval of the new charter of LLC by the shareholders of LLC. The shareholders of LLC shall conclude the incorporation deed of LLC and approve a new charter of LLC within one month from the date of transfer of ownership of all shares owned by LLC to persons determined in accordance with this Decree. LLC’s incorporation deed and charter shall vest all shareholders of LLC with the same rights and duties as those belonging to shareholders of the Company.
 5. The law of the Russian Federation shall apply to legal relations connected with the implementation of the Agreement.
 6. Disputes arising out of legal relations related to the implementation of the Agreement shall be heard by the Arbitrazh (Commercial) Court of the City of Moscow.
 7. Provide the right to give official explanations to:
 - a. The Central Bank of the Russian Federation- on the issues of application of this Decree as it relates to “C” account transactions;
 - b. The Government of the Russian Federation on other issues regarding the application of this Decree.
 8. This Decree shall enter into force from the date of its official publication.

[seal: The Office of the President of the Russian Federation]

President of the Russian Federation

V. Putin
Moscow, Kremlin
June 30, 2022
No. 416