FOREIGN INVESTMENT IN RUSSIA'S OIL AND GAS: LEGAL FRAMEWORK AND LESSONS FOR THE FUTURE

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1. INTRODUCTION

Despite the high political, economic, and regulatory risks associated with investing in Russia,[1] its vast oil and gas reserves[2] continue to draw the interest of foreign investors. Throughout the last decade, the participation of foreign investors in the exploration of Russia's resources can be divided into three main stages: the early 1990s, when the Russian Federation made its first attempts to attract foreign investment;[3] the middle 1990s, when the first Law on Production Sharing Agreements ("1995 PSA Law") was ratified;[4] and 1999 to 2001, the era of a new Law on Foreign Investment,[5] an

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1 According to the survey of country credit ratings by Institutional Investor, Russia was ranked 92nd out of 145 countries. *See September 2001 Country Credit Ratings*, II MAGAZINE PLATINUM, Sept. 2001, *at* http://www.iiplatinum.com/rr/premium/countrycredit/ccr/2001.htm.

2 As of December 2000, Russia had an estimated 49 to 55 billion barrels of proven oil reserves and 1,700 trillion cubic feet of proven gas reserves. *See* U.S. ENERGY INFO. ADMIN., RUSSIA (2000), *available at* http://www.eia.doe.gov/emeu/cabs/russfull.html (last modified Feb. 22, 2000).

3 *E.g.*, The Law of Russian Federation No. 2395-1 on Underground Resources, Sobr. Zakonod. RF, 1992, No. 2395-1, *translation available at* LEXIS, Intlaw Library, RFLAW File, Garant 10004313; Law of the RSFSR of June 26, 1991 on Investment Activity in the RSFSR (with the Additions and Amendments of June 19, 1995), Ross. Gazeta, 1991, *translation available at* LEXIS, Intlaw Library, RFLAW File, Garant 10005703.

4 President Yeltsin signed this law on December 30, 1995. *See* Federal'niy Zakon o Soglasheniyax o Razdele Produktsii [Federal Law No. 225-FZ on Production Sharing Agreements], Sobr. Zakonod. RF, 1995, No. 160-FZ [hereinafter 1995 PSA Law], *translation available at* LEXIS, IntLaw Library, RFLAW File, Garant 10005771.

5 *See* Federal'niy Zakon ob Inostrannix Investitsiyax v Rossiyiskoi Federatsii [Federal Law No. 160-FZ on Foreign Investment in the Russian Federation], Sobr. Zakonod. RF, 1999, No. 19-FZ [hereinafter 1999 Law on Foreign Investment], *translation available at* LEXIS, IntLaw Library, RFLAW File, Garant 12016250.

Amendment to the 1995 PSA Law,[6] and the implementation of the four chapters of Part II of the Russian Tax Code[7] that deal with the tax regulation of production sharing agreements.

The overall level of foreign investment in Russia has remained low.[8] In particular, the amount of foreign investment in Russia's oil and gas sectors has fluctuated and taken different forms. The once popular joint ventures with Russian oil companies were gradually shifted into attempts to form joint projects financed by commercial banks and multilateral agencies, and then again transformed into direct purchases of shares in existing Russian oil producing companies by foreign oil magnates.

Evaluations of potential foreign investment risks generally focus on the assessment of financial feasibilities of investors and the risks associated with operations, commercial activities, legal frameworks, and enforcement procedures, as well as political and regulatory concerns in the host country.[9] This Comment argues that the peculiarity of investing in Russia's oil and gas sectors results from the extreme irregularity, uncertainty, and speculation that surrounds Russia's legal and regulatory frameworks—thus making legal and regulatory risks[10] the key factors in foreign investors' interest to invest in Russia's oil and gas industry. The

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[6] *See* Federal'niy Zakon o Vnesenii Popravok v Federal'niy Zakon o Soglasheniyax o Razdele Produktsii [Federal Law No. 19-FZ on the Introduction of Amendments and Addenda into the Federal Law on Production Sharing Agreements], Sobr. Zakonod. RF, 1999 [hereinafter 1999 PSA Amendment], *translation available at* LEXIS, IntLaw Library, RFLAW File, Garant 12014154.

[7] *See* Nalogoviy Kodeks Rossiiyskoi Federatsii: Chast' Vtoraya [Tax Code of the Russian Federation: Part II No. 117-FZ], Sobr. Zakonod. RF, 2001, No. 117-FZ [hereinafter, Tax Code Part II], *translation available at* LEXIS, IntLaw Library, RFLAW File, Garant 10800200. Tax Code Part II was adopted by Duma on July 19, 2000 and became effective on January 1, 2001. *Id.*

[8] As of 1999, only $35 billion had been invested in Russia since the fall of the Soviet Union, which is less than the annual foreign investment in China. *See* Inostranie Investitori Obhodiat Rosiju Storonoj [Foreign Investors Avoid Russia], KOMMERS., June 16, 1999, *translation available at* 1999 WL 11793940.

[9] *See generally* EDWIN F. FEO ET AL., GUIDE TO FINANCING INTERNATIONAL OIL AND GAS PROJECTS (1996) (canvassing different aspects of foreign investment and the factors that attract financiers to oil and gas projects).

[10] Legal risks include the inability of investors to rely "on a well-developed body of commercial law to ensure enforcement of security interests, and on an independent judiciary and expedient legal process to pursue claims, if necessary." *Id.* at 33. Regulatory risks include regulations pertaining to natural resources management, access to resources, degree of intervention by the governmental authorities, and rules regarding the establishment and operation of subsidiaries. *See id.* at 41-42.

Comment analyzes the three stages of Russian lawmaking related to the oil and gas industry and evaluates how laws such as the 1995 PSA Law, Law of Subsoil, Law on Foreign Investment, and the Tax Code have affected the types and amounts of foreign investment that flowed into the oil and gas sectors, shifting the focus among joint ventures, project financings, and direct investments into the Russian oil companies. The Comment argues that the introduction of the 1995 PSA Law and its subsequent amendment render the project finance method of foreign investment the most preferable in light of the high risks associated with investing in Russia. In addition, the Comment projects onto the future development of foreign investment in the oil and gas sectors on the basis of the latest Russian laws.

Sections 2 and 3 of the Comment address the political, economical, and structural risks that foreign investors face when investing in Russia's oil or gas projects. Section 2 describes the possible political risks, such as a *force majeure*, expropriation, the nationalization of the oil and gas industry,[11] the negative effects of the August 1998 crisis on the Russian economy, and the current administration's effort to improve Russia's investment climate. Section 3 reviews the structure of Russia's oil and gas sectors: major oil and gas companies, their privatization efforts, and the opportunities for foreign investment. The structural risks to foreign investors include, but are not limited to, the present control of Russia's oil and gas sectors by Financial Industrial Groups led by former oil and gas ministers, the existence of an oil pipeline monopoly that controls all oil transfers throughout the Russian Federation,[12] and the lack of antitrust measures and willingness on the part of the Russian government to end the Transneft and Gazprom monopolies. Section 4 explores legal and regulatory risks that existed prior to the 1995 PSA Law and how the protectionist attitude of the Russian politicians in the early 1990s, as reflected in the laws on foreign investment and use of subsoil, discouraged foreign investment in the oil and gas industry.[13] Section 5 views the 1995 PSA

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[11] For a detailed description of these risks, see *id.* at 23-57.

[12] *See infra* Section 3.2.

[13] *See, e.g.*, *Russian Oil: A Little Crude*, ECONOMIST, Jan. 20, 1996, at 68 (discussing the 1996 Russian Law of Production Sharing Agreements and its possible negative implications for foreign investments). But protectionist fears of the Russian politicians were still present in 1999, when they were reflected in the 1999 Amendment to the PSA Law, which required foreign investors to give Russian

Law as the first major initiative taken by the Russian government in attracting foreign investment, even though it also proved to be mostly unsuccessful. Section 6 analyzes how the recent amendments to the Law on Foreign Investment, the Law of Subsoil, the 1995 PSA Law, and the Tax Code provide a new regulatory framework that favors foreign investment in Russia's oil and gas sectors. Section 7 evaluates various types of foreign investment in Russia's oil and gas, including project financing and direct foreign investment in the oil companies. This Section analyzes the risks and advantages of both methods and argues that project financing becomes more preferable in the current regulatory climate that favors and facilitates production sharing agreements ("PSAs"). Finally, this Comment evaluates Russia's past regulatory experiences in the oil and gas sectors and predicts how the new laws, coupled with the lessons derived from the past regulatory attempts, may change the types and amounts of future investments and favor the use of project finance for future investments. The fact remains that Russia, with its substantial oil and gas resources, shares common interests with the foreign oil companies in a joint exploration of the Russian oil and gas. Once legal and regulatory risks are reduced, foreign participation in the development of Russia's natural resources will increase dramatically.

2. ASSESSMENT OF RUSSIA'S POLITICAL AND ECONOMIC RISKS

Many factors influence the flow of foreign investment into Russia. These factors include, among others: the availability of a regulatory structure designed to provide guarantees and incentives to foreign investors, permission to invest in certain sectors, the existence of necessary laws that would protect the investors' interests and alleviate tax burdens, and the commercial viability of the projects, including the availability of oil export routes, favorable market prices, and demand.[14] In addition to the above, local currency devaluation remains a real threat.[15] Importantly, Russia's long-

companies the priority right to become suppliers, contractors, and carriers for PSA projects. *See infra* Section 6 and accompanying notes 139-40.

[14] *See* Mark R. Yzaguirre, *Project Finance and Privatization: The Bolivian Example*, 20 HOUSTON J. INT'L L. 597, 610-15 (1998).

[15] *See* Kent F. Moors, *Fiscal Imbalance*, RUSS. PETROLEUM INVESTOR, Aug. 2001, at 19 (noting that Russia's current influx of foreign currency increases domestic inflationary pressures because a "surplus of hard currency becomes translated

term political and macroeconomic factors play vital roles in attracting foreign investment. Political risks of investing in Russia include a danger of outright expropriation[16] of oil or gas projects by the government or of creeping expropriation that is a result of "altering the rules of the game to such a degree that the investor's financial calculations and projections based on feasibility studies become useless."[17] Additionally, investors should not discount the risk of nationalization of the entire industry.[18] Finally, there is a risk of *force majeure*,[19] including a risk of political violence.[20]

The foreign investors in Russia should not disregard the political risks listed above. In the past several years, Russia's political environment was marked by continuous changes in the top leadership.[21] A more pro-Western government of the early 1990s, with Yegor Gaidar as an acting Deputy Prime Minister, was gradually replaced with politicians who favored slow reforms.[22] In addition, the ongoing Chechen crisis that cost the Russian government $2 billion in 2000 alone,[23] has rendered uncertain the future of the Russian Federation's political integrity.

The status of Russia's economy also raises concerns for foreign investors. Russia's financial crisis in August 1998 had a devastating impact on the Russian economy. Gross domestic product ("GDP") declined from around $428 billion in 1997 to $282 billion

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into a surplus of rubles when the hard currency is redeemed, since the ruble is the only official currency for transactions in the Russian domestic economy.")

[16] *See* FEO ET AL., *supra* note 9, at 35 (discussing how outright expropriation may be lawful if certain conditions are satisfied, most importantly, if the host government provides adequate compensation for the expropriated project).

[17] *Id.*

[18] *See infra* Section 3.1.

[19] *Force majeure* is an "event or effect that can be neither anticipated nor controlled. The term includes both acts of nature (e.g., floods and hurricanes) and acts of people (e.g., riots, strikes, wars)." BLACK'S LAW DICTIONARY 657 (7th ed. 1999); *see also* GRAHAM D. VINTER, PROJECT FINANCE 88-94 (2d ed. 1998) (delineating limits to the concept of *force majeure* and the limitation of liability).

[20] *See* FEO ET AL., *supra* note 9, at 35 (defining political violence as "any type of violent act undertaken with the primary intent of achieving a political objective").

[21] For example, the Russian Ministry of Energy had ten different ministers in the last ten years. Mikhail Kroutikhin, *Tyros to the Fore*, RUSS. PETROLEUM INVESTOR, Aug. 2001, at 7.

[22] Davis Filipov, *Putin Now Mired in Chechnya*, BOSTON GLOBE, June 21, 2001, at A1.

[23] *See* Albert Galyazimov, *Oil Dollars Again!*, VERSIYA, Dec. 12-18, 2000, *translation available at* LEXIS, IntLaw Library, RUSNWS File.

at the end of 1998.[24] The inability of Russian banks to meet their debt obligations and the government's suspension of foreign debt payments caused many foreign investors to flee. In the first half of 1999, the total volume of foreign investments fell by 44.5% to $4.27 billion, as compared to the first half of 1998, before the crisis.[25] As a result, Russia, which already heavily depended on tax revenues and export earnings from its oil and gas industry, had to place an additional burden on that sector.[26]

Yeltsin's resignation on New Year's Eve of 1999 left Russia to Vladimir Putin, then a Prime Minister, who was elected President in March 2000. Putin has emphasized his commitment to improving Russia's investment climate.[27] In 2000, Russia's GDP grew by 7.6%, which placed Russia among the ten fastest-growing economies.[28] However, Russia's analysts remain skeptical as signs of a world economic slowdown are coupled with fluctuating world oil

[24] The World Bank Group, *WDI Data Query*, *available at* http://devdata.worldbank.org/data-query/ (last visited Nov. 5, 2001).

[25] Foreign Investment Promotion Center under the Ministry of Economy of the Russian Federation, *On Foreign Investments into the Russian Federation*, http://www.fipc.ru/fipc/reviews/statjul99.html (last modified Nov. 23, 1999). Foreign investment in the Russian Federation in the first half of 2000 was $4.8 billion. *See Investment in Russian Regions in First Half of 2000*, INTERFAX RUSS. NEWS, Nov. 16, 2000, *translation available at* LEXIS, IntLaw Library, RUSNWS File.

[26] The oil industry is one of the largest economic sectors in Russia. "Oil export revenues account for almost 40% of the country's foreign currency inflows, and taxes levied on oil and gas companies account for more than 50% of the federal government's tax receipts." Tina Obut et al., *Roots of Systemic Woes in Russian Oil Sector Traceable to Industry Evolution*, OIL & GAS J., Jan. 25, 1999, at 27. For example, in 2001, the total projected oil and natural gas revenues will exceed $40 billion, which is $23 billion more than in 2000. *See* Kent F. Moors, *Fiscal Imbalance*, RUSS. PETROLEUM INVESTOR, Aug. 2001, at 19. In December 1999, Putin signed a resolution increasing oil export duty to 15 euros per ton ($2 per bbl), which resulted in $640 million in additional revenue each month. *See* U.S. ENERGY INFO. ADMIN., RUSSIA, *supra* note 2.

[27] *See, e.g., Vladimir Putin: Attraction of Foreign Investments Into Russia Is the Most Important Factor of Her Integration into Global Economy*, RUSS. ECON. NEWS, Oct. 31, 2000, at 1, *available at* LEXIS, IntLaw Library, RUSNWS File (describing Putin's commitment to ease tax burdens and restructure the banking system to entice foreign investors); Sergei Kovalev, *The Putin Put-On*, N.Y. REV., Aug. 9, 2001, at 29 (critically discussing current domestic policies of Putin's administration).

[28] See Vladislav Kuzmichev, *Russia Among the Ten Fastest-Growing Economies*, NEZAVISIMAYA GAZETA, Dec. 29. 2000, *translation available at* LEXIS, Intlaw Library, RUSNWS File.

prices and continuous efforts by the Russian government to service its debt to the Paris Club[29].[30]

In theory, foreign investors can mitigate political and economic risks by changing the structure of their projects. Some of the alternatives that do not require intervention by the host government include: restructuring the deal so as to minimize the exposure of the investors' assets at risk, ensuring the investors' control over issues that may lead to expropriation, "forming a joint venture with a local company; ensuring extensive local participation in the project; [or] including a multilateral agency in the financing."[31] However, political risk factors, with the probable exception of *force majeure*, depend largely on the regulatory framework of the host country at the time of the project and the government's readiness to change laws that may discourage foreign participation. Most oil and gas exploration projects extend beyond six years[32] and there is a high risk that the laws that were in force at the beginning of a project may be replaced several years later by new regulations.[33] Thus, regulatory and legal risks of foreign investment in a country like Russia, where laws are still being formed and may change drastically within a decade, are pivotal to the evaluation of political and economic risks, and affect the structure and amount of foreign investment.

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[29] Paris Club is an informal group of creditor nations that meets with debtor countries that have defaulted or are about to default in order to negotiate rescheduling of outstanding debt. *See* Paris Club, *Frequently Asked Questions*, *at* http://www.clubdeparis.org/en/tools/faq (last visited Oct. 29, 2001). Russia's debt to the Paris Club, which constitutes one-third of Russia's total foreign debt, was restructured in 1999. As a result, Russia's payments in 2000 declined from $13.5 billion to $9.5 billion, but are expected to increase again to $18 billion in 2003. *See* Standard & Poor's, *Russia Raises Stakes in Confrontational Game with the Paris Club*, *available at* http://www.standardandpoors.ru (Jan. 10, 2001).

[30] *See* Standard & Poor's, *supra* note 29. The Russian budget for 2001 has not included the additional $3.5 billion that Russia needs to cover its dues to the Paris Club. *See* Galyazimov, *supra* note 23. However, Standard & Poors noted that the Russian Central Bank's reserves of $24.3 billion as of the end of 2000 have increased optimism about Russia's ability to service its foreign debt in 2001. *See* STANDARD & POOR'S, *supra* note 29.

[31] FEO ET AL., *supra* note 9, at 37.

[32] *See id.* at 36-37.

[33] *See, e.g.*, discussion *infra* Section 4.3 (describing the Sakhalin-I and II oil projects that were formed in 1995 but only Sakhalin-II started producing oil in 1999). The 1995 PSA Law was amended in 1999. *See* 1999 PSA Amendment, *supra* note 6.

3. RUSSIA'S OIL AND GAS SECTORS: STRUCTURAL AND ORGANIZATIONAL RISKS

Partial privatization of the Russian oil companies and the existing monopolies in the oil transportation and gas sectors suggest a strong continuing influence of the Russian government on the operation of the oil and gas sectors.[34] The absence of legal and regulatory frameworks addressing many structural and operational aspects of oil and gas companies contributes to the reluctance of foreign investors to work with Russian companies. In particular, Russia lacks public disclosure obligations on the part of oil and gas companies, laws addressing oil exportation problems experienced by many project developers, and antitrust measures and regulations to curtail the broad power of Gazprom, Russia's gas monopoly.

3.1. Privatization of Russia's Oil Sector

Structural and organizational problems in Russia's oil and gas sectors should caution foreign investors who consider committing their capital to Russia. For instance, privatization of Russia's oil production sector has served as an example of opaqueness and possible conspiracy in the Russian market. Russia launched privatization of many oil companies through the Law on Underground Resources and the adoption of a new constitution in 1993.[35] Currently, Russia's oil sector mostly consists of vertically-integrated companies ("VICs"), some of which are: Lukoil,[36] Yukos, Surgutneftegaz, Tyumen Oil Company ("TNK"), Sidanko, Sibneft, Slavneft, Eastern Oil Company, Orenburg Oil Company (Onako), Komitek, Chechen State Oil Company, and Rosneft.[37] Originally, the

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[34] *See* Obut et al., *supra* note 26, at 30 ("The power vested in [ministry of fuel and energy and committees for geology and mineral resources] is administrative rather than managerial.... However, the agencies continue to wield proxy power in the form of licensing requirements, regulation of prices, and influences on legislature and on Transneft....").

[35] *See id.*

[36] Lukoi is the largest VIC in terms of production and its reserves of 16.8 billion bbl of oil and 1.1 tcf of gas (as of 1998) make it the largest private owner of oil reserves in the world. Tina Obut et al., *Comparing Russian, Western Major Oil Firms Underscore Problems Unique to Russian Oil*, OIL & GAS J., Feb. 1, 1999, at 20, 21 [hereinafter *Russian Oil*].

[37] U.S. ENERGY INFO. ADMIN., RUSSIA, *supra* note 2; *see also Russian Oil*, *supra* note 36, at 21-24 (providing additional information about Russia's largest VICs).

privatization was only partial: the Russian government retained the controlling interest in the industry[38] and limited foreign ownership to fifteen percent in the oil sector.[39] As of October 2001, several of the VICs, such as Rosneft, still remain fully state-owned. Sale of the VICs during 1995 to 1997 occurred at sub-market prices and resulted in a transfer of control of these companies to the Financial Industrial Groups.[40] The current ownership of these financial groups and the VICs has substantially remained in the hands of the former Soviet oil and gas elite.[41] In addition, although the Russian government has been selling its remaining shares in VICs,[42] there are rumors about deprivatization and the creation of a national oil company.[43] The possibility of such an event is remote,

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[38] *See* Decree of the President of the Russian Federation No. 1403 on Specific Features of Privatization and Reorganization Into Joint-Stock Companies of State-Sector Enterprises, Production and Scientific and Industrial Amalgamations in the Old and Oil-Refining Industry and Oil Supplies (with Amendments and Additions of Apr. 10, 1998, Sept. 25, 2000, and May 29, 1995), Sobr. Zakonod. RF, 1992, No. 1403 [hereinafter Presidential Decree No. 1403], *translated in* LEXIS, Intlaw Library, RFLAW File, Garant 297; *see also* Dylan Cors, *Breaking the Bottleneck: The Future of Russia's Oil Pipelines*, 7 DUKE J. COMP. & INT'L L. 597, 601-04 (1997) (providing "the context for a discussion of pipeline policy describing the privitization of Russina oil producers").

[39] *See* Presidential Decree No. 1403, *supra* note 38, art. 5(b). The subsequent decree repealed this limitation. *See* Decree of the President of the Russian Federation No. 1148 on the Effect of Specific Acts of the President of the Russian Federation, Sobr. Zakonod RF, 1997, No. 1148, *translation available at* LEXIS, Intlaw Library, RFLAW File, Garant 12004030.

[40] *See* Obut et al., *supra* note 26, at 30. "Under the *loans-for-shares* scheme, the government relinquished its shares in VICs as collateral for loans to the government from Russia's newly privatized banks." *Id.* The subsequent government's default on these loans transferred control of the companies to those banks. *See id.* For a critical discussion of the loans-for-shares method of privatization of the Russian oil companies, see Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000).

[41] Lukoil CEO Alekperov is a former minister of the oil industry in the Soviet government; Viktor Chernomyrdin, a former chairman of Gazprom, was the Prime Minister of Russia; Mikhail Khodorkhovsky, chief executive of Yukos, was a high ranking Communist Party official; Rem Viakhirev, president of Gazprom, was a minister of the gas industry in the Soviet government. *See id.*

[42] For example, in 1999, the Russian government sold its forty-nine percent share in TNK. *See id.* In September 2000, the Russian government sold its eighty-five percent stake in Onako for $1.1 billion, which was more than double the beginning price. *See Oil Change*, ECONOMIST, Sept. 21, 2000, *available at* 2000 WL 8143760. Rosneft, however, is still owned by the Russian government. *See* Kent F. Moors, *Partner for All Seasons?*, RUSS. PETROLEUM INVESTOR, Nov.-Dec. 2000, at 5.

but it is one of the risks that may negatively affect foreign direct investment in Russia's oil.

3.2. Russia's Oil Pipelines

Another structural impediment to foreign investment in the oil sector is the state control of the oil pipeline monopoly and its exemption from any reporting requirements. Such exemption surrounds the operation of a key sector in Russia's oil industry with complete secrecy and deters potential investors from participating in Russia's oil exploration projects. The main problem for foreign companies arises from the absence of regulatory requirements that would compel the oil pipeline monopoly to allow transport of extracted oil through its pipelines. The pipeline enterprise is owned and controlled by a federal monopoly, Transneft, in accordance with Article 4(c) of Presidential Decree No. 1403.[44] A number of joint-stock companies within Transneft own the actual pipelines.[45] Transneft does not reinvest much of the proceeds in the pipeline system, and unlike other holding companies, Transneft is exempt from quarterly reporting requirements.[46] The company exercises complete control over the access to pipelines, and allegations abound that it has accepted bribes for the use of its pipelines at around $2 to $3 per ton of oil.[47] The current monopoly in oil transportation also allows the government to charge extra fees to cover certain projects, such as restoring portions of the Chechen bypass, which ultimately serves as 'backdoor taxation.'[48] Such a monopoly may create significant problems in exportation of oil from remote Eastern Siberian or Northern sites. There is currently no law that

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[43] *See id.* at 5 (noting that Fuel and Energy Minister Viktor Kalyuzhny supported a formation of a state oil company).

[44] *See* Presidential Decree No. 1403, *supra* note 38, art. 4(c) (transferring the controlling number of shares to the newly created state-owned holding company, Transneft). For more information on Transneft, see generally Nick Mikhailov, *Russia's Pipeline System and Oil and Gas Transportation Projects, at* http://bisnis.doc.gov/bisnis/country/000818rspipetrans.htm (Aug. 2000) (providing a general overview of Transneft and stating that the company will play a central role in upgrading and modernizing Russia's extensive pipeline infrastructure).

[45] *See* Cors, *supra* note 38, at 607.

[46] *See id.*

[47] *Oil. Just Too Terrible To Resist*, ECONOMIST, Sept. 9, 1995, at 66.

[48] *See* Kent F. Moors, *Blazing Its Own Trail*, RUSS. PETROLEUM INVESTOR, Jan. 2001, at 12.

would require the Russian government to issue regulations protecting the exportation interests of foreign companies. The bottleneck, therefore, remains virtually unregulated. Even the draft Law on Pipeline Transport, if adopted in its current form, will not provide sufficient assurance of oil export routes.[49] The Law will require Transneft to provide equal access to all those seeking to transport oil, but only if the application for shipping is submitted using the correct form and in advance. If the demand for oil transportation exceeds a pipeline's capacity, oil will be transported proportionately to each applicant's total production.[50] The problems encountered by the Kharyaga oil development project in negotiating its export routes with Transneft exemplify the extent of the difficulty. Kharyaga oil field, which is in the far east province of Timan-Pechora, is an oil production project, equity shares in which are split among the French TotalFina (fifty percent), Norway's Norsk Hydro (forty percent), and Nenetsk Oil Co. (ten percent).[51] Although the PSA for the exploration of the Kharyaga oil field was signed by the Russian Federation in 1995, it became effective only in 1999. One of the causes for the delay was the uncertainty of exportation routes that would allow the project to export all of its production, as was specified in the PSA.[52] After exhaustive negotiations between the Kharyaga project and Transneft, the pipeline monopoly remains interested only in short-term agreements for transportation of Kharyaga oil, whereas the project's total life is estimated to be approximately thirty-three years.[53]

In the near future, Transneft's monopoly may end. In the fall of 2000, the Russian government contemplated a sale of twenty-five percent of its interest in Transneft, thus reducing its holdings to fifty-one percent.[54] Also, Lukoil, the largest oil producing company, has directly challenged the Transneft monopoly by announcing in early 2001 its plan to build a separate oil pipeline.[55]

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[49] *See North v. South*, RUSS. PETROLEUM INVESTOR, Jan. 31, 2000, *available at* http://www.wtexec.com/rpi013103.html.

[50] *See id.*

[51] *See id.*

[52] *See id.* (noting that an average export quota is over thirty-six percent).

[53] *See id.*

[54] *See* Moors, *supra* note 48, at 13.

[55] *See id.*

3.3. Investment Opportunities in the Gas Sector

There are opportunities for foreign investors in Russia's gas sector. Gazprom, the Russian natural gas production and transmission monopoly, controls approximately seventy percent of Russia's natural resources.[56] Gazprom inherited all of the Soviet gas industry and maintained its monopoly even after it was privatized in 1992.[57] Although foreign direct investment in Gazprom was limited to fifteen percent of its outstanding shares,[58] opportunities for creating joint ventures with Gazprom exist in the area of pipeline construction and gas distribution. For instance, Gazprom's Blue Stream project of building a pipeline to Turkey, a joint venture with Italian partner ENI, plans to start gas deliveries in 2001.[59] The Russian Duma ratified a protocol regarding tax breaks for Gazprom for the Blue Stream project in 1999.[60] Gazprom has also announced joint ventures with Finnish and Dutch companies for construction of pipelines to deliver Russian gas to Western Europe.[61] In addition, the Russian government is creating opportunities for foreign and domestic investors to enter the Russian gas market as competitors to Gazprom.

Weak antitrust laws may contribute to cautious attitudes by foreign investors towards Gazprom. As of 2000, "Gazprom overs[aw] eight production associations, own[ed] and operat[ed] Russia's 88,000-mile gas pipeline grid, r[an] trading houses and marketing joint ventures . . . and control[led] one-fifth of the world's natural gas reserves."[62] Government pressure to disinte-

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56 *Gazprom*, INTERFAX RUSS. NEWS, Aug. 31, 2000, *available at* LEXIS, Intlaw Library, RUSNWS File; *see also* JONATHAN P. STERN, COMPETITION AND LIBERALIZATION IN EUROPEAN MARKETS 158 (1998) (remarking that "Gazprom has a transmission and wholesale monopoly of all large customers, including distribution companies" and Russia's only gas export company, VEP Gazexport, is a wholly owned subsidiary of Gazprom).

57 Currently, the federal government owns 38.37% of Gazprom, and foreign investors own 10.31%. *See* GAZPROM, SHAREHOLDER'S PAGE, *at* http://www. gazprom.ru/eng/billboard (last visited Nov. 14, 2001). Management officials own approximately thirty-five percent of Gazprom and the owners of the remaining twenty-seven percent are unknown. *See* Black, Kraakman & Tarrasova, *supra* note 40, at 1774.

58 *See* Presidential Decree No. 1403, *supra* note 38, at 5(b).

59 *See* U.S. ENERGY INFO. ADMIN., RUSSIA, *supra* note 2.

60 *See id.*

61 *See id.*

62 *Id.*

grate Gazprom is also mounting. In 1997, the Federal Energy Commission created a report, which proposed to separate the production from the transmission spheres of Gazprom and to encourage new investors to develop new and existing fields and pipelines.[63] Even though no immediate action followed this report,[64] according to the U.S. Energy Information Administration report, the Russian Duma approved a draft federal law directed at ending Gazprom's monopoly by establishing trade companies to compete with Gazprom and offering equal access to gas pipelines.[65] The final break-up of the Gazprom monolith may be slow to come, but the Russian government has already embarked on the path of introducing competition into the gas market.

4. REGULATORY FRAMEWORK FOR FOREIGN INVESTMENT ADOPTED IN THE EARLY 1990S

Legal and regulatory risks of investing in Russia's oil and gas sectors were particularly high in the early 1990s, when the Russian Federation began to establish a framework of laws regulating foreign investment. The 1991 Law on Foreign Investment[66] reflected the determination of the Russian government to develop fuel and energy sectors without foreign participation,[67] and the Law also provided little guarantee to foreign investors against political risks,[68] such as a coup d'état that occurred only one month after the Law's enactment. Additionally, the 1991 Law on Foreign Investments and the 1992 Law on Underground Resources ("Law of Subsoil")[69] determined the types of foreign investment that could flow

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[63] *See* STERN, *supra* note 56, at 160-61.

[64] As explanation for inaction, Stern suggests that "[t]he roles of the Federal Energy Commission, Anti-Monopoly Committee, Ministry of Fuel and Energy, and the offices of the Prime Minister and Deputy Prime Minister seem to become more and less influential on a monthly basis." *Id.* at 161.

[65] *See* U.S. ENERGY INFO. ADMIN., RUSSIA, *supra* note 2.

[66] *See* Federal'niy Zakon o RSFSR ob Inostrannix Investitsiyax v RSFSR [Law of the RSFSR No. 1545-1 on Foreign Investments in the RSFSR], Sobr. Zakonod. RF, 1991 [hereinafter 1991 Law on Foreign Investment], *translation available at* LEXIS, Intlaw Library, RFLAW File. For a detailed discussion of the 1991 Law on Foreign Investment, see *infra* Section 4.1.

[67] *See* 1991 Law on Foreign Investment art. 20.

[68] *See id.* art. 7.

[69] *See* The Law of the Russian Federation No. 2395-1 on Underground Resources, Sobr. Zakonod. RF, 1992 [hereinafter Law of Subsoil], *translation available at* LEXIS, Intlaw Library, RFLAW File, Garant 10004313. For a detailed discussion of the Law of Subsoil, see *infra* Section 4.2.

into the country by allowing foreign investors to repatriate profits but not the products,[70] thus making joint ventures with foreign monetary investments preferable to production-sharing agreements because foreign participants would be entitled to a certain proportion of extracted oil.

Although the first Russian laws directed at attracting foreign investment were inadequate, some foreign companies still invested in Russia's energy sectors. From 1987 to 1990, twenty-seven joint ventures were formed with foreign partners in the energy sector.[71] However, the break-up of the Soviet Union increased the uncertainty surrounding the obligations and entitlements of foreign investors in the Russian Federation. Consequently, as of 1995, only about $700 million had been invested in Russia's energy sector, "though more than $2 billion was most likely spent in search of the investment opportunities."[72] Foreign investment in the oil and gas industry in the early 1990s came in forms of joint ventures and joint-stock companies.[73] The number of joint ventures did not increase greatly throughout the 1990s. As of 1999, only about 100 joint ventures were operating in Russia's oil and gas sector, the most successful of which were applying new technologies to the old fields in order to increase production.[74] The main investments to date are Conoco's Polar Lights, projects on Sakhalin Island,[75] and the Timan-Pechora fields.[76]

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[70] *See* Law of Subsoil art. 10.

[71] *See* James P. Dorian & Eugene M. Khartukov, *International Oil and Gas Investment in the CIS States, in* THE ENERGY CHARTER TREATY 39 (Thomas W. Walde ed., 1996).

[72] *Id.* at 47. "Through early 1994, more than 70 joint ventures were registered in Russia, with 40 being operational, but only 30 actually processing." *Id.*

[73] *See id.* at 52-53 (noting that even though the production sharing agreements were preferable, the law on production sharing agreements was still incomplete as of early 1995).

[74] *See Joint Ventures in the Russian Oil Sector: Rocky Marriages?*, OIL & GAS J., Jan. 25, 1999, at 28.

[75] Most of Russia's oil and gas reserves are in the Far East, with sixty percent of those located on the Sakhalin Island. As of 1999, there existed three consortiums developing oil and gas on Sakhalin Island. *See id.*

[76] *See id.*

4.1 Early Regulation of Foreign Investment: The 1991 Law on Foreign Investment

Russia's 1991 Law on Foreign Investment[77] allowed foreign legal entities to invest in Russia through share participation in enterprises, the formation of wholly foreign-owned operations, and the acquisition of enterprises, property, and user rights[78]. Article 7 provided guarantees against nationalization and confiscation, "except for exceptional cases when such measures may be taken in the public interest."[79] As incentives to foreign investors, Article 24 provided enterprises with foreign investors an exemption from custom duties and import taxes for items imported for the enterprise's own needs and Article 25 provided Russian-foreign joint ventures with over thirty percent foreign participation an exemption from the requirement to obtain a license to import or export products for their needs. Further, Article 10 allowed for free repatriation of hard-currency profits, dividends, and interest, but only after the relevant taxes, such as a fifteen percent withholding tax, had been paid.[80] However, the 1991 Law on Foreign Investment placed many burdens on foreign investors. It treated fuel and energy as restricted sectors for foreign investment[81], required obtaining permission to open a large-scale construction projects with the involvement of foreign investment[82], and mandated registration with the Ministry of Finance of all enterprises with more than 100 million rubles of foreign investment[83].

4.2. Law of Subsoil

In addition to the 1991 Law on Foreign Investment, investment in the gas and oil industry was regulated by the Law of Subsoil.[84] The Law of Subsoil allowed production-sharing agreements with foreign citizens and legal entities[85], but required the acquisition of

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[77] *See* 1991 Law on Foreign Investment, *supra* note 66, art. 2.

[78] *See id.* art. 3.

[79] *Id.* art. 7. Foreign investors could appeal such state decisions in the courts of law and arbitration. *See id.*

[80] *See id.* art. 10.

[81] *Id.* art. 20.

[82] *Id.* art. 14.

[83] *Id.* art 16.

[84] *See* Law of Subsoil, *supra* note 69, art. 10.

[85] *Id.* art. 9.

licenses for the use of underground resources[86]. Although the Law allowed the use of concession agreements, production-sharing agreements, and service contracts, it never fully defined these activities and did not address the issue of consolidation of the required licenses and production sharing agreements.[87] The Law of Subsoil and the Regulations on the Issuance of Licenses for the Use of the Subsoil of July 15, 1992[88] imposed charges on all users in connection with the licenses: royalties (payments for the use of underground resources), excise taxes, and charges for mineral replacement.[89] Foreign investors also became subject to a multitude of taxes.[90]

Further, Russia lacked a concessions law that would regulate foreign participation in exploration of Russia's natural resources. Although the draft of such a law has been circulated since 1993, the regulation was unable to find the necessary support in the Duma and the government. At the end of 1999, the State Construction Committee asked the European Bank for Reconstruction and Development to assist in drafting the new concessions law.[91]

In summary, the 1991 Law on Foreign Investments and the Law of Subsoil imposed heavy regulations on foreign investors

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86 *Id.* art. 11.

87 *See* James W. Skelton, Jr., *Investing in Russia's Oil and Gas Industry: The Legal and Bureaucratic Obstacles,* 8 NAT. RESOURCES & ENV'T 26, 27 (1993).

88 *See* Resolution of the Supreme Soviet of the Russian Federation No. 3314-1 on the Order of Carrying into Effect the Regulations for Licensing the Use of Mineral Resources, Sobr. Zakonod. RF, 1992, *translation available at* LEXIS, Intlaw Library, RFLAW File, Garant 10004319.

89 *See* Law of Subsoil, *supra* note 69, art. 39.

90 As of January 1, 1995, all users of Russia's underground resources became subject to: export duty (exemptions could be granted to joint ventures incorporated before January 1, 1992 with no less than thirty percent of foreign investment for no more than three years); VAT (20%, but waived for exports according to the Law of the Russian Federation on Investment Tax Credit (with the Additions and Amendments of July 16, 1992), Sobr. Zakonod. RF, 1991, *translation available at* LEXIS, IntLaw Library, RFLAW File, Garant 2536); excise duty ($8.20 per ton of oil or 15% for gas); royalties (6% to 16%); contributions for mineral reserves replacement (10%); property tax (up to 2%); road-use tax (0.4 %); land tax (from $2 to $10 per hectare); profit tax (up to 38%—13% federal and up to 25% regional, although reductions were available for joint ventures registered after January 1, 1994); withholding tax (15%). *See* Dorian and Khartukov, *supra* note 71, at 55-57. Certain enterprises with foreign participation are additionally subject to the 1991 Law on Foreign Investments and are exempt from taxes, as discussed *supra* Section 4.1.

91 *See* Skelton, *supra* note 87, at 28; *see also* EBRD, *Strategy for the Russian Federation* (2000) [hereinafter EBRD], *at* http://www.ebrd.com/english/policies/starts/russtrat.pdf (last modified Apr. 19, 2001).

interested in exploration of oil and gas in Russia and offered inadequate incentives. Protectionist attitudes of the Russian politicians prevailed over the revenues that Russia could collect from increased oil and gas production and exploration of new deposits.[92]

5. MID-1990S: NEW ATTITUDES, NEW REGULATIONS

Russia's participation in the Energy Charter Treaty signaled a willingness on the part of the Russian government and Duma to take steps to encourage foreign participation in the oil and gas projects. The 1995 Law on Production Sharing Agreements, discussed below, was a response by the Russian government to the Energy Charter Treaty.

5.1. Energy Charter Treaty

In 1994, Russia signed a multilateral Energy Charter Treaty ("ECT") that was directed at "establish[ing] a legal framework in order to promote long-term cooperation in the energy field, based on complementarities and mutual benefits."[93] This treaty provided guarantees to foreign investors in Russia's energy sector in the vital areas of access to natural resources, trade regulation, transit, and access to capital and technology.[94] At the same time, ECT classified Russia as a "country with a transition economy" due to Russia's current state of development of a legal framework necessary for foreign investments, and allowed Russia to suspend full compliance with the ECT until July 1, 2001.[95] As of June 2001, the Russian

[92] *See generally* discussion *infra* Section 7 (describing Russia's need for foreign investments to maintain adequate production levels).

[93] Energy Charter Treaty, Dec. 17, 1994, art. 2, *reprinted in* Dorian & Khartukov, *supra* note 71, app. 2, at 624.

[94] For example, paragraph 1 of Article 10 obliges each party to "encourage and create stable, equitable, favorable and transparent conditions" for investments, provide "fair and equitable treatment" and not "impair by unreasonable or discriminatory measures [investors'] management, maintenance, use, enjoyment or disposal." Paragraph 12 of Article 10 requires each party to "ensure that its domestic law provides effective means for the assertion of claims and the enforcement of rights with respect to Investments, investment agreements, and investment authorizations." *Id.* at 631-32; *see also* Andrei A. Konoplyanik, *The Energy Charter Treaty: A Russian Perspective*, *in* THE ENERGY CHARTER TREATY 156, 168 (Thomas W. Walde ed., 1996).

[95] Energy Charter Treaty, *supra* note 93, arts. 32(1), 32(3). For example, Russia elected to suspend full compliance with Article 10(7) and to "require that companies with foreign participation obtain legislative approval for the leasing of federally-owned property." *Id.* art. 10(7).

Duma had not ratified the ECT and the prospect of its ratification remain uncertain.[96] Although the ECT would play an important role in attracting foreign investment to Russia by creating a more stable investment environment, the treaty has not yet fulfilled the hopes of creating a possibility of "being an external 'legislative driving power' for the Russian internal legislative process."[97]

5.2. *Dubious Success of Production Sharing Agreements ("PSAs")*

The 1991 Law on Foreign Investments and the Law of Subsoil provided inadequate incentives to foreign investors. In 1993, President Yeltsin directed the Duma to draft legislation addressing the application of production sharing principles on the territory of the Russian Federation.[98] Two years later, in December 1995, the Russian Duma passed the hotly debated 1995 PSA Law.[99]

The new law brought yet another change to the legal and regulatory framework of foreign investment in Russia's oil and gas sectors. The 1995 PSA Law opened additional joint ventures avenues for investment. The law allowed oil companies to recover their operating costs from the percentage of revenues gained in their oil and gas projects. In theory, the 1995 PSA Law provided a realistic solution to the high risks associated with oil and gas exploration projects: due to the high costs of machinery, operation, maintenance, and transportation, as well as the uncertainty of reserves composition,[100] the PSA structure allowed participants to recover their costs without having to wait for their projects to become profitable.

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[96] *Ratifying the Energy Charter Treaty Would Be Good for Russia*, ALEXANDER'S GAS & OIL CONNECTIONS, Apr. 26, 2000, *at* http://www.gasandoil.com/goc/news/ntr12286.htm (last modified June 1, 2001).

[97] Konoplyanik, *supra* note 94, at 165.

[98] Russian Federation Presidential Edict No. 2285 on Production-Sharing in Subsoil Use, Sobr. Zakonod. RF, 1993, *translation available at* LEXIS, Intlaw Library, RFLAW File.

[99] *See* 1995 PSA Law, *supra* note 4. The 1995 PSA Law defines a production sharing agreement as one under which the Russian Federation grants "an exclusive right for exploration, development and production of mineral raw materials on the subsoil area provided for in the Agreement" and which will provide a "procedure for sharing produced production between the parties to the Agreement," meaning the Russian Federation and the participating investors. *See id.* arts. 2, 3.

[100] See *infra* text accompanying notes 110-11 for a description of the uncertainty of reserves composition at Sakhalin-I fields.

The 1995 PSA Law was directed at attracting foreign investors and regulating the government's relationship with oil producing companies and attract foreign investment. However, the law "fell prey to protectionist politicians, who argued for safeguards to prevent foreigners from cashing in on Russian resources while Russian firms were too poor to do so themselves."[101] On one hand, the 1995 PSA Law had positive effects on foreign investment: Article 9.2 of the 1995 PSA Law exempted investors' export of oil from any quantitative restrictions and Article 13.1 exempted investors from any payments and taxes except for the profits tax and payments for the use of subsoil.[102] On the other hand, the 1995 PSA Law had numerous ambiguities and limitations: it could be applied only to ten percent of all mineral reserves and only to the subsoil plots selected by the government of the Russian Federation and an executive government body of a corresponding subject of the Russian Federation.[103] Additionally, the 1995 PSA Law left unresolved the ambiguity in application for a license required by the Subsoil Law to PSAs. The Law of Subsoil made the receipt of a license to use the subsoil paramount, whereas Article 4.2 of the 1995 PSA law made such requirement supplementary to the Agreement.[104] Probably the most controversial provisions of the statute were Article 16.1, which prohibited investors' assignment of their rights and obligations under the Agreement to a third party without the State's consent, and Article 17.1, which provided that amendments to the Agreement could be made by either party "in case of a significant change in circumstances in accordance with the Russian Federation Civil Code."[105] Finally, Articles 22 and 23 on dispute resolution and state immunity were ambiguous as to whether Russia would agree to be bound by the laws of any jurisdiction other than the Russian Federation.[106]

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[101] *Russian Oil: A Little Crude*, *supra* note 13, at 68.

[102] Investors are still subject to annual payments for conducting exploration (rentals) and royalties (percentage of the production volume). *See* 1995 PSA Law, *supra* note 4, art. 13.4.

[103] *See id.* art. 2.5.

[104] *See id.* art. 4.2.

[105] *Id.* art 17.1. For a discussion of these provisions, see Ernest Chung, *Petroleum Investment in the Russian Federation—Russian Federal Law No. 225-FZ on Production Sharing Agreements (Dec. 30, 1995)*, 37 HARV. INT'L L.J. 551, 557-61 (1996).

[106] *See* 1995 PSA Law, *supra* note 4, arts. 22, 23.

The limited effectiveness of the 1995 PSA Law in achieving its intended purpose, attraction of foreign investment to the oil and gas industry, is best exemplified through the law's practical application. As of October 1999, four years after the implementation of the 1995 PSA Law, only three PSA projects started production: Sakhalin I and II, connected with the exploration and drilling of Sakhalin Island fields, and the Kharyaga field project, discussed earlier in Section 3.2. Negotiations of the first PSA projects lasted for an average of eight years and three months, despite the high-level lobbying at the government level.[107] Each project had to obtain on average 1,500 permits in order to start operations.[108]

The Sakhalin Island exploration initiative includes four separate projects and a variety of international sponsors.[109] Sakhalin-I, located offshore, is an international consortium and is now comprised of Exxon Neftegas (30%), Japan's Sodeco (30%), Sakhalinmorneftegas-Shelf (23%), and Rosneft-Sakhalin (17%).[110] The PSA for the project was approved in 1995. However, Sakhalin-I's partners have not yet declared their project to be commercially viable. Until recently, their exploration efforts revealed only gas, which is more expensive to extract and export than oil.[111] Sakhalin-II, valued at $15 billion, has two fields off the coast of Sakhalin, Astokhskoye and Lunskoye, and is developed by Sakhalin Energy Investment, a joint venture comprised of Marathon (30%), Mitsui (20%), McDermott (20%), Shell (20%), and Mitsubishi (10%).[112] The

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[107] *See* Marina Mikhilyukova, *The PSA Patron*, RUSS. PETROLEUM INVESTOR, Sept. 2001, at 11.

[108] *See id.* at 13.

[109] Duma is expected to permit twelve new PSAs by the end of 2001, including blocks of what is now known as Sakhalin-V, a 25,000-square kilometer block just north of Sakhalin island in the Sea of Okhotsk. Sakhalin-V's reserves are estimated at 600 million tons of oil and 600 billion cubic meters of natural gas. *See* Vladimir Baidashin, *PSAs Gain Momentum*, RUSS. PETROLEUM INVESTOR, Sept. 2001, at 14.

[110] *See* Jeanne Whalen, *Companies: Sakhalin Oil Find Holds Promise*, WALL ST. J. (Eur.), Sept. 29, 2000, at 4.

[111] *See id.* Additionally, in 1999 Russian authorities withheld the consortium's drilling permit because of certain environmental violations. *See id.* In comparison, Sakhalin-I's resource base is estimated to equal 17.1 million tons of oil, 194 billion cubic meters of gas, and 17.1 million tons of condensate, whereas Sakhalin-II's resource base is 103.4 million tons of oil, 384.2 billion cubic meters of gas, and 31.5 million tons of condensate. *See* Dean E. Gaddy, *Yukos Priobskoye Litmus Test for Foreign Investment in Russian E&P*, OIL & GAS J., Mar. 6, 2000, at 25.

[112] *See* Whalen, *supra* note 110, at 4. In October of 2000, the President of Shell Exploration and Production B.V. Rein announced Shell's plans to invest $5 billion

PSA was approved in 1995 and the consortium started producing oil in 1999.[113] Sakhalin-III was awarded to the Mobil/Texaco consortium but the production has not yet begun. Its PSA was approved on May 31, 1999.[114] Finally, the Sakhalin-IV tender took place in 1994, and is estimated to contain 200 million metric tons of oil and 60 to 70 billion cubic meters of natural gas.

The Kharyaga oil project[115] became the second project, after Sakhalin-II, to produce and export oil.[116] Although the investors were guaranteed the export of one hundred percent of production,[117] the PSA terms "place[d] the Russian government's share of oil at 47.7% at the initial stage, to be gradually increased to 73.8% upon payback, plus a 6% royalty payment. The investors w[ould] share the remaining oil in proportion to their equity stakes in the project."[118]

In summary, the difficulty in obtaining PSA permits, state monopoly over the oil pipeline system, and the presence of a powerful monopoly in the gas sector provided disincentives to investing in Russia. The 1995 PSA Law, although it provided an opportunity for a different type of foreign investment, was protectionist in nature. As seen from the Sakhalin and Kharyaga experiences, the PSA Law attracted some investment, but not nearly as much as it could have. Also, an absence of investment from multilateral institutions limited the scope of prospective investors to rich oil companies that had enough cash for investment.

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in the development of Sakhalin-II project, making Shell prospectively the largest investor in Russia. *See Shell to Invest $5 Billion in Development of Pilstun-Astokhskoe and Lunskoe Fields of Sakhalin-2 Project*, RUSS. OIL & GAS REP., Oct. 12, 2000, *translation available at* LEXIS, IntLaw Library, RUSNWS File.

113 *See* Whalen, *supra* note 110, at 4.

114 Federal Law No. 87-FZ on Areas of Subsurface the Right of Use of Which May be Granted on Conditions of Sharing of Products (Kirinsk Long-term Block of "Sakhalin-3" Project), Sobr. Zakonod. RF, 1999, *translation available at* LEXIS, Intlaw Library, RFLAW File, Garant 12015508.

115 Its resource base is estimated at 152.9 million tons of oil. *See* Gaddy, *supra* note 111, at 25.

116 *See Oil Just Too Terrible to Resist*, *supra* note 47, at 66.

117 *See* discussion *supra* Section 3.2. (offering an explanation for Kharyaga project's difficulties with export routes).

118 *Oil Just Too Terrible to Resist*, *supra* note 47, at 66.

6. RECENT AMENDMENTS TO RUSSIA'S LAWS

In the last three years the Russian government enacted amendments to its previous laws related to the regulation of foreign investment in the Russian Federation in general and in the oil and gas sectors in particular. This Section will show how the new amendments are geared towards minimizing the legal and regulatory risks connected with investment in Russia's energy sector. However, the application of these laws and their enforceability still remains to be tested.

6.1. The 1999 Law on Foreign Investment

The long awaited guarantees for foreign investment came with the adoption of the 1999 Law on Foreign Investment.[119] The Law addresses many of the legal and regulatory concerns of foreign investors by granting them rights to sue and be compensated, and by offering legal protection against certain political and economic risks. The 1999 Law on Foreign Investment provides for the state guarantees to foreign investors if investment conditions worsen. Importantly, the Law codifies the principle of national treatment for foreign investors, which was a major part of The Energy Charter Treaty, discussed in Section 5.1.[120] This principle was absent from the 1991 Law on Foreign Investment. It includes the right to purchase securities[121], protect rights in Russian federal courts or in an international arbitration court,[122] transfer or assign property rights,[123] repatriate funds abroad,[124] and be compensated for nationalization[125] or illegal acts by "state bodies, local self-government bodies and or officials thereof . . . ."[126] Unlike the 1991 Law on Foreign Investment, the current statute allows foreign investors to implement foreign investments in any form as long as

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119 *See* 1999 Law on Foreign Investment, *supra* note 5.

120 *See id.* art. 4.1 "The legal treatment of the activities of foreign investors the use of profit received from investments shall not be less favourable than the legal treatment of the activities and the use of profit received from investments granted to Russian investors." *Id.* art. 4.1.

121 *See id.* art 13.

122 *See id.* art. 10.

123 *See id.* art. 7.1.

124 *See id.* art 12.

125 *See id.* art. 8.

126 *Id.* art. 5.2.

not prohibited by the current Russian legislation.[127] Immediately following the general clause are the exceptions to the principle of national treatment, including those necessary for "protecting the fundamentals of the constitutional system, morals, health, rights and lawful interests of other persons, national defense and state security."[128] Again, the exceptions of the 1991 Law on Foreign Investment vaguely referred to "public interest,"[129] whereas the present law specifies the circumstances under which the exception would apply. Although the present exceptions appear to be broad, their exact scope will be determined through practical application. Article 9 protects for seven years the existing "priority" investment projects and those with foreign participation over twenty-five percent from unfavorable changes in the Russian law.[130] "Priority" projects are defined as those with charter capital of over one billion rubles (approximately $40 million) or investment projects with foreign contribution of at least 100 million rubles (about $4 million).[131] The grandfather clause of Article 9 applies to investments of at least one billion rubles that have a duration of more than seven years.[132] Overall, the 1999 Law on Foreign Investment is a great step towards attracting new foreign investments.

6.2. *The New Law of Subsoil*

Another positive development is the Federal Amendment to the Law of Subsoil,[133] signed on January 2, 2000, which introduces a clearly defined, although complicated, framework for the use of subsoil. Article 4 defines the length of the rights to use subsoil plots for different projects (length may vary).[134] Article 5 provides fourteen ways in which an interested party may obtain the right to use the subsoil plots, including tender or auction, and PSA.[135] The

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[127] *Id.* art. 6.

[128] *Id.* art. 4.2.

[129] *See* 1991 Law on Foreign Investment, *supra* note 66, art. 10.

[130] *See* 1999 Law on Foreign Investment, *supra* note 5, art. 9.

[131] *See id.* art. 2.

[132] *See id.* art. 9.3.

[133] *See* Federal Law No. 20-FZ of Jan. 2, 2000 on Introduction of Amendments and Addenda into the Law of the Russian Federation on Subsoil, Sobr. Zakonod. RF, 2000, *translation available at* LEXIS, Intlaw Library, RFLAW File, Garant 12017895.

[134] *See id.* art. 4.

[135] *See id.* art. 5.

law also defines the tender and auction procedures, and lists multiple ways in which the rights to use subsoil plots may be transferred or assigned.[136] This law provides the necessary legal framework for the use of subsoil.

6.3. *The 1999 Amendment to the 1995 PSA Law and Other Related Amendments*

The highly anticipated 1999 PSA Amendment[137] to the 1995 PSA Law finally passed in 1999. It is possible that before August 1998 Russia still hoped to develop its oil and gas sectors without help from abroad. However, the difficult financial crisis of 1998 prompted the Russian politicians to set aside nationalistic fears and protectionist tendencies and welcome foreign investors.[138] According to the Petroleum Advisory Forum, the implementation in 1996 of twenty-four PSA projects, as was originally planned, would have added $2.5 billion in direct and indirect government revenues in 1998, $3.1 billion by 2000, and $64 billion by 2008.[139]

The 1999 PSA Amendment opened up thirty percent of Russia's hydrocarbon resources for PSAs instead of ten percent as provided in the 1995 PSA Law.[140] It also removed the requirement of the Duma's approval of each PSA project. Responding to the protectionist fears of Russian politicians, the new Article 7 of the 1999 PSA Amendment requires projects "to grant Russian legal entities the priority right" to become contractors, suppliers, and carriers for PSA projects; to ensure that at least eighty percent of the projects' personnel are citizens of the Russian Federation; and to place at least seventy percent of all orders for needed technology and machinery with companies registered as taxpayers in Russia.[141]

Although the 1999 PSA Amendment facilitated foreign investments in Russia's oil and gas sectors, it still has drawbacks. One example is the continuing presence of a "change in circumstance" clause, which enables the Russian government to demand a greater

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136 *See id.* arts. 9, 13.

137 *See* 1999 PSA Amendment, *supra* note 6, at 1.

138 *See* Anna Sherman, *Russia Tries to Come to Terms With West*, FIN. TIMES (London), Oct. 4, 2000, at 38 (stating that Russia's new production sharing agreements are seen as a last chance to draw foreign investment to its oil and gas sectors).

139 *See id.*

140 *See* 1999 PSA Amendment, *supra* note 6, art. 3.2.

141 *Id.* art. 7.

share of the output while the PSA project is already in progress.[142] Another drawback is the exception that laws relating to health, safety, and the environment are outside of the scope of PSA contracts, which may subject investors to additional compliance obligations should such laws change.[143] Finally, there is a need for a reconciliation among various tax laws, including the Tax Code, and the tax provisions in the PSA Law. The present confusion surrounding the tax treatment of PSAs, as discussed in more detail below, may lead foreign investors to believe that they have no guarantees that the present levels of PSA taxation would not be raised when the next president comes into office.

Recently, the PSA Law was supplemented with the introduction of Part II of the Russian Tax Code,[144] which provided rules for paying value-added taxes ("VAT") and excise taxes. The first four chapters of the Code became effective on January 1, 2001. These chapters demonstrate the Russian government's commitment to the law regulating PSAs. The Code fully preserves the existing tax regulation of PSAs,[145] and also improves and clarifies the related tax laws.[146] However, since the implementation of the Tax Code, there have been concerns raised over the fact that all PSA tax regulations should be contained in the Tax Code instead of the PSA Law because only tax law can amend tax treatment of PSA projects if a need for a change arises.[147] This led to attempts by various governmental bodies to draft supplements to the Code, elaborating on the relationship between the Tax Code and the PSA Law. On December 20, 2000, Duma passed a draft law that has a discouraging effect on the interests of foreign investors. Duma's amendment introduced the principle of direct sharing, which would replace all taxes, including taxes on profits, royalties, and rentals due to investors with a unified payment taken in produced products.[148] The

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[142] *Id.* art. 17.1, discussed *supra* Section 5.2.; David Slade, *Contracts: Myth Vs. Reality*, RUSS. PETROLEUM INVESTOR, Aug. 2001, at 42, 48.

[143] *See* 1999 PSA Amendment, *supra* note 6, art. 18. *See also* Slade, *supra* note 140, at 48.

[144] *See* Tax Code Part II, *supra* note 7.

[145] *See* 1999 PSA Amendment, *supra* note 6, art. 13.

[146] *See* Andrei Mescherin, *Russia's New Tax Code Is More PSA Investor-Friendly than Former Laws*, RUSS./CENT. EUR. EXECUTIVE GUIDE, SEPT. 15, 1999, *available at* http://bisnis.doc.gov/bisnis/country/001019rstxcdepsa.htm.

[147] *See* Slade, *supra* note 142, at 47.

[148] *See A New Scandal Around the Law on Production Sharing Agreement Has Broken Out*, AGENCY WPS, Dec. 25, 2000, *available at* LEXIS, RUSNWS File; *see also*

draft would expose foreign investors to double taxation: unified tax in Russia and the tax on profit in their home country,[149] which would be collected regardless of whether the investor elects to pay the unified tax "because investors will not have relevant documents confirming payment of taxes in Russia."[150]

In May 2001, the Russian Ministry of Finance produced its own version of tax rules for PSAs, which appears to contradict the tax provisions of the PSA Law.[151] The Ministry of Finance draft introduces eighteen taxes in addition to the four taxes specified in the 1999 PSA Amendment. The draft "subordinates the PSA regime to the general system of taxing profits . . . thus subvert[ing] the contractual foundation of production sharing and the principle of stability,"and does not allow tax deductions for non-reimbursable expenses in contradiction to the 1999 PSA Amendment, and eliminates the VAT exemption provided in the Tax Code and the 1999 PSA Amendment.[152] Although neither version of the tax regulations has become law, uncertainty surrounds the current and future tax treatment of PSAs and may significantly deter foreign investors and sponsors from committing large resources to the development of PSAs in Russia. Overall, the 1999 PSA Amendment was a promising step forward toward the promotion of foreign investment in Russia's energy sector. However, only a stable and predictable legal environment, including favorable and reliable PSA tax laws, can provide enough incentives to foster PSA growth.

The attitude of the general Russian public towards the 1999 PSA Amendment is ambiguous. Some are skeptical about the new

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Sharing Production Law Amended, KOMMERS., Dec. 21, 2000, *reprinted in* RUSS. OIL & GAS REP., Dec. 22, 2000 ("Under pressure from domestic oil companies, the Duma has passed amendments introducing so-called direct sharing."), *translation available at* LEXIS, IntLaw Library, RUSNWS File.

149 Participation in direct sharing is voluntary: either foreign investors pay the Russian government all due rents, royalties, taxes on profit, and concede part of their production, or they pay the unified tax and a tax on profit in their home country. Previously, foreign investors paid taxes in Russia and the difference between the Russian taxes and the taxes imposed by their home country. *See Sharing Production Law Amended, supra* note 148.

150 *Id.* If the investors elect out of the direct sharing, international treaties against double taxation would not apply since the election is voluntary. *Id.*

151 *See* 1999 PSA Amendment, *supra* note 6, art. 13.

152 Andrei Mescherin, *Stability Undermined,* RUSS. PETROLEUM INVESTOR, June-July 2001, at 5, 6.

PSA Amendment.[153] They worry about the increasing foreign control of Russia's economic development, foreign influence in Russian politics, weakening of Russia's control over its strategic resources sector, and potential environmental problems in ecologically sensitive areas. "The PSA is also seen as having the possible effect of locking Russia into a raw materials dearth."[154] But other Russians are more optimistic: they see PSA-based investments as contributing to the modernization of Russia's energy complex and the development of Russia's infrastructure around the project areas, as well as discovery of new oil and gas fields.[155]

Throughout the 1990s, foreign investors faced a great deal of uncertainty related to the applicable laws. This Comment has shown how the laws relating to foreign investors in oil and gas sectors changed unexpectedly in a short time. While the current laws seem to favor foreign investment, there is no guarantee, based on past experiences, that the laws will remain the same several years from now. The uncertain future of PSA tax treatment seems to once again discourage foreign investment in the energy sector by exposing companies to potentially onerous taxation. A part of the Russian public shares the protectionist and nationalistic attitudes of certain Russian politicians,[156] and these attitudes may one day regain the majority in the Russian Duma. Consequently, foreign investors should not disregard legal and regulatory risks and should structure their investments so as to minimize them. The next Section evaluates two popular methods of foreign investment in the energy sector and argues for the preference of a PSA and project finance combination.

7. PREFERRED TYPES OF FOREIGN INVESTMENT IN RUSSIA'S OIL AND GAS

Although some Russian protectionists may disagree, Russia needs to attract foreign investment. Approximately eight to ten billion dollars per year is needed to maintain the current levels of oil and gas production.[157] "Failure to attract adequate investment

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[153] *See Russian Oil and Gas Production-Sharing Agreements Promising but Worrisome,* OIL & GAS J., Oct. 18, 1999, at 36.

[154] *Id.*

[155] *See id.*

[156] *See supra* text accompanying note 141.

[157] *Russian Oil and Gas Production-Sharing Agreements Promising but Worrisome, supra* note 153, at 36.

would force Russia to either scale back oil exports or reduce domestic consumption."[158] According to Dorian and Khartukov, foreign assistance is needed mainly in three areas: "the transfer of technology, capital, and management skills."[159] Foreign capital is needed to maintain the run-down equipment, modernize the obsolete technologies from the Soviet era, preserve the environment in ecologically sensitive areas, and increase efficiency in oil production.[160] To attract high levels of investment, Russia needs to minimize regulatory risks and provide incentives to foreign investors to find alternative sources of financing for its oil and gas projects. As the oil and gas industry received hardly any funding from the government in the early 1990s, joint ventures with foreign investors were sought after for funding.[161] Project financing and direct ownership of the Russian oil companies by foreign investors became two alternative methods to funding projects in Russia's oil and gas sectors.

This Section argues that the development of PSA agreements makes the project finance model of investment in Russia's oil and gas sectors more advantageous than foreign investors' direct participation in oil companies' ownership. Although the latest laws adopted in 1999 and 2000 reduced legal and regulatory risks by providing foreign investors with greater legal protection, the Russian legal system is still in the formation stages. The current draft Law on Joint Stock Companies has many ambiguous provisions and inadequately protects the interests of shareholders. Without the adoption and efficient enforcement of a new legal framework, including an amendment to the Law on Joint Stock Companies, the legal risks of direct investment, such as the absence of a well-developed body of commercial law and enforcement mechanisms that would enable project participants to seek legal recourse during the lifetime of a project, are very high. The experience of several

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[158] *Id.*

[159] Dorian & Khartukov, *supra* note 71, at 49.

[160] *See* Cors, *supra* note 38, at 598-600 ("The poor maintenance of the pipelines which did exist meant that in 1991 the newly independent Russian Federation inherited a network annually suffering an estimated 700 explosions and leaking several million tons of oil."); *see also* Mikhailov, *supra* note 44 (explaining that pipeline breakdowns typically occur due to corrosion, wear-out damages, technological, and construction defects, and that "[a]bout 50% of trunklines have been in service for 30 years or longer, often surpassing their projected service life of 33 years").

[161] *See* Dorian & Khartukov, *supra* note 71, at 48.

foreign investors who decided to buy stakes in Russian oil companies, as illustrated in Section 7.1., revealed that Russian laws afford inadequate protection of minority shareholders' rights and that minority shareholders have little influence on company's operations. On the other hand, project finance is preferable for investments in Russia because, coupled with PSA agreements, it would successfully minimize the legal, regulatory, and financial risks of investing. As it will be explained in Section 7.2., the PSA agreements assure project lenders that they would be able to recover their investment through ownership of a percentage of initial product output even before the project becomes profitable.

7.1. Buying Stakes in Russia's Oil and Gas Companies

From 1995 to 1997, several major Western oil companies announced their plans to buy Russian oil companies instead of developing new or existing oil fields. In November 1997, Royal Dutch/Shell Group ("Shell") and British Petroleum PLC ("BP") announced plans to invest about $1.75 billion into Russia's oil and gas sectors.[162] Shell invested around $1 billion in Gazprom by buying its convertible bonds and BP bought a ten percent stake in AO Sidanko, Russia's fourth largest oil company, as well as a twenty percent stake in eastern Siberian gas fields, controlled by Sidanko, receiving forty-five percent of Sidanco's sixty percent holding in that project.[163] Both of these deals resembled a 1995 deal between Atlantic Richfield & Co. ("Arco") and Lukoil, in which Arco bought $250 million of convertible bonds in Lukoil that gave Arco a 7.99% stake in Lukoil (each bond was later converted into 170 shares of common stock).[164]

However, direct investment into Russian oil companies has its risks, one of which is the lack of transparency of the companies and the resulting speculation about the companies' assets and financial position. Sidanko became subject to bankruptcy proceedings in 1998 that resulted in an out-of-court settlement in the be-

[162] *See* Matthew Brzezinski & Bhushan Bahree, *The Eastern Oil Rush*, WALL ST. J. EUR., Nov. 18, 1997, at 1.

[163] *See id.*

[164] *See* Steve Liesman, *Arco May Enter Russian Market Via Lukoil Deal*, WALL ST. J. EUR., Aug. 31, 1995, at 3.

ginning of 2000.[165] As a result of the settlement, TNK seized two of the best production subsidiaries of Sidanko, Kondpetroleum and Chernogorneftegaz.[166] BP Amoco protested. In December 1999, the United States blocked $498 million in loans to TNK for their Samotlor oil field and Ryazan oil refinery projects after TNK's acquisition of Chernogorneftegaz, "a move widely regarded as a devaluation of foreign investment."[167] TNK and BP finally reached an agreement in 2001 to jointly own and run Sidanko (TNK owns eighty-four percent and BP owns ten percent of Sidanko)[168] and the Export-Import Bank released its loans.[169]

Another risk connected with direct investment in Russia's oil companies is the weak protection of shareholders' rights. Yukos, Russia's second largest oil company, was involved in litigation with its Western minority shareholders, led by Kenneth Dart, over Yukos's attempt to sell additional shares in some of its subsidiaries, thus diluting the shares' value.[170] Dart is believed to hold between twelve and fourteen percent of Samaraneftegaz, Tomskneft, and Yuganskneftegaz, three of Yukos's drilling subsidiaries.[171] Allegedly, the additional shares were issued at a meeting to which Western shareholders were denied admission. The issuance was confirmed at another Yukos meeting, the location of which was changed to over 100 miles outside of Moscow one hour before it began.[172] Dart sued Yukos and secured six international injunctions to stop the transfer of the newly issued shares. On June 28, 1999 Dart won his first legal battle in the Samara court in Russia.[173]

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[165] *BP Amoco, TNK Make Peace, Freeing Ex-Im Loans,* OIL & GAS J., Apr. 10, 2000, at 38 (noting that Sidanko owes a total of $461.9 million, including $24.2 million to BP Amoco).

[166] Chernogorneft was "the jewel in Sidanko's crown," with its output equal to one-half of Sidanko's total production. *See id.* at 38.

[167] *Id.*

[168] See Kent F. Moors, *World Class,* RUSS. PETROLEUM INVESTOR, Sept. 2001, at 57 for particulars of TNK's purchase of Sidanko's subsidiaries and a subsequent agreement with BP.

[169] *See id.* at 57.

[170] *Russia's Regions: Western Siberia,* BUS. RUSS., July 10, 1999, *available at* 1999 WL 10863515.

[171] Kent F. Moors, *Landmark Shareholder Battle Heats Up at Yukos Oil Holding,* RUSS./CENT. EUR. EXECUTIVE GUIDE, June 30, 1999, *available at* http://www.wtexec.com/ew063099.html.

[172] *See id.*

[173] *See id.*

The parties settled this dispute in December 2000.[174] In a similar situation, Slavneft's foreign shareholders' shares representing 12.6% of the outstanding shares were arrested and prevented from participating in the annual meeting electing the new board members.[175] As a result, the foreign shareholders were unable to vote for their preferred candidates. The above examples highlight some of the risks that foreign investors assumed by investing directly in Russia's oil companies due to the lack of legal protection for minority shareholders' rights and the absence of laws requiring transparency in operations of Russian companies.

Concerns over the lack of minority shareholders' protection have been recently addressed by the Russian Duma's adoption of a draft law entitled "On Changes and Amendment to the Federal Law 'On Joint Stock Companies,'" (the Draft Amendment).[176] Once signed by the president, the Draft Amendment will provide incentives to increase foreign direct investment in Russian companies. For example, minority shareholders' proposals will no longer be rejected for minor technical violations and will be presented at the general shareholders' meetings in their exact wording, measures will be implemented to limit the dilution of minority holders' shares through closed share issuance, and an increased number of decisions will require the unanimous approval by the board of directors.[177] However, the Draft Amendment has met opposition from Russia's powerful oligarchs, who particularly dislike the unanimous voting requirement for an increasing number of decisions and a lack of balance between the interests of majority and minority shareholders.[178] Thus, it remains unclear when the Draft Amendment will be signed and whether it will be signed in its present form.

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174 Andrew Jack, *Pouring Oil on Troubled Waters*, FIN. TIMES (London), Jan. 19, 2000, at 21.

175 *Slavneft's Foreign Shareholders Call Extraordinary Meeting*, INTERFAX RUSS. NEWS, Aug. 8, 2000, *translation available at* LEXIS, IntLaw Library, RUSNWS File.

176 *See* Julia Romanova, *Striving for Clarity*, RUSS. PETROLEUM INVESTOR, Sept. 2001, at 62-65. The proposed draft would amend the Federal Law No. 208-FZ on Joint-stock Companies (previously amended on June 13, 1996 and May 24, 1999), Sobr. Zakonod. RF, 1995, *translation available at* LEXIS, Intlaw Library, RFLaw File, Garant 10005712.

177 *See* Romanova, *supra* note 176, at 62-63.

178 *See id.* at 65. The interests of majority shareholders are further limited by the fact that the Russian Law does not allow freezing out of minority shareholders with less than a certain small percentage of outstanding shares. *See id.*

7.2. Project Financing of Russia's Oil and Gas PSA Deals

The 1999 PSA Amendment allowed more resources to be developed by foreign investors and relieved the investors from the onerous requirement that each PSA project be approved by the Russian Parliament.[179] This recent facilitation of a PSAs' implementation should prompt more foreign investment into Russia's oil and gas projects.[180] As discussed above in Section 5.2, the essence of a PSA agreement is that the developer of the project (a sponsor and/or lender in a project finance setting) shares the ownership of the produced oil or gas with the Russian government on a contractual basis. Considering the long-term nature of PSA projects, a PSA contract is necessary to shield the project participants from varying attitudes and regulations of the host government. A PSA contract must be carefully negotiated. Most importantly, a PSA agreement has to be legally enforceable against the host government (not against one of its agencies that may not exist five years after the agreement is signed and may not have had the requisite authority to enter into the PSA arrangement) regarding the key rights of the project participants. These rights include, among others, the right to produce, to import necessary equipment, to export production, and to own a certain portion of the output.[181] Additionally, project participants may elect to have foreign law govern the PSA contracts, although questions remain about Russia's willingness to waive its foreign immunity.[182]

The Kharyaga PSA project exemplifies a PSA project where at the initial stages of production the Russian government allowed the developers to export and sell more than fifty percent of the produced oil in order to recover their production costs.[183] After the project turns profitable, the Russian government will hold most of the rights to the produced oil.

As discussed below, with a project finance method of financing oil and gas developments, lenders may be reluctant to invest in

[179] *See* discussion *supra* Section 6.3.

[180] *See* Vladimir Baidashin, *PSAs Gain Momentum*, RUSS. PETROLEUM INVESTOR, Sept. 2001, at 14 (discussing that by the end of 2001, Russia intends to conclude twelve more PSAs to develop blocks of oil and gas reserves off the shore of Sakhalin island).

[181] *See* David Slade, *Contracts: Myth Vs. Reality*, RUSS. PETROLEUM INVESTOR, Aug. 2001, at 42.

[182] *See id.* at 48.

[183] *See* discussion *supra* Section 5.2., and text accompanying notes 111-14.

projects where there is a high risk that they may not recover their loans and additional interest. The PSA arrangement insures recovery of investments as soon as the project produces its first output. Thus, the recent amendment to the 1995 PSA Law provides incentives to the project finance model of investment in Russia's oil and gas sectors.

Project finance is a method of financing "in which the lenders look principally to the cash flow generated by the operation of the project for the source of funds from which the loans will be repaid."[184] Lenders assess the creditworthiness of the project, rather than of the sponsoring firms. Projects may be financed on a non-recourse or, more commonly, a limited recourse basis.[185] Such methods of financing provide incentives to the sponsors to engage in developing projects even if they entail a higher than average degree of risk. Foreign sponsors in Russia's energy sector will be willing to develop projects only if they can expect a higher rate of return than what they can get elsewhere. Lenders' interests coincide with those of long-term sponsors, whose profits depend on the success of the project. Other sponsors may have different interests, such as securing supply contracts for the project.[186] As a result of the possible divergence of interests, lenders usually require the sponsors to contribute significant capital to the project.[187]

Project sponsors form a separate legal entity that owns and operates the project. The entity is most frequently a consortium or a joint venture, depending on the tax and other benefits offered by

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[184] FEO ET AL., *supra* note 9, at 3.

[185] In a non-recourse project finance deal, sponsors are not liable to the lenders for the money lent to the project. However, if the project fails, the lenders will take the project's assets held as security for the loan, even if the assets were contributed by the sponsors. In a limited recourse financing, lenders have some recourse to the sponsors, either during certain early stages of the project development or in cases of overspending the estimated project budget. But even in limited recourse financing, project lenders still look at the project for the main source of repayment of their loans. *See* INTERNATIONAL FINANCE CORPORATION, LESSONS OF EXPERIENCE, LESSON 7: PROJECT FINANCE IN DEVELOPING COUNTRIES 4-5 (1999) [hereinafter IFC].

[186] *See* FEO ET AL., *supra* note 9, at 4.

[187] "Lenders require sponsors to contribute equity to decrease the strain imposed on project revenues by debt service and also to create an incentive for project sponsors to make the project successful." *Id.* at 11. Typical contributions range from five to twenty-five percent, but may be as great as fifty percent for the high risk projects. *See id.*

the host country's regulations.[188] International commercial banks may become project lenders through providing loans on a syndicated basis with a group of banks, thus spreading the risks and raising larger amounts of money.[189] According to the *Russian Petroleum Investor,* "syndicated bank loans [would] remain the primary external funding mechanism for virtually all Russian oil deals in 2000."[190] A typical interest rate paid on such loans is LIBOR (London Interbank Offered Rate) plus seventy basis points ("bps"). Russia's syndicated loans are considered high risk and carry a high interest. Thus, TNK, a Russian oil company, received in October of 1998 a syndicated loan of LIBOR plus 450 bps; Sibneft received LIBOR plus 400 bps, and only the Sakhalin-II project received a significantly lower rate of LIBOR plus 175 bps in 1999.[191]

Multilateral lending agencies and export credit agencies may also provide project financing. Occasionally, several agencies invest in the same project.[192] Drawbacks of lending by multilateral agencies may include a lengthy approval process, limitations on the currency of the loan, and rigid environmental requirements.[193] Among the multilateral institutions involved in financing oil and gas projects in Russia, International Finance Corporation ("IFC"), a private entity of the World Bank, typically limits its investment to up to twenty-five percent of a project's costs and offers a variety of loans, equity, and quasi-equity financings.[194] For example, in 1998 IFC provided a loan for $25 million and an equity investment of up to $5 million to a project called Bitech-Silur JSC, owned by Bitech Petroleum Corporation, a Canadian company, to fully develop

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188 *See id.* at 8.

189 *See id.* at 13.

190 Kent F. Moors, *Banking on Loans,* RUSS. PETROLEUM INVESTOR, Jan. 31, 2000, (stating that "[m]ajor foreign banks recorded at least $2.5 billion in direct losses from Russian loan defaults and another $3 billion in related write-offs" in the second half of 1998 though the end of the first half of 1999), *available at* http://www.wtexec.com/rpi013101.html.

191 *See id.*

192 *See* FEO ET AL., *supra* note 9, at 15 (using for example the Polar Lights project to develop the Ardalin oil field in Siberia, Russia, sponsored jointly by Conoco Inc. and Russia's Arkhangelskgeologia, was financed in part by the IFC ($60 million), the EBRD ($90 million), and OPIC ($50 million)).

193 *See id.*

194 *See generally* IFC, *supra* note 184 (discussing and explaining project finance as a cost-effective investment tool that is becoming more popular for those investing in developing markets).

three oil fields—South Kyrtayel, Lekker, and Subor—located in Pechora, Komi Republic of Russia.[195]

Another lending institution that promotes private development in Central and Eastern Europe is the European Bank for Reconstruction and Development ("EBRD"). EBRD limits its involvement to thirty-five pecent of the project costs, and imposes requirements such as project sponsors with a proven record and equity contribution of thirty-five percent from the sponsors.[196] As of September 30, 2000, EBRD's contributed 629 million ecus, the European Union's currency, to the financing of eleven projects in Russia's oil and gas extraction sectors.[197] Overseas Private Investment Corporation ("OPIC"), a U.S. governmental agency that offers project financing and political risk insurance, became a lender to the Sakhalin-II project, disbursing $59 million of its total $116 million commitment in June of 1998.[198]

Project financing is advantageous for sponsors because they are not held liable for the project's loan defaults and thus their creditworthiness is not affected by the project's failure. Associated risks of a project are allocated among many participants and do not require sponsors to bear the full financial burden.[199] However, in order to attract such financing, a project has to be already structured with the necessary permits and licenses secured. This preliminary stage of the project may be too expensive for some sponsors who wish to limit their involvement in the project, pursue their own investing agenda, or initiate smaller ventures, which may not attract the attention of the lenders. These sponsors may turn to direct investing in Russia's oil companies or they may form joint ventures with Russian companies and assume their share of the risks. However, with the introduction of the PSA Law, sponsors may attract external loans to even smaller projects if they receive permission from the Russian governmental bodies to form production-sharing

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[195] *See* IFC Project Documents, *Summary of Project Information*, *available at* http://www4.worldbank.org/sprojects/ (last visited Nov. 5, 2001). For a description of other projects with IFC or EBRD financing, see IFC Press Release, IFC Approves First Projects in Russia (June 17, 1993), *available at* http://www.ifc.org (last visited Nov. 5, 2001).

[196] *See* FEO ET AL., *supra* note 9, at 17-18.

[197] *See* EBRD, *supra* note 91. Projects include KomiArctic Oil, Polar Lights Co., and Sakhalin-II (Phase 1) Oil Project. *See id.*

[198] *See* OPIC Press Release, *OPIC Makes First Disbursement to the Historic Sakhalin Oil and Gas Project in Russian Far East* (June 11, 1998) (on file with author).

[199] *See* FEO ET AL., *supra* note 9, at 7-8.

agreements, according to which lenders would receive rights to the Russian oil before any profits are realized by the project. A combination of PSAs and project financing may significantly raise the number of oil exploration projects and the volume of extracted oil.

As the analysis of the recent amendments have shown, Russia, a country that has the world's largest reserve of natural gas and approximately 49 to 55 billion barrels of proven oil reserves,[200] may finally achieve its goal of attracting foreign investment to help explore its oil and gas deposits through the use of PSAs and project finance.

8. CONCLUSION

In spite of the ambiguities surrounding PSA tax treatment, Russia has achieved more in terms of attracting foreign investment in its oil and gas sectors in the period of 1999 to 2001 than it did in the previous twelve years of *perestroika*.[201] Current stabilization in Russia's political environment along with the presidency of Vladimir Putin and his commitment to reform leaves foreign investors optimistic that Russia will one day open its markets to global trade and commerce. Throughout the last decade, legal and regulatory uncertainties in the Russian system constituted the key risk factors in investing in Russia's energy sector. Foreign investors interested in participating in the exploration of Russia's vast oil and gas reserves had to restructure their investments to minimize these risks. Currently, project financing of PSA projects presents the preferable type of investing because it limits the financial exposure of project sponsors, guarantees early returns on the loans of the lenders, and protects certain rights of the project participants through a binding contractual arrangement with the host government. However, there is no guarantee that the Russian laws will remain unchanged. Russia needs to demonstrate its commitment to attracting foreign investment through the provision of consistent and reliable legal and regulatory frameworks. Foreign investors need additional guarantees that the Russian legislature will not again favor protectionist laws of the early and mid-1990s. Russia also needs to re-

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200 *See* U.S. ENERGY. INFO. ADMIN., RUSSIA, *supra* note 2.

201 *Perestroika* is a movement started in 1987 by Mikhail Gorbachev directed at restructuring the Soviet system into a market-oriented economy and introducing a democratic political process.

structure its oil transportation and gas sectors to introduce competition and facilitate the entry of foreign developers.

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