Oil, Law and Politics in Russia

By Doran Doeh, *managing partner, Denton Wilde Sapte*

This article is based on talks I gave at various seminars and conferences in the first half of 2005 and covers a number of loosely associated subjects. It reflects circumstances at the time of writing (4 August 2005). Change in Russia takes place at a very rapid pace, and therefore this article may become out-dated very quickly.

The views expressed are my own and should not be ascribed to my firm or to any other person or organization.

Russia and the Rule of Law

The question of the rule of law in Russia arises time and again, posed in many different ways, and is fundamental.

It is paradoxical that the rule of law requires a strong state to establish and maintain a comprehensive, coherent and effective set of laws and also an independent judiciary to enforce them. A strong state is also needed to enforce judgments. The state then also needs to be able work effectively within the judicial framework established without being humiliated and to abide by the results without being weakened. It is part of the paradox that a state which fails to establish the rule of law, or to abide by it, undermines itself.

The adage "Russia is never as strong as it seems or as weak as it seems" has been variously attributed to Talleyrand, Napoleon and Metternich. Whatever its origin, its enduring aptness tells us something about the nature of Russian power. In relation to the rule of law, the weakness of the Russian state during periods when it is weak is as much of a problem as its strength when it is strong.

The Khodorkovsky and Yukos cases have heightened concern over the issue both for participants in the oil and gas industries and for more general investors.

Recently, events elsewhere in the former Soviet Union have also brought into focus issues of general political stability and the potential consequences of regime change. The role of the Ukrainian judiciary in the peaceful transition that took place in their country has emphasised the important role that the rule of law can play in the CIS. It should be noted that President Putin urged reliance on the judiciary in resolving the Ukrainian crisis and accepted the result once the legal process was completed.

In Russia, the rule of law does not have an unblemished reputation. From the point of view of ordinary Russian people, the ruthless use of legal methods in the 1990s by well-connected businessmen gave the impression that law is only an effective tool in the hands of the rich who can afford to engage the best lawyers and use the system to their advantage. Foreign investors who were involved at the time have not entirely forgotten or forgiven the injuries they suffered by the use of such techniques.

On the other hand, the perpetrators themselves have moved on and need the rule of law to protect them from each other and from the depredations of the state. The Khodorkovsky/Yukos saga has made clear the importance to everyone of having clear rules that are well understood, accepted and enforced.

Recently in Russia, it has been common to contrast the *rule of law* with the *rule of administration*. This recognizes that the legal system is only part of the story and that the way administrative discretions are used can be equally – if not more – important in determining outcomes in a highly bureaucratic state like Russia. Those with a cynical turn of mind regard the contrast as being between the power of money and the power of power (i.e. those in positions to exercise power through the use of administrative measures).

The Legal System – then and now

It is worth making the point that, in respect of the rule of law, the past 20 years since the beginning of *perestroika* in 1985 have been completely out of keeping with the Russian past.

Historically, Russia has been isolated in the Eurasian land-mass, remote from other centers of civi-

lization but nonetheless at most times facing some kind of serious external threat, poorly developed economically with a largely illiterate population and very little in the way of a merchant class. It has traditionally had an authoritarian form of government. Even those rulers like Peter the Great who initially started with liberal intentions have ended as autocrats out of frustration in dealing with vast domains and unruly people. From a lawyer's point of view, nothing characterizes the peculiar character of the old Russian and Soviet states more than secret laws (as with secret police, developed in the Tsarist period and used ruthlessly and with 20th century efficiency by the Communists). Secret laws are not for the subject to know and abide by (or assert rights under) but rather empower officials and legitimise their activities. This tradition was brought to an end by providing, under the current Russian constitution, that laws are not effective until officially published.

The 1990s were a chaotic and confusing period in Russia, during which the Soviet Union collapsed and a new society had to be fashioned out of the rubble. Particularly at the beginning of that period, there was a serious risk that the Russian state would implode. The speed with which action was required did not allow for long deliberation, and, in any case, the situation was in many ways unprecedented. Often there was widespread uncertainty as to exactly what the new rules were or which ones had come into effect, let alone how they were supposed to work. I can remember the practice whereby Russian lawyers would, whenever they met, exchange newspaper clippings of new laws because that was the only way they could keep track of them. For a number of years, Russian company law consisted of a single decree issued by President Yeltsin.

From a practicing lawyer's point of view, there is a vast difference between 2005 and 1995. The Russian system of law has been completely revised over the past 15 years, and is now based primarily on German, Netherlands and Swiss civil law precedents with some US influence. (This influence is found more in the policies behind some of the laws than the laws themselves – US laws, being based on a common law rather than a civil law system, would be directly transposable into Russian law only with great difficulty.) The Russian legal system is more settled, coherent and predictable, and it is possible to give clients definitive legal advice in most areas, although there are still many inconsistencies, lacunae and poorly drafted provisions. In general, there is greater transparency in the way affairs are conducted, although Russians in general are instinctively mistrustful of the state (and one another) and therefore inclined to be highly secretive. The reform of the tax system has played a part in this, because lower and fairer taxes encourage proper recording of transactions. Partly due to greater transparency and partly due to reform of the court system and judiciary, litigation in the Russian courts and arbitration tribunals has been a strong growth area. Serious foreign direct investment has increased, and therefore foreigners are now in a stronger position to assert their needs for greater legal certainty and stability.

Privatization Russian Style – Today's Corporate Legacy

Today's Russian business environment largely results from the privatizations of the first half of the 1990s and their consequences.

Privatisation in Russia was both very rapid and pervasive. Virtually the whole economy was privatised within a three year period. To understand the nature of Russian privatization, it is necessary to have some appreciation of the system that preceded it.

In the Soviet Union, all property belonged to the state, so in order to give a degree of independence to management state enterprises were established which had "management" or "economic" control over the assets entrusted to them. In practice, under the Soviet system, most enterprises were under the *de facto* ownership of their managements because physical control gave them power over the assets regardless of any legal theory as to their ownership.

Privatization of a former state enterprise involved establishing a joint stock company designated for the purpose of privatizing the relevant enterprise and transferring the relevant assets and people to it, by administrative instrument having effect as secondary legislation. Under the main method of privatization, management and workers were given 51 per cent of the ordinary shares (comprising 38 per cent of the total capital, as usually 25 per cent of the capital was structured as preferred shares), the remainder of the shares being offered for vouchers that were distributed to the public at large to enable them to bid for shares in the industries being privatised. In effect, this recognised the realities of economic power under the Soviet system, the state's "real" share in the enterprise being transferred to the public through the voucher auctions.

However, the "commanding heights" of the economy (including most of the oil companies) were not privatised in this way but were kept back because they were considered too valuable to be given away in this fashion.

Subsequently, many of the privatised companies found themselves with inadequate capital. Many of the managements bought out their workers' shares, and in a wide range of instances, both managements and workers were bought out by third parties, often Russian banks seeking to accumulate valuable businesses which they, with their greater access to capital, would be able to restructure and redevelop more effectively. This resulted in sprawling, vertically integrated financial-industrial groups increasingly consolidated under the control of a small number of "oligarchs".

In the run-up to the 1996 presidential election, it became necessary to raise large sums of money to support President Yeltsin's faltering campaign. Under the "loans-for-shares" scheme, shares in the industries previously reserved as too valuable to privatize in the normal way were offered as security for loans from banks controlled by the "oligarchs" – only Russian banks were allowed to participate and the oligarch-controlled banks were the only ones big enough to lend the sums required. The government subsequently defaulted on the loans, the security was put up for judicial auction, and the bank that had made the relevant loan was usually the one successful at the relevant auction.

It has been widely suggested that the oligarchs obtained these businesses – which included most (but by no means all) of the big oil companies – very cheaply. It has also been argued, conversely, that these companies were so poorly managed under the previous ownership of the state that, in their condition at the time, they were not worth more than was paid. In my experience of privatization at the time, it was the case that very little information was available about the industries being privatised, so a banker who had direct access to an enterprise, even for a relatively short period of time before it was privatised, would be in an advantageous position to bid against someone else who had not. So far as I am aware, it has never been asserted that the loans-for-shares scheme was in any way tainted by fraud or otherwise legally invalid, although such allegations have been made in relation to some of the earlier (non-oil-company) privatizations. There were, however, many irregularities in the privatization process. Most of these were, even earlier this year, covered by the 10 year limitation period, and by the end of 2005, even the loans-for-shares companies would have been so covered.

However, to draw a line under the privatizations, President Putin has pushed through legislation so that the privatizations will, in the future be unchallengeable (except possibly where overt criminal activity was involved). His willingness to do so indicates a policy of upholding the original privatization process, in contrast to Ukraine which has announced a policy of re-examining privatizations. In any case, the situation in Russia is different from Ukraine because in Russia, many foreigners have bought shares in privatized companies and any form of re-nationalisation would be substantially complicated because of that.

In an interview with the *Financial Times* published on 13 November 2004, Anatoly Chubais, one of the chief architects of Russian privatization including the loans-for-shares scheme (and now the head of RAO UES the partially privatized national electricity holding company), commented:

> *"We did not have a choice between an 'honest' privatization and a 'dishonest' one, because an honest privatization means clear rules imposed by a strong state that can enforce its laws. In the early 1990s we had no state and no law enforcement. The country's security service and police… were taught the Soviet criminal code, which implied prison for private business activity. Our choice was between bandit communism or bandit capitalism….*
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> *"If we did not have the loans-for-shares privatization, the communists would have won the 1996 election and this would have been the last election Russia ever had, because these guys do not give up power easily….*
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> *At the time, I did not understand the price we would have to pay. I underestimated the sense of deeply rooted injustice it would leave in people."*

Law, the Russian Oil Industry and International Oil Companies

PSA vs. tax & royalty – what was that all about?

When international oil companies ("IOCs") started coming into Russia during the early 1990s, they found an environment different from anything they had experienced before. Russia was not a new province without an existing petroleum industry – quite the contrary, oil and gas had been produced in the Russian Empire and subsequently the Soviet Union since the late 19th century. And yet,

it was almost completely unknown territory for the IOCs. The managements of the Russian oil production enterprises, as well as many other Russians, were well aware of the huge wealth to be derived from obtaining ownership post-privatization. IOC's seeking to do deals were, in effect, competing with these insiders for control of the producing assets.

Many IOC's were mistrustful of the legal framework they found in Russia, partly out of Cold War conceptions which were carried forward into the new era but also because of the chaotic situation in the country.

The Russian government, having been advised that the system of granting one-year administrative oil production permits that had been used in the Soviet period would not be acceptable to international investors, introduced a licensing system. However, although IOC's generally found licensing systems acceptable in Western Europe, the idea of relying on an instrument (i.e. a licence) subject to administrative law was unacceptable to many (but not all) in the Russian context.

Many IOC's (but again, by no means all) were also reluctant to get involved in onshore projects. Russian export pipeline capacity was (and remains) inadequate to export all Russian oil production and was therefore pro-rated amongst producers by reference to production volumes. Therefore to produce onshore would involve having to become involved in the Russian domestic market, with which IOCs were wholly unfamiliar (and in which prices were generally much lower than in international markets). The biggest IOCs were also interested only in very big projects, which were more readily available offshore (where generally Russian companies could not compete because the sums of capital required were so much greater than they could command).

The lobbying of the IOCs for PSAs ultimately resulted in legislation which provided for PSAs as an alternative regime to the licensing regime. However, the legislation was long delayed in being passed by the Russian parliament, largely because of the strong lobby against it (see below). After its initial passage, the PSA law proved to be defective and needed amendment. The secondary legislation needed to implement it was also slow in coming (the PSA regime was incompatible with the licensing regime and therefore needed a separate set of rules and instructions to officials). In practice, only three projects have been developed on the basis of PSAs, two of them offshore and one in a remote region of northern Russia that, for practical purposes, has many of the characteristics of an offshore project.

As the PSAs provided for government take (apart from profits tax to which the participants remained subject), the licensing regime became known as the "tax and royalty" regime by contrast. However, the fiscal aspects were by no means the most important – it was important to IOCs that their interests should be governed by contract (and subject to international arbitration) rather than administrative instrument (in respect of which recourse would be to the Russian courts).

A variety of interests lobbied against the PSA regime. Partly this was political – the PSA regime was favoured by foreigners, and nationalistic politicians wished to keep them out. A number of the Russian oil companies also lobbied against it. The ostensible reason was that the tax and royalty regime was much more favourable to them fiscally, and they wished to discourage the government from pursuing the PSA regime on any broad scale. However, it also had the effect of keeping foreigners out, leaving it to Russian companies to acquire whatever good acreage remained onshore.

The collapse in oil prices in 1998 also discouraged foreign investment in the Russian oil industry, and reinforced the advantages of the domestic industry in playing at home.

This period came to an end when BP announced its deal with TNK. The BP-TNK joint venture is essentially an onshore one almost exclusively conducted under the tax and royalty regime. The international industry very rapidly capitulated on the issue of PSAs vs. tax and royalty, and accepted the mainstream regime if it wanted to have a substantial future in Russia. With prices – both internationally and in Russia – going ever upwards, the attractions of investment in the Russian oil industry for IOCs also increased.

The above narrative and analysis neglects the Russian gas industry, which has remained as a monopoly primarily.

What now, what next?

The Russian government finds itself in a difficult position in dealing with the oil industry. There are essentially three groups of players – the Russian oil industry (largely controlled by oligarchs), the Russian state sector (Gazprom and Rosneft – see below), and the IOCs.

The Russian government has found it difficult to deal with the oligarchs, and much of President's Putin's efforts since he came into office have been spent trying to bring them under control. In a country like Russia, a small number of very wealthy men controlling key industries could wield enormous power – it has been suggested that some were in the process of privatizing the state itself. Whether the methods used to bring the oligarchs under control – particularly the attack on Yukos and Khodorkovsky – were well judged, history will tell. What can be said at this stage is that an uneasy relationship has been established which gives the government more leverage over big business than it had at the beginning of the decade.

In theory, the state sector should be more biddable to the government's commands. However, the most powerful actor there, Gazprom, is a huge and sprawling organization that has often been characterised as a "state within a state". Again, efforts were made early on in Putin's presidency to bring Gazprom under control and it is thought that these have, to a significant extent, been effective. Recent incidents, however, in relation to the folding of Rosneft (the company that held the residual unprivatized oil assets of the Russian state) into Gazprom have made it clear that control is not complete and, indeed, that state sector top management are capable of effectively defying government will in pursuit of their own interests if they are sufficiently determined. President Putin has also stated on many occasions that he does not believe that the state sector is capable of managing assets as efficiently and effectively (from an economic point of view) as the private sector.

This leaves the IOCs as the third leg of the triangle. Although in some ways, IOCs are likely to be the most co-operative with the government of the three groups, improved relationships with IOCs are easy for nationalistic opposition politicians to attack. Also, as in any country, there is uneasiness from a defense and national security point of view in allowing such a strategically important industry come under foreign control.

In my view, therefore, it is likely that for the foreseeable future, the Russian government will have to make the best of a problematic situation by keeping up the pressure – and the tension between – each of these groups. One way in which they are likely to seek to alleviate this is to co-operate amongst themselves, and there are many signs of this currently. As the industry evolves – particularly if new entrants come in from outside, as is also starting to happen, or new Russian companies emerge (also happening) – this picture will change.

The most recent development is a set of proposed changes to the subsoil law which will deal with many of the problems that have been of concern in the past. These include:

- a new contractual regime to replace the licensing regime – this will meet the IOCs' preference for a civil law rather than administrative law instrument (although effectively it will be judiciable in the Russian courts, which are not subject to international arbitration);
- participants will be required to establish Russian (i.e. onshore) companies in order to receive contracts – i.e. participation through offshore vehicles (for Russians or IOCs) will no longer be accepted;
- rights for companies that had made exploration discoveries to be granted production contracts;
- the contracts will be assignable with government consent;
- the contracts will be capable of being pledged, i.e. it will be possible to secure borrowing on the contracts, which will make project financing of Russian oil and gas developments more practicable; and
- fields of "strategic" importance will require at least 50 per cent Russian participation.

I would just make three comments on this.

The new contracts will be subject to the tax and royalty regime, i.e. the new regime will combine elements of both of the previously available regimes. There are, however, suggestions from various quarters that the PSA regime will not be wholly abandoned and may be used for some big projects in offshore and remote areas. However, given the change of the main regime to a contractual basis, PSAs should fit much more easily with the standard approach in the country at large.

The contractual regime, although giving the IOCs what they want in terms of legal character, is also favoured by President Putin. He has stated that he believes they will give him much more control that licenses which are subject to cozy deals between oil companies and administrators over whom he has only very indirect control. However, existing licenses will not necessarily be converted to contracts, if their holders wish them to continue under the licensing regime.

The requirement for at least 50 per cent Russian participation in "strategic" fields has been contro-

versial, and to discuss the issues properly would require more space than is available for this article. President Putin has indicated that this should be seen in the context of his policy of making clear to foreign investors what is and is not open to them in Russia, so that when they invest, they may do so with confidence.

How this will play out in practice remains to be seen. The legislation has only just been presented to the Russian parliament and will have to go through a number of stages – at which it may be revised significantly – before it is finally passed. As usual nowadays, the Russian scene is a rapidly changing one. □