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# OIL AND GAS LAW REFORM IN RUSSIA: THROUGH THE SMOKE OF BATTLE

*Sheila S. Hollis and John W. Berresford\**

## I. INTRODUCTION

Oil and gas are not “just another commodity” in Russia. They are of overriding importance to the nation, as they are to the worldwide economy. The magnitude of Russia’s reserves is believed to be greater than that of Saudi Arabia and many other potent oil-producing nations. To the Russian economy, those reserves are the fastest route to earn desperately needed hard currency in the short term; in the long term, oil and gas are the resources that will lift Russia to full membership in the world economic system. To foreigners (non-Russians) in the business, Russia is one of the last great frontiers, and maybe *the* last frontier.

The development of Russian oil and gas has been swept up into huge political conflicts about the country’s future. The old ways are discredited, but the new ones have not been charted (much less travelled). Physical structures are deteriorating rapidly<sup>1</sup> so something must be done, but no one agrees what or how. Free market ideas seem unreal in a system that has known only control for seventy years and more recently only chaos. The old guard opposes radical change and, one suspects, is holding out for a

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1. After years of surplus and hard currency earnings, Russia’s production declined sharply in 1992 and 1993, chiefly through neglect of infrastructure. It is even feared that in 1994 Russia may have no surplus at all to export and will need to spend hard currency on imports just to meet the internal needs of its restive populace. *Burn, Lenin, Burn*, THE ECONOMIST, Jan. 23, 1993 at 52; *Russia’s Cold Shoulder*, THE ECONOMIST, Mar. 13, 1993 at 73. See generally D. REMNICK, *LENIN’S TOMB* at 24, 199 (Random House 1993).

central role in any new arrangements.<sup>2</sup> Foreigners want to follow their own accustomed ways, with minimal risk and with a return as prompt and abundant as possible.

For almost three years, this strife has echoed through attempts to reform Russia's oil and gas laws. So many drafts have circulated reflecting the opinions of so many groups (and compromises among them) that it would be pointless to compare one with another (and another, and so on). Rather, this article will concentrate on the basic issues and basic "conservative" and "reformist" positions.

## II. THE CONSERVATIVE POSITION

The views of the "old guard" on oil and gas reform are based on and reflected in the fundamental Russian law on the subject, The Law of the Russian Federation on Underground Natural Resources ("Underground Resources Law").<sup>3</sup> This law (and others) keep oil and gas, to the greatest extent possible, in the hands of the government and out of those of private (especially foreign) owners.<sup>4</sup> Many, many layers of government must be pierced before limited "rights to use" may be the objects of "commercial relations."<sup>5</sup>

Rights to use (that is, to operate an extraction business), when finally granted, may include rights to sell and export, but these are subject to the discretion of the licensing authorities.<sup>6</sup> The general effect is to discourage the foreign developer and to leave unfettered negative power in the hands of the government.

2. The old guard in oil and gas has more credibility than elsewhere because, for so many years, their system worked rather well. Oil and gas were found, extracted, and refined. The country was heated. Vast amounts of hard currency were earned by sales of surplus to foreigners. Soviet oil and gas experts contributed to development of petroleum resources in other Soviet bloc countries and developing countries. All these efforts were accomplished while supplying a massive military complex with its energy needs. Few industries of the Soviet era have such a solid record. The old system began to disintegrate only in 1986 with the worldwide decline in oil and gas prices. See Khartukov & Fesharaki, *Ex-Soviet Oil Industry: Humpty Dumpty All Over Again?*, 10 Oil & Gas L. & Tax'n. Rev. at 41 (1992).

3. [title in Russian transliterated in English letters], Law of the Russian Federation On Underground Natural Resources, citation to Vedomosti RSFSR, Feb. 21, 1992. [hereinafter Underground Resource Law] (all Vedomosti RSFSR citations on file with the Library of Congress).

4. See [transliteration of Russian title], id., Article II, (providing that all used and unused areas of underground resources located within the Russian Federation constitute the state fund of underground resources). See also KONST. RSFSR, Art. XI, 1992, Constitution of the Russian Federation, Art. XI; KONST. SSSR, Art. VI, Dec. 12, 1992, (providing for property laws); *Id.* at § 1 (prohibiting private ownership of underground resources); [transliteration of Russian title], Basic Civil Legislation, Art. IV, Vedomosti RSFSR 91-22-768, 1992 (holding that underground resources are not real estate); [transliteration of Russian title], Law Regarding Provision of the Economic Basis of the Sovereignty of the Russian Federation, Art. I, Vedomosti: 120690, 1992.

5. These layers include the Russian Federation itself, its sixteen autonomous Republics, its five autonomous provinces ("oblasts"), ten autonomous regions (variously called "okrugs," "krais," and "raions"), municipalities and within each of these, various legislatures, ministries, departments, bureaus, and courts.

6. See [transliteration of Russian title], Underground Resources Law, *supra* note 3, art XXII.

The Russian government, in one of its first acts, took most of the former Soviet oil and gas apparatus and formed it into a wholly owned subsidiary called the Russian State Oil and Gas Corporation ("Rosneftegaz").<sup>7</sup> While nominally a move towards privatization, this entity is suspected to be the old Soviet bureaucracy in entrepreneurial clothing. These new "captains of industry" are expected to keep whatever they can of their former franchise on all parts of the business in Russia.

Conspicuous by their absence from the conservative posture are: market mechanisms, any check on government power, room for private incentive, and any impetus to efficiency, cost containment, cost-based pricing, or quality control. One senses that the conservatives would like to leave these and other matters as discretionary as possible. This serves the aims of preserving their (Rosneftegaz's) dominant position, delaying change, and continuing Russia's centuries-old tradition of bureaucratic fiat (subject to unilateral change at any time) as the principal way of doing business.<sup>8</sup>

### III. THE REFORMIST POSITION

Many Russians and almost all foreigners consider that vastly more change is needed for Russia's oil and gas complex. They call for the creation of something approximating the western model of free enterprise under government regulation, as in New Deal-era regulatory agencies and state public utility commissions. Of course, this is easier said than done. Even at a conceptual level, it is difficult to say exactly where to begin, how fast to go, and how far.<sup>9</sup> And "models" are worthless, even harmful, in reality if they are too far ahead of the people, and no one follows them.

The reformists are concentrating on drafting a Russian Federation Law on Oil and Gas ("Oil and Gas Law"), which is to be a statute complementing the Underground Resources Law.<sup>10</sup> Russian drafting has been led by the Federation's Ministry of Fuels and Energy. The Ministry was assisted by the University of Houston Law Center and the World Bank, both of which are interested in creating a welcoming environment for foreign investment.

The law, when it is adopted, will be some amalgam of the drafts now in circulation. Certain key points of it are reasonably clear.

First, the law will establish a logical sequence of licensing for different kinds of activities (exploration, production, and export). In the most recent drafts, a license to explore a territory is not exclusive and creates no preference for the explorer when it comes time to issue a license to pro-

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7. Khartukov & Fesharaki, *supra* note 2, at 44.

8. See generally [transliteration of the Russian title], *Underground Resources Law*, *supra* note 3. Bureaucratic fiat as a way of life in Russia pre-dates communism. See NIKOLAI GOGOL, *DEAD SOULS* 159-73 (Penguin Books 1993) (1842).

9. For example, the creation of Rosneftegaz out of the old Soviet bureaucracy may be a form of privatization (and therefore a good thing); but without any antitrust principles or enforcement, the new company may become simply a profit-maximizing, unregulated and unaccountable monopoly.

10. *Underground Resources Law*, *supra* note 3.

duce in the territory. Licenses to produce may be exclusive but need not be.

Multiple layers of government remain involved in the licensing process; there is no one body determining the chronological, geographical, and functional scope of licenses and choosing licensees from among applicants. Federal-state conflicts, however, are reduced to some extent by broad grants to the Russian Federation Government of authority to approve all regulations issued by lower levels and all licenses granted to non-Russians. Licenses will be granted based on competitive bids or auctions, with negotiation remaining an option in limited instances.<sup>11</sup>

Licenses, while not approaching the status of an American title in fee simple, convey something approximating vested rights and may not be altered or revoked by the government except in rare circumstances and for good cause. Licenses are generally transferrable, even to non-affiliates. Holders of production licenses may have their terms extended beyond their nominal expiration. Competition will be injected into the operation of pipelines, with equal access to them guaranteed for all similarly situated users. There is also talk of a statutory *pro rata* allocation scheme in the event of a shortfall in pipeline capacity.

Finally, the reform proposals make a laudable start towards a system of taxation (or, more broadly, raising revenue for the government) that is comprehensible and stimulates exploration, development, production, and efficiency. Today, companies interested in Russian oil and gas face an array of payments to government authorities that are uncertain in their application and bewildering in their number. Payments are required by acts of the Russian Federation Parliament,<sup>12</sup> by Presidential Decrees, by Executive Orders, by regulations issued by various ministries of the Federation government, and by similar enactments of republics, autonomous regions, and cities.<sup>13</sup> There are fees, royalties, taxes, remittances, duties, commissions, tariffs, and contributions; and in some cases there are exemptions from the foregoing. Payments, to name just a few, are required in exchange for licenses granted by different government units covering exploration, exploitation, and extraction.<sup>14</sup> Payments are also required for the right to use the surface and subsoil (and offshore waters and sea bed), for the production of raw materials (and even for the production of geoscientific information<sup>15</sup>), for the import of equipment and other tangibles,<sup>16</sup>

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11. Negotiation is the least preferred means of granting licenses because compared to competitive bids and auctions it is the most susceptible to several forms of abuse.

12. Examples include [transliteration of Russian title], the Underground Resources Law, *supra* note 3.

13. There is, predictably, a gargantuan battle among these government entities in Russia for the revenues collected under these exactions. The Underground Resources Law purports to divide the collection of certain royalties among certain government units, but this division reflects, at most, the outcome of a battle; the war goes on.

14. See, e.g., [transliteration of Russian title], Underground Resources Law, *supra* note 3.

15. See, e.g., [transliteration of Russian title], Underground Resources Law, *supra* note 3 and regulations thereunder.

and for exporting different kinds of petroleum products.<sup>17</sup> This list does not reach the additional payments that are called for in laws and regulations that apply generally to foreign businesses.<sup>18</sup>

This Gordian Knot of financial incentives and penalties cannot, of course, be cut clean through by the Oil and Gas Law.<sup>19</sup> But the drafters of the Law do appear to be thinking of revenue raising, however it is labeled, as a comprehensive process rather than a series of "gotcha's." They also are planning it as a process that should, on the whole, stimulate optimal behavior by foreign enterprises — long-term investment, production of added value, and development of Russia's resources consistent with Russian national and local interests. Some drafts of the Oil and Gas Law contemplate fees and taxes being set not at "whatever the market will bear," but on a rational basis — for example, reflecting the government's cost of processing an application or the value of the right being granted, or in order to stimulate desired behavior (high-volume production, environmental protection, etc.).

Another encouraging development is that most drafts of the Law adopt the principle that the developer is entitled to earn a reasonable rate of return on his investment. While arguments over what is "reasonable" are inevitable, this is a significant reduction of downside risk and a remarkable principle to find stated in the laws of a country which recently considered such ideas to be anathema.

Finally, by reading between the lines of the various drafts, one can detect a few ideas taking shape slowly that are recognizable to a westerner. The oil and gas law will make clearer the separation between government (the owner of oil and gas and regulator of their use) and business (its developer and user). It will place more property rights in private hands, including foreign ones. It also presumes equality of treatment for Russian and foreign investors and for all similarly-situated licensees in bidding, taxation, and access to pipelines. Marketplace mechanisms, entrepreneurship, and

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16. See, e.g., [transliteration of Russian title], (Presidential Decree 630), Vedomosti RSFSR 1992 (concerning imports).

17. See, e.g., [transliteration of Russian title], (Presidential Decree 628) Vedomosti RSFSR 1992 (concerning exports), and [transliteration of Russian title], (Presidential Decree 629), Vedomosti RSFSR 1992 (concerning export duties), and [transliteration of Russian title], (Executive Order 1375), Vedomosti RSFSR July 27, 1992 (exempting certain foreign owned enterprises from certain export duties).

18. *Id.* These also include [transliteration of Russian title], (Presidential Decree 629) Vedomosti RSFSR, (concerning export duties), *supra* note 17; [transliteration of Russian title], (Presidential Decree 630), Vedomosti 1992 (concerning imports; currency repatriation tax; corporate income tax and "super profits" taxes); [transliteration in Russian title], the Law on Mortgages, Vedomosti 1992, (concerning the recordation of real estate transactions and mortgages); and other laws which, while not expressly finance-related, directly impact the ability to earn and keep revenue, such as [transliteration of Russian title], (Presidential Decree 854), Vedomosti RSFSR 1992 (concerning import and export licenses and quotas for commodities, works and services).

19. To be fair, it must be admitted that all the revenue-raising measures of the United States' federal, state, and local governments and agencies do not form a symphony of Mozartian clarity and symmetry. Perhaps the western reaction to the Russian system comes from its newness and the lack of operating experience among its administrators.

competition will multiply, and foreign investment in and profit from oil and gas in Russia will generally rise from a seigniorial favor to a regular practice.

#### IV. OUTLOOK

The conflict between the old guard and the reformists was evinced in several skirmishes as the draft laws proliferated. The two groups disputed, for example, whether the general Underground Resources Law or the specific Oil and Gas Law would prevail where the two are in conflict. The conservatives, of course, wanted the Underground Resources Law to reign supreme, conceivably nullifying virtually the entire Oil and Gas Law. The reformists, on the other hand, wanted the Oil and Gas Law to govern and to spell out in one place a comprehensive regulatory plan. This may be resolved in a section of the Oil and Gas Law, or may be left, after it is enacted, to resolution as individual problems come up.

Another flashpoint of old guard and reformist conflict was whether and to what degree the government's oil and gas assets would be privatized under Russia's sweeping laws on that subject.<sup>20</sup>

At the center of the conflict, though, was the drafting process of the Oil and Gas Law. The Ministry of Fuel and Energy and the Ministry of Ecology and Natural Resources were supposed to prepare a draft by mid-1992. The reformists' draft was prepared with the University of Houston and the World Bank, and was circulated a few months later. The old guard countered with their own draft, prepared by a scientific institute. Consideration by the Parliament was scheduled for December 1992, but "compromise" drafts proliferated and other events pushed oil and gas reform into the background. In December, the issue was effectively tabled in the Supreme Soviet.

Larger issues then occupied the Russian government and petroleum industry — chiefly, the substitution of Viktor Chernomyrdin for Mr. Gaidar as Prime Minister and the huge power struggle between Yeltsin and the old guard.<sup>21</sup>

With Yeltsin's victory at the polls in April 1993 and his fiery victory over the Parliamentary reactionaries in October, the chances of a reformist Oil and Gas Law increased dramatically. However, it is unlikely that any law will be enacted before mid-1994. Elections for a new legislature are scheduled for late 1993, with the elected representatives to convene early the following year. A new legislature in its first session will require months to fashion such a significant piece of legislation.

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20. *Yeltsin Orders Privatization Move for Russian Oil*, 90 OIL & GAS J. 37 (1992) (describing "stiff opposition by Communists and ultranationalists").

21. Prime Minister Chernomyrdin can be expected to give special attention to oil and gas matters. He has had a long career in the industry, most recently as Vice Prime Minister, Ministry of Fuels and Energy. Those favoring a resolution — any resolution — in this area should rejoice at the presence of someone at the top of the Russian government with so much experience. Even without his personal background, anyone in his position would recognize that boosting production (or, at least, slowing its decline) is an urgent national need.

Members of the worldwide oil and gas business, of course, have their own keen interests in developing Russia's reserves — to ensure their own long-term future and to help Russia become a prosperous (and petroleum-based) country. While the creation of an effective Law has been on hold, deals are taking place between many companies and Russia, as well as many of the CIS states.<sup>22</sup> Thus, transformations in the industry's operations may precede the clarification and finalization of a reshaped legal framework. Nothing this big and complicated can be done simply or quickly.<sup>23</sup> Risks, difficulties, crises, and success have characterized the oil and gas business in other countries. Visionaries in the business will remain obsessed with this latest "Prize"<sup>24</sup> and will want to be heard in the halls and lobbies of the new Russian Federation Legislature as the new oil and gas law approaches enactment.

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22. Agis Salpukas, *In an Oil Rush to the East, Elf Plays Pied Piper*, NEW YORK TIMES, June 27, 1993, at F7. Indeed, other CIS countries have gone much farther than Russia in welcoming foreign petroleum companies. See, e.g., *Kazakhstan's Oil Industry - Tomorrow's Gusher*, THE ECONOMIST, July 25, 1992, at 72.

23. Westerners who wish that Russia would "just let us do what we'd like" should remember the Shah of Iran, who accommodated foreigners while ignoring the real needs of his own, increasingly restive, people.

24. Dr. Daniel Yergin, in his Pulitzer Prize winning book, has concluded that Russia could well be the most attractive new opportunity in the oil world. DANIEL YERGIN, *THE PRIZE: THE QUEST FOR OIL, MONEY & POWER* 773-80 (1991).



