

Transfer of Rights to Work Oil and Gas in Russia: The Debate Over Legislative Change

by Janet Keeping*

Introduction

When the USSR was dissolved, the Russian Federation emerged as a country looking to adopt at least some aspects of a market economy. For a variety of reasons, much of the technical assistance provided to Russia by western countries since then has focused on the energy sector.¹ One of the areas that has been of particularly great interest to Russian government officials is rights issuance and management. Concrete steps have been taken by Russian law-makers to adopt rights issuance mechanisms which are suitable to a more market-driven oil and gas industry, including in some of the earliest pieces of reform legislation.² Canadian approaches to rights issuance have been thought to be especially relevant in certain regions of Russia, most notably in the Khanty-Mansiysk Autonomous Okrug of western Siberia, which still produces about one half of all Russia's oil. Regional oil officials in Khanty-Mansiysk have been studying Alberta oil and gas legislation since the early 90s and have imple-

mented key parts of that province's resource management regime.

Although there is still a considerable thirst for information on Canada's resource management regimes generally, interest has also grown in particular, more detailed facets of them. There has been a fairly widespread acceptance of competitive mechanisms for rights issuance in Russia, even though implementation of such measures has not always been smooth. But with at least the general concept in place in much of the country, the attention of many who are interested in continuing to improve the legislative scheme for regulation of the Russian oil and gas industry has shifted to some of the less obvious features of market-driven rights issuance and management schemes – less obvious, but probably no less important. One of these is the ability of companies to sell, transfer or pledge all or part of the right that has been issued to them by the state.

This article will, then, briefly discuss the following:

1. The role that this ability of rights holders plays in the Canadian oil and gas sector;
2. The desirability of similar flexibility in Russia;
3. Russian law on this subject; and
4. The factors at play in the Russian debate on this topic.

Résumé

Cet article se penche sur la nécessité d'une modification de la législation russe afférente aux hydrocarbures qui permettrait plus de souplesse dans le transfert des licences. L'auteur note qu'au Canada, les sociétés jouissent d'une très grande liberté eu égard à la cession des droits afférents aux hydrocarbures qu'elles ont obtenus du gouvernement et souligne que ceci facilite le développement des ressources en hydrocarbures. L'auteur étudie les avantages d'une telle flexibilité en Russie ainsi que l'état de la législation russe en la matière et le débat sur les récentes modifications à cette législation. Enfin, l'auteur note les liens qui existent entre des questions spécifiques, telles que celle analysée dans cet article, et les sujets plus généraux, par exemple le développement de la règle de droit en Russie.

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The Transfer, Sale or Pledge of Interests in Oil and Gas

The rights issuance processes in effect in Canada result in private companies acquiring legally defined interests in publicly owned resources. Once these interests are acquired by companies, they become corporate assets which may be used in a number of ways. Some companies, which acquire mineral interests, proceed on their own with exploration and development. But others sell, or otherwise dispose of, all or part of their interests in order to raise revenue, spread risk, combine or gain access to expertise, or achieve other corporate objectives. As well, the fact that mineral interests are viewed as assets means that they can be used as collateral for financing. For example, a company that acquires mineral rights may need to borrow money in order to undertake exploration and development. In a wide variety of ways, companies may use a license to raise the money needed to make the expenditures which are required before a given mineral property begins to generate a positive cash flow.

All Canadian rights issuance and management systems recognize that the transfer of complete or partial ownership of mineral interests is a standard type of commercial transaction in the oil and gas industry and that these transfers meet important needs of the industry in undertaking exploration and development. This is especially so in western Canada which has had an active, diversified and highly effective oil and gas industry for many years. Indeed, it has been said that the ability to transfer whole or partial interests in oil and gas licenses is the "grease" which allows the industry to function smoothly in the region. As activity picks up in the frontier regions of Canada, particularly in onshore plays in the western Arctic, the same will be equally true in those regions. It is probably not an exaggeration to say that it is impossible to imagine a Canadian-style oil and gas industry without such freedom to trade in interests acquired from the state.

The Desirability of Similar Flexibility in Russia

Both Russians and foreigners have often observed that much more capital needs to be invested in the Russian petroleum sector, if the levels of production and discovery of new resources are to recover from their sharp falls in recent years. Many different recommendations have been made as to how investment might be attracted to the Russian industry. One has advocated that Russian law be changed so as to allow the transfer of oil and gas licenses amongst companies in a fashion which is at least similar to that found in Canada. As noted above, the ready transfer of such licenses amongst companies working in Canada is critically important to the financing of operations there. The notion that a company working in Russia might be able to use its interest in a license as security for a loan is very attractive given the huge gap between the level of investment thought to be needed and that which has actually been made in the Russian oil and gas sector over the last few years.

But it is not just for the purposes of raising more money that the transfer of licenses has import. One of the characteristics of the Russian oil and gas sector of greatest worry to government officials is that an increasingly large percentage of remaining reserves are of the type classified as "difficult to produce".³ The criteria for categorization as such vary; for example, some of Russia's largest finds are very distant both from markets and existing transportation infrastructure. This is the situation regarding the massive amounts, especially of gas, in the northern parts of both European Russia and of western Siberia. Then, there are the significant amounts offshore, both in the regions already mentioned, and also in the Russian Far East (Sakhalin Island, most notably at present, but there are likely to be large reserves under other parts of the Sea of Okhotsk, that is, offshore the Kamchatka peninsula and the Magadan area), the difficulty of the

production of which is inherent in the fact they are located offshore. But another category altogether is constituted of those resources which, while not so problematically located, are found in reservoirs where the easy to produce resources have been depleted or are nearly so. These resources may require secondary or tertiary production methods or other technologies, with which Russian companies, having concentrated naturally enough on the easy to produce resources, have hitherto not had to deal. It is not clear that the kind of company which now dominates the Russian oil and gas sector is best suited, from either the technological or corporate management point of view, to produce such reserves profitably. And so, they are not being produced, and in all likelihood will not be produced for a long time to come, if companies of different size and approach are not allowed into the market. But how do they get into the market?

The licenses to this type of hard to produce reserves have in many cases been issued, as part of larger tracts of land, and they rest in the control of Russian oil companies who are not producing them. Were it possible for these companies to farm-out some of these lands to companies truly interested in trying to make a go of producing from them, then the likelihood that they would be produced increases, perhaps significantly. But without the ability to earn an interest in the license itself, there has been great reluctance to engage in this sort of arrangement.⁴

The notion that an effective and resilient oil and gas industry is composed of a wide range of companies, each one of which finds its niche, or rather that a sophisticated industry is constituted of many different niches, which are best filled by companies of different size and focus, is fully appreciated by few in Russia. But the cogency of arguments in favour of this point of view have not been lost on some of the more progressive oil and gas officials in Russia who know full well what could

be accomplished in their regions, if only the regulatory regime permitted greater flexibility. These officials are, of course, familiar not only with the potential utility of a freer system of license transfers but also with other facets of licensing systems, such as Alberta's, which encourage the turnover of non-producing lands. Many Russian oil and gas officials are aware that in a jurisdiction such as Alberta rights to work lands of potential oil and gas significance have been sold 7 times over and they have not been slow to understand the advantages to the State of a system of which this could be true.

Russian Law on the Transfer, Sale or Pledge of Licenses

The law of the Russian Federation "On the Subsoil" is the primary statute governing the development of oil and gas and other sub-surface resources in the country.⁵ It was first enacted in February of 1992, and has been amended twice. Until early in 2000, the law "On the Subsoil" allowed for the transfer of rights to use the subsoil (i.e., licenses) in only three, very narrow, circumstances:

- 1) where the interest holder changes its legal form;
- 2) where the license holder is reorganized either through a take-over of another company or through a merger with another company, but only where the former license holder-company owns no less than half the newly created company; or
- 3) where the license holder reorganizes its affairs so that it creates a subsidiary which continues to operate the lands in accordance with the license issued to the former license holder.

It is to be noted that in each of these circumstances, which are set out in Article 17-1 of the statute, it was the entire interest that could be transferred. The statute did not contemplate

the possibility that partial interests might be the subject of a transfer.⁶

A debate arose about the restrictiveness of these provisions, some of which will be described in the next section. But the changes eventually made were not very extensive. Although more radical measures were proposed, some of which were promoted in the professional literature in Russia, what was enacted did not go very far:

What has passed is a new provision allowing assignment of rights by a user directly to another qualified entity (which must be Russian-incorporated) in which the existing user has at least a 50 per cent capital interest at the time of the assignment. This, for the first time, gives clear statutory basis for the practice of Russian oil companies' transferring rights as capital contribution to a joint venture, such ventures typically being formed with foreign participation and investment to accelerate field development. ...

The other substantive addition ... is a new provision to allow a company (again, only a Russian company, and which otherwise meets the [statute's] requirements for resource users) that acquires a resource-use debtor's entire property ... in bankruptcy proceedings to obtain that debtor's use rights, including the licence, as a matter of right. ... This change was likely spurred by some actual cases of resource-user bankruptcy that have arisen over the past few years ...⁷

The statute still makes no provision for the transfer, under any circumstances, of less than the entire license.

The Debate on Liberalization of Article 17-1

Dissatisfaction with the restrictiveness of Article 17-1 had been growing. There were very practical sources of this dissatisfaction: although probably few in number, there were companies who could see the advantage that would immediately accrue to themselves should the law be significantly loosened. There were those too who, in the process of studying the legal regimes applicable to the oil and gas industry in

other countries, had been impressed by the importance of the role played in other jurisdictions by a relatively generous right of transfer, whether to other producing companies, lending institutions or other organizations. Russians involved in the industry were expressing a growing interest in the mechanics of transactions which make use of this kind of flexibility, for example, the farm-out, whereby a license-holder which wants some work done on licensed lands, agrees to convey a specified fraction of the license to another company in return for the latter's performance of some work, usually the drilling of a well. The license holder, which either cannot or does not want to pay the costs of such work, exchanges part of the license for the drilling of a well. Both private parties benefit, but so does the government which issued the license for it wants the benefits (royalties, perhaps tax revenues, and spin-off economic growth, such as increased demand for the companies which provide services to the oil and gas industry) which could flow (both literally and figuratively) from such a development. But this, apparently appealing, outcome was not adopted by the Russian Parliament. Why?

It was not for want of sufficiently liberal proposals. Several were advanced: "There were, from industry and some quarters in government, proposals to open up the right of assignment altogether".⁸ There were, indeed, some very carefully crafted solutions which could have ameliorated the situation considerably. For example, in an article entitled "Security and the Right to Use the Subsoil", M. Amyetov recommended amending the "Law on the Subsoil" to include the following:

A right to use the subsoil, which has been received by a user of the subsoil, may be transferred completely or in part to another entity upon the agreement of the agency authorized to grant licenses, where the persons to whom the right will be transferred have at their disposal

financial and technical resources sufficient to carry out the work on the licensed parcel of land.

This proposal would have seen transfers approved if the appropriate assurances could be given about the qualifications of the company receiving the transferred interest in the license. This proposal may be as permissive as is appropriate, given that fundamental rights issuance and approval for operations are combined in the same document in Russia. Whether it would have been flexible enough to stimulate the level of investment which is thought necessary, which would have been its purpose, is an important question, the answer to which might well depend upon the transparency of the transfer approval process. If the agency reviewing transfers applied only the legislated criteria, that would be one thing. If other criteria, extraneous to the legislation and its intent were brought to bear, that would be another. In any event, this proposal and others like it which would have increased the flexibility of the system, were not adopted. Again B why not?

No doubt some of the reasons are beyond explanation on the grounds that would usually be considered in such an article. The ways of the Russian Parliament are often opaque, at best. But some elements of the debate were clearly articulated and some strongly held views openly expressed. For one thing, there was among many Russians paying attention to the issue a real confusion as to what is meant when it is said that an oil and gas license, once issued to a company, becomes an asset of that company. Their belief was that to accede to that view meant that once the license was granted the oil and gas in the lands to which the license pertained belonged to the license-holder. And this they believed was not only contrary to Russian law (according to which, in place subsoil resources belong to the people of Russia), but deeply wrong, because to trade, then, in licenses was in effect to trade in

pieces of one's country, of the "Motherland", or "Fatherland", as Russia is referred to in the Preamble to its Constitution.

This understanding of what is owned by a company which is said to hold a license as an asset is, of course, misguided. It is not oil and gas which is the corporate asset here. The corporate asset is the interest in the license, or if the company holds 100% of the license, then the license itself which is the asset. At least in Canada, and the legal opinion has been given that the same is true under a Russian oil and gas license, the oil and gas resources themselves remain the property of the State until they are produced: ownership changes at the well-head. So, commercial transactions in licenses do not constitute trading in state-owned oil and gas; instead, a transfer of a license amounts to a transfer, in whole or in part, of an opportunity to explore for, develop or produce resources.

But it is entirely understandable that such a confusion would arise. The distinction between the right to the opportunity to exploit certain resources and the right to those resources is subtle enough for a person born and bred in a culture where private property has played a major role for hundreds of years. For most Russians, these are new concepts that do not sit comfortably with their traditions. They may or may not eventually have to get used to them, but for the time-being such concepts are not, for the vast majority, easy to embrace.

Not only was this conceptual confusion sometimes at play, but so too was there often strong resentment that the very companies which were not fulfilling obligations under their licencing agreements (to produce defined amounts from specified fields by certain dates) stood to benefit from the adoption of a more liberalized Article 17-1. Many following the debate were unenthusiastic about the prospect that companies, who after all were sitting on huge reserves and holding enormous assets

of other kinds, should be saved from their failure to perform by a change in the law. It did not help that these companies might also make some money in the process. That, in at least some cases, these companies really did not have the capital necessary to fulfill their obligations and that the desired legal change might enable them to raise some of the money needed, were propositions they either could not understand or did not want to accept.

And of course, reasonable discussion of any measure that might ease the difficulties faced by Russian oil and gas companies is always, at this point in Russia's history anyway, complicated by the fact that the those calling for help for the industry did not pay, most Russians believe, fair consideration for control of those companies. Early privatizations in the oil and gas sector are said by many to have resulted in control of these huge and critical enterprises changing hands "for a song" to insiders. It seems beyond doubt to most observers that most of the privatizations carried out so far were handled extremely badly. But the problem now, of course, is how to go on from that sad fact? There is no consensus in Russia on this question, and the recent high prices for oil and gas have only inflamed passions aroused by the issue. So mistakes of the past haunt decision-making for the future, by severely curtailing the range of measures that will be viewed as acceptable by deputies to the Duma, that is, the Russian Parliament. There are Russians willing to "let go" of the issue, to accept that what happened (however unfortunate), happened and to move on. But the weight of opinion, in both the public and officialdom, is not on their side.

Conclusions

This article has addressed only one, seemingly narrow, issue from the broad range of legal and regulatory problems faced by the Russian oil and gas sector. But the issue, as has been suggested above, is nevertheless an important one. While it is perhaps not strictly nec-

essary that companies have greater freedom to transfer interests acquired from the State in order that the Russian industry attract investment capital in the amounts which are claimed to be needed by it, there is no doubting that such a change would be of assistance in reaching that goal. But there is also no doubting that whether such measures will eventually be adopted is not unconnected with the higher profile and more passionate debates in Russia about how privatization in the sector was handled, what to do about the apparent mistakes of the privatization process and to just what extent market forces are going to be allowed to determine the development of the industry.

But the bigger, political picture is not the only source of broader considerations which impinges on the question of legislative change that would permit freer transfer of oil and gas licenses. In the West, the mechanisms pursuant to which interests in oil and gas are sold, traded or pledged as security do not stand apart from a country's legal and financial systems. On the contrary, those mechanisms are embedded in and form part of those systems. We have only to ask why our transfer mechanisms function so well to begin immediately to see how they are dependent upon other processes, which we may sometimes take for granted. Consider our systems for registry of oil and gas interests.

Given the frequency with which oil and gas rights are transferred amongst companies in the Canadian industry, it has proven important to have registries of those interests. Registers are established pursuant to law and maintained by government; they are open to the public, although a fee may be charged for their use in order to cover administrative costs. Transfers of mineral interests are recorded in the registers, as are financial encumbrances (e.g. security interests acquired by lenders) which may be attached to them. This system ensures a high degree of openness as to ownership of mineral interests.

One of the most important features of registration is the protection it provides to the company holding oil and gas rights: a registered interest is valid in law as against any unregistered interest. This means that if there is a dispute over who owns what, the company that has registered its interest will prevail. The same is true of registered security interests: the company which has acquired a security interest in oil and gas rights, for example, by loaning money on the strength of a license, if it has registered that interest, will have priority over any subsequently registered transfer or security interest, or over any unregistered interest. Thus, the registry system also ensures a degree of predictability.

But the registry system itself could not function as it does, if standing behind it were not a reliably independent judiciary which is prepared to hear and fairly dispose of disputes should they arise.

Pursuing this line of thinking even only so far, we see that the success of a flexible system of license transfers is dependent upon a degree of openness and predictability which is achieved through a legislative scheme backed by an independent judiciary. So that a seemingly innocent question about the possibility that companies should be able to assign oil and gas licenses is unavoidably connected with much broader questions about development of the rule of law in Russia, including the creation of an independent judiciary.

And the matter does not stop there: many of the oil and gas deals in the West are never registered and yet very little litigation ensues. Why? Because against such a stable institutional background, the informal "rules of the game" have developed to such a point that the formal procedures need not always be invoked. Thus, another important element, trust amongst participants in the industry, also functions to keep the whole process going along reasonably smoothly.

So is the morale of this story that,

because the pre-requisites to giving industry almost free reign in the transfer of interests are so far from being obtained in Russia, there is no point in advocating for the kind of legislative change discussed in this article? Not at all. It is one thing to point out the institutional connections amongst the various parts of the puzzle. But it is quite another to insist that there is a uniquely correct place to start in reform of a whole political-economic system. It will be a very long time indeed before any system of, say, rights issuance and management in Russia looks very much like that in operation in one of the advanced, western democracies. But that does not mean that meaningful progress cannot be made today and in the near future. On the contrary, it must be made if Russian society is to advance, and advance it must, if the world is to become a safer place.

The morale is neither pessimistic nor optimistic it is simply declarative: that the profundity of a change towards a contemporary market economy, from a command economy based upon a longer tradition of highly centralized control, cannot be overstated. What is at stake is nothing less than an attempt to substitute one set of behaviours, instincts one could almost say, for another:

1. Flexibility for administrative rigidity;
2. Adherence to law for the supremacy of ideology and the personal power of selected individuals;
3. Openness for secretiveness; and
4. Trust for mistrust.

None of this is new, but it seems nevertheless sometimes to be forgotten by those who think that there are "technical" questions of regulation which can be isolated from the bigger questions of reform, such as establishment of the rule of law. Regulatory reform, such as greater flexibility in the management of oil and gas rights, can and will be

achieved, but only in concert with progress on reform of related institutions. There need not be a recognizably complete rule of law in Russia before the rules applying to license transfers can be much further liberalized, but there probably first needs to be made more progress in that direction.

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Notes

1. For a description of the technical assistance projects related to the Russian oil and gas sector, in which the Canadian Institute of Resources Law has been involved, see "Policy Advice on the Russian Oil and Gas Sector", Resources, No. 65, Winter 1999.
2. The Law on the Subsoil, was enacted in 1992 and amended in 1995 and 2000, and the Regulations on Licensing enacted a few months after that law, are such examples. Taken together they created at least a partial legal framework for the issuance of rights pursuant to competitive tendering.
3. The figure was about 50% two or three years ago and is now probably higher.
4. It may, but it may not, go without saying that there are other enormous challenges facing any company contemplating an entry into, or further investment in, the Russian oil and gas sector. An onerous taxation regime, undependable legal system, and sometimes unpredictable access to pipelines are only some of the substantial problems to be faced. This article focuses only on one, apparently narrow issue, but it is one which, as acknowledged later in the text, is ineluctably connected with others which are both better known and much broader in their scope.
5. Apart from offshore resources, which fall under the exclusive jurisdiction of the central government (that is, the government of

the Russian Federation), legislative jurisdiction over "questions of the possession, use and disposition of land, subsoil, water and other natural resources" is said by Article 72, part 1(c), of the Russian Constitution to be "within the joint jurisdiction of the Russian Federation and the subjects of the Russian Federation (the regions)". The constitutionally proper parameters for the exercise of this "joint jurisdiction" are, not surprisingly, not yet clear, but the paramountcy of federal legislation in these fields is. Accordingly, regions which would like to legislate for greater flexibility in licensing matters are constitutionally obliged not to legislate in contradiction of such federal legislation as the law "On the Subsoil".

6. The contrast with the situation in a jurisdiction such as Alberta is so stark as to merit comment. There is no limit of practical significance to the size of interests which can be carved out of oil and gas licenses granted by the government of Alberta. The regulations specify the number of decimal points that can be used in description of interests, but the matter is hardly of any real concern. As well, the statute provides that the Minister need not allow the registration of very small, fractional interests: if the interest conveyed is "less than 1%" the Minister may decide it is not worthwhile to allow its registration. But the flexibility permitted is enormous.

7. Jonathan H. Hines and Dmitri V. Nikiforov "New Amendments to Russia's Underground Resources Law" (2000) 18 Journal of Energy and Natural Resources Law at 196-197.

8. Hines and Nikiforov, at 196.

9. This recommendation can be found at the end of an article in the Russian journal Oil, Gas and Law, No. 2(20), 1998, on pages 8 and 9.

Human Rights and Natural Resource Development

CIRL hopes to develop a proposal for a project on the overlap between the body of law which applies to the development of natural resources and that which applies to the protection of human rights and civil liberties. The proposal will be a joint one, involving the Alberta Civil Liberties Research Centre, which is also located on the University of Calgary campus. The range of possible issues is very broad, from instances where the legal framework within which natural resources are developed may conflict with some of the fundamental civil liberties, such as freedom of expression, to some of the most dramatic of world tragedies, such as the accusations of genocide associated with mining, forestry or oil and gas operations in the third world. A similarly wide range of corporate instruments and legal, or governmental, institutions could be the subject of study, from corporate codes of ethics and bilateral agreements between companies and indigenous peoples to statutory-based project-approval processes.

The CIRL Research Associate working on this proposal is Janet Keeping. She would appreciate hearing from any readers of Resources who have thoughts on which of the possible legal issues or corporate or governmental processes would be most appropriate for study. The first stage of this work is likely to focus on the human rights issues which arise in the context of natural resource development in Alberta. But another topic in which considerable interest has already been expressed is the role that corporate codes of ethics or behaviour could play in avoiding human rights abuses by Alberta companies working abroad.

Comments can be sent to Janet Keeping at <cirl@ucalgary.ca>.

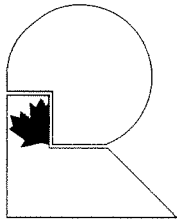
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This book provides a thorough and timely analysis of the new regulatory regime applicable in the Mackenzie

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