Contracts for Oil Transportation by Trunk Pipelines: Theory and Practice of Enforcement*

By S. Sitnikov, Intern, Baker & McKenzie

While the energy sector generally is booming in Russia, there is a lack of clarity on certain aspects of Russian legal regulation regarding oil transportation.

This paper will analyze contracts for oil transportation via long-distance pipelines ("Pipeline Contracts"), as well as relations arising out of and in connection with negotiation, execution, and implementation, and the special features of related government regulations, focusing on the civil law aspects of the same.

Government Regulation of Pipeline Contracts: Background

Presently, the three principal options for oil transportation are:

1) railways;

2) sea-going tankers; and

3) trunk pipelines.

Since the trunk pipeline network covers most of Russia and is constantly expanded and upgraded, this mode of transport is practically the most important.

The regulation of commercial usage of the trunk pipeline system in contemporary Russia is believed to have largely commenced with Russian Presidential Decree No. 1430 dated November 17, 1992, *On the Specifics of Privatization and Corporization of State-Owned Enterprises and Production and Science-and-Production Associations in the Oil, Crude Refining, and Oil Product Supply Industries*. It was followed by Council of Ministers Resolution No. 810 of August 14, 1993, *On the Establishment of the Transneft Joint Stock Company for Oil Transportation* ("Transneft").

Transneft is a natural monopoly in its field of operation,[1] which impacts its dealings with third parties.[2]

A legislative framework is currently in place to regulate a wide spectrum of relations involved in the pumping of oil via trunk pipelines, including oil supplies for export. That legislation makes Transneft entities the major determinant of such relations, which are basically of a civil-law nature (see below for details regarding such regulation). The principal pieces of legislation in question include, but are not limited to:

- Russian Government Resolution No.1446 *On the Exportation of Oil and Oil Products From the Customs Territory of the Russian Federation from January 1, 1995*, dated December 31, 1994 (as subsequently amended);
- Russian Government Resolution No.209 *On the Regulation of Access to the System of Trunk Oil Pipelines, Oil Product Mains, and Terminals at Seaports for Exporting Oil and Oil Products From the Customs Territory of the Russian Federation*, dated February 28, 1995;
- *Regulations on the Procedure for Assigning Rights of Access to the System of Trunk Oil Pipelines and Terminals at Seaports During Transportation of Oil From the Customs Territory of the Russian Federation*, as approved by a Russian Ministry of Fuel and Power Development order dated August 4, 1995 (as subsequently amended);
- *Regulations on the Acceptance and Flow of Oil Within the Trunk Oil Pipeline System,* as approved by a Russian Ministry of Fuel and Power Development order dated September 1, 1995 (as subsequently amended) (the "Oil Flow Regulations");
- Russian Government Resolution No.1130 *On the Allocation of Additional Oil Trans-*

* The author expresses his profound gratitude to D.V.Baranov, head of the oil transportation contract department of Transneft Joint Stock Company for Oil Transportation OAO, for advice in writing this article. However, the ideas set out below represent the author's own opinion.

[1] See, for instance, Article 4 of Federal Law No. 147-FZ *On Natural Monopolies,* dated August 17, 1995, and Russian Federal Energy Commission Resolution No.15/6 of March 24, 2000.

[2] Transneft has a standard Pipeline Contract, which Transneft is usually very reluctant to amend for a particular transaction.

portation Quotas for Export Purposes, dated September 2, 1997; and

- *Instructions on Accounting for Oil During its Transportation Via the Trunk Oil Pipeline System of Transneft Joint Stock Company OAO*, as approved by the Russian State Committee on Standardization and Metrology under Registration Code FR.1.28.2001.00274.

There are broad differences of opinion on the government regulation of the civil-law relations arising in oil transportation operations. Some authors[3] even question the very legitimacy of any such government regulation of arrangements related to oil transportation in general, and contracts for oil transportation via trunk pipelines in particular.

However, an adequate analysis disproves contentions that the Oil Flow Regulations run counter to applicable Russian legislation. The Oil Flow Regulations have also been very successfully implemented in practice ever since their issue and adoption. Evidently, when forging their contractual relationship and drafting related agreements, prospective partners are well advised to abide by the relevant provisions of both the Oil Flow Regulations and other acts applicable to the sector.

Substance of Pipeline Contracts

The Civil Code contains no special regulations regarding Pipeline Contracts and related arrangements. Such arrangements are subject to Article 421 of the Civil Code, which entitles the parties to a civil-law relationship to enter into any contracts – both those provided for in the Civil Code and those not envisaged therein.

However, with the Civil Code providing no direct guidance, certain questions may arise, the answers to which will be the key to defining the rights and obligations of the parties to a Pipeline Contract. There are debates currently under way on the type of agreement constituted by such a contract. This issue is exceptionally important because the regulation of parties' rights and obligations under a Pipeline Contract and the allocation of risks to be encountered in its performance[4] are directly dependent on its type.

The existing theories regarding the type of agreement that a Pipeline Contract constitutes can essentially be summarized as follows: transportation contract, paid services contract, energy supply contract, or processing contract.

However, theoretical and practical analysis of Pipeline Contracts and relationship thereunder added weight to another point of view, which appears to be preferable, whereby the substance of relations between oil consigners and Transneft and their Pipeline Contracts constitutes a mixed arrangement (Article 421.3 of the Civil Code).

Therefore, a Pipeline Contract consists of elements of an exchange contract and a services contract. These include, but are not limited to, dispatch control over oil flows and oversight over oil pumping, transshipment, loading (except loading into oil tank trucks), and offloading.

However, the services provided by Transneft under Pipeline Contracts serve basically ancillary function of supporting the parties' exchange of one commodity for another, meaning that the services contract format makes the exchange contract possible or, to quote M. I. Braginsky, "caters to the contractors' principal function".[5]

Practical aspects

Incorporating elements of exchange contracts into the definition of a Pipeline Contract indeed makes it possible:

1) to identify the owner of the oil handed over by the consigner to the trunk pipeline network. This issue arises as the result of such oil being "depersonalized" after being fed into the system of mains and due to the resulting disappearance of a thing in specie – the consigner's oil – in the form in which it was pumped into the Transneft pipeline network (see above). Identifying the owner of the oil passing through the mains' system in the process of transportation makes it possible to determine the party bearing the risks associated with the possible loss of the quantity of oil surrendered by the consigner;[6] and

2) to explain the reduction in the amount of output oil compared with that quantity handed over for transportation by the consigner (for details on such reduction, see below).

This issue also calls for analyzing a correlation between:

1) the passing of a title to the consigner's oil surrendered to the Transneft transportation system from the consigner to Transneft; and

[3] See, for example, *Logofet D. D.,* "Oil Transportation Contract" [in Russian] in Pravo i Ekonomika [Law and Economics], Issue No. 4, 2003.

[4] For example, the risk of accidental loss of that oil fed into the pipeline network.

[5] *Braginsky M. I.,* Contract of Storage [in Russian], Moscow, 1999, p. 7.

[6] The risk of accidental loss of such oil transported under the current Transportation Contract, for example, should be borne by Transneft by virtue of Article 211 of the Civil Code and in accordance with a relevant clause contained in the Transportation Contract itself.

2) the consigner's right to dispose of its oil in transit, since it is perfectly clear that the consigner may have certain agreements determining the oil's destiny upon its delivery.

The consigner does indeed retain the right to dispose of a commodity having similar characteristics (within the corresponding GOST state standard) to those of the oil it pumped into the Transneft network. However, the oil received by the consignee is not the same oil pumped into the network by the consigner, but that which the consignee is entitled to obtain under the corresponding Pipeline Contract as an exchange of oil. For, once the consigner has pumped oil into the Transneft network, then that oil effectively no longer exists, as it has mixed with oil from other consigners, and can no longer be extracted from the Transneft network in its original form. Thus, once a consigner has pumped oil into the Transneft network under a Pipeline Contract, it has lost its ability and its right to dispose of that oil, and will only be able to dispose of the output oil, which it has a right to receive and dispose of under the Pipeline Contract, and which will probably have different qualitative characteristics (within GOST standards), and will invariably have different quantitative characteristics (due to process losses) than the oil the consigner originally pumped into the Transneft network.[7] Should the consigner dispose of the oil by selling it, the sale will be subject to Article 455.2 of the Civil Code dealing with the disposal by a seller of property to which it will obtain title in the future.

The party to such exchange with Transneft (i.e., more often than not, the oil consigner itself) is also able, to the extent stipulated by civil legislation, to dispose of its rights and demands in respect of Transneft by virtue of such exchange relations.[8]

The consigner's possible assignment of its rights under a Pipeline Contract, resulting in the assignee obtaining the right to make demands of Transneft, is another form of a disposal by the consigner of its oil in transport (or, more precisely, its related rights). However, Transneft's standard Pipeline Contract provides a list of grounds on which the oil consigner may assign its rights and obligations thereunder. For this reason, it is difficult to speak of any free disposal by the consigner of its rights in the oil in transport.

The specific form of disposing of the oil or the related rights, as well as the terms and conditions of the corresponding contract, should be selected with extra care in each particular case, since the choice will be the key not only to the parties' rights and obligations, but even to the contract's underlying validity.

Besides, the fact that Pipeline Contracts are to be classified as exchange agreements entails a number of important consequences for the parties, namely, the oil consigner and Transneft.

One such effect is the accounting consequences owing to the disappearance of the consigner's oil as a thing in specie, along with the change of title to the oil in transport, and Transneft's obtaining ownership rights in the corresponding oil. The result is that it is necessary to maintain accounting for such changes on the balance sheets of both companies. In addition, the oil consigner's rights and demands arising in respect of Transneft as part of exchange relations should likewise be duly accounted for.

Another effect is the consequences of a possible Transneft's bankruptcy. Thus, in case of the bankruptcy of Transneft, all dealings (including transfer, disposal) with all its property, including oil in the Transneft's trunk pipeline system (the "Property"), may be prohibited.[9] Moreover, all Transneft's Property may be sold in auction in order to discharge the company's indebtedness. However, consigners will become creditors of Transneft in the bankruptcy process enjoying the rights provided for by applicable bankruptcy legislation. It is clear that this may be a complicated situation for both Transneft and any consigner, therefore, each case should be examined individually.

Participation of Federal Authorities in the Execution of Pipeline Contracts

A calculated oil production and allocation balance is among the principal documents underlying oil transportation operations. The Russian Ministry of Fuel and Power Development[10] approves this kind of document for oil along with gas condensate 45 days prior to the beginning of each quarter, and brings it to the notice of the oil producers, Neft TsDU and Transneft.

Under the Oil Flow Regulations, Transneft is required to provide the Ministry of Fuel and Power Development, at least 30 days before the start of each quarter, with data describing the throughput capa-

[7] It is understandable, therefore, that the consigner of oil may exercise far from all forms of its disposal before actually obtaining it on the other end of the pipe.

[8] Our future articles will dwell on certain forms of such disposal in greater detail.

[9] For example, by the means of interim relieves.

[10] According to the Russian President Decree No. 314 of March 9, 2004, functions of the Ministry of Fuel and Power Development are transferred to the Ministry of Industry and Energy.

city of its trunk pipeline network over the forthcoming quarter, including oil pipe stoppages for preventive maintenance, to be considered when allocation access rights to trunk pipelines and export terminals among oil producers or other business entities. The relevant clause expressly allows for business entities other than oil producers to take part in the transportation process, given that producers may assign oil shipping rights to third parties.[11]

Based on a calculated oil production and allocation balance, oil companies producing oil are to provide the Ministry of Fuel and Power Development, 30 days prior to the beginning of each quarter, with proposals for supplying oil outside the country's customs territory. The Ministry, for its part, approves schedules for supplying oil outside national customs territory 20 days before the beginning of each quarter, with due regard for producer requests and Transneft data on the throughput capacity of its trunk pipeline network.

[11] Contracts assigning oil transportation rights will be analyzed in greater detail in one of the subsequent articles.

[12] For example, should the corresponding dispute be heard in court?

***

The rights and obligations of the parties to Pipeline Contracts (regarding, for example, the allocation of risks of accidental loss of the oil in transport and, consequently, of resulting financial losses) are directly dependent on the accepted (or proven)[12] solution to the discussion of the legal nature of Pipeline Contracts.

Although many of the prescriptions set out in the Oil Flow Regulations are outdated and effectively no longer invoked, this regulatory act is still valid. Therefore, both individual provisions in a Pipeline Contract and contract as a whole may be challenged should the parties to the corresponding contract find this course of action to be expedient in a specific case.

The design and implementation of a contractual system of which Pipeline Contracts will make an integral part should take into account the specific regulation of individual aspects of such contracts (for example, the rates of natural losses of oil during its transportation via the trunk pipeline network) so as to avoid damages and losses that will inevitably arise when an unsophisticated approach to the problem under review is taken. □