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# **CURRENT DIFFICULTIES IN FORMING POLICY AND ATTRACTING THE FOREIGN OIL INDUSTRY TO THE FORMER SOVIET UNION**

**D. Thomas Gochenour\***

## **I. INTRODUCTION**

For eighteen months before the August coup in the Union of Soviet Socialist Republics (USSR), volumes of enactments, decrees, regulatory rulings, and laws were issued by the Soviet government, all related to foreign investment in the oil and gas sector. Some of these acts, while seeking to clarify the investment situation, actually contradicted or annulled terms contained in previous rulings. The situation was reminiscent of China in the 1978-1982 period when that country first opened its doors to foreign investment in its oil industry.

This sudden legislative activity in the former Soviet Union was a poorly understood attempt to construct from scratch the legal environment—the guarantees, rules, terms and conditions, and rights and obligations—that would give the necessary reassurance and incentives to foreign oil companies to invest. In fact, the effort achieved just the opposite for reasons which are still little understood in the successor Republics of the Commonwealth of Independent States (RCIS).

## **II. THE OPERATIONAL INFRASTRUCTURE OF THE SOVIET SYSTEM**

The problem with the Joint Venture Law of 1987 and the successor laws was that they were not part of a constitutional legal system. The oil and gas industry, as most other economic activities in the former Soviet Union, was not governed by laws but rather by an operational infrastructure managed by the Council of Ministers in Moscow.

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This operational infrastructure worked well internally as long as the premises were not questioned. But Western oil industry contractors and vendors were well aware that it was an arbitrary system with no legal basis. Contractors and vendors alike were subject to the whims of ministerial decisions, sudden re-alignment of state priorities, and the abrupt reallocation of budgeted funds away from their contracts. While this situation occurred less frequently among the Soviet state export agencies, such as *Soyuznefteexport* or *Gazprom*, it was a recurrent feature of import or domestic contracting transactions. A contract to sell oil field services in the Soviet Union would often take months to be concluded and registered with the Ministry of Finance, but it would only be signed if an actual budgetary allocation was made for that contract by the appropriate sponsoring ministry. Under this operational system, things worked in a reasonably predictable fashion. Problem solving was a political lobbying effort, and the *Gosbank* (Central State Bank) was proud of its good credit in making its contractual overseas payments, although only after a tedious maze of permits, clearances, and procedural controls.

President Gorbachev's *perestroika* by and large dismantled this operational infrastructure without replacing it with any constitutional or legal system that could function in its absence. Since the August coup, the process of making commercial deals in the RCIS has grown more and more confusing. Nearly every assumption and operational procedure have been challenged or swept away. As a result, Russian policy makers, joined by policy-makers in other RCIS, are left with the daunting task of constructing a new system from the ground up.

Some very basic constitutional principles and systemic reforms need to be addressed first, but the crisis situation in the RCIS and in the oil industry makes this nearly impossible. The oil industry in Russia and in the other Republics is functioning as best it can, but very little Western capital has been committed in the past six months. The confusion has been amplified by the scores of foreign agencies, oil companies, investment banks, institutes, individuals, and consultants who have been offering advisory services or specific recommendations to all of the surviving agencies of the government, especially in Moscow and Alma-Ata. On just about any visit, a potential foreign investor or company official receives a half dozen competing and contradictory versions of how his venture might be treated under the current system.

The plethora of laws and edicts—some of which have been carried over from the last months of the Soviet Union, some of which are more

recent, but none of which have a constitutional basis—exist as a barrier to current investors if for no other reason than that they are untried, uninterpreted (and in some cases uninterpretable), and often already unenforceable at the time of their enactment. Oil companies have no choice but to write their own foundation laws into the joint enterprise document. These massive documents, which serve as joint venture contracts, run to hundreds of pages because nothing can be left assumed or undefined. However, the comfort of a heavy document may be misleading. The recourse offered in these documents is almost non-existent and completely untried up to now. These documents offer little protection from the real obstacles facing foreign investors in the oil and gas sector.

These obstacles have existed and been well documented throughout Russian history. Russia, then the Soviet Union, and now the RCIS, has always been recognized to be a veritable treasure house of resources, but it has always been a place where doing business was exceedingly difficult and where many investors lost fortunes. Much of the explanation for this can be found in some long abiding cultural traits of the country.

Neither Tsarist Russia nor the Soviet Union was ever governed by an independent legal system. One could argue that neither regime had allowed enough political participation for a mature legal system to develop. Matters of state concern, whether the Tsar's or the Communist party's needs, always took precedence over the rule of law. Politics and the political process in the new RCIS are still too immature to create a society based on law and public participation.

### III. "SQUATTERS' RIGHTS" PREVAIL

This political immaturity is evident in the structures and forms that are taking hold. In the confusion over authority and jurisdiction, a new localized rule has been emerging that confirms what might be called prevailing "squatters' rights." That is to say, the local organizations which have physical control of or access to local assets are claiming *de facto* title and usufruct. In the near-term, the political debate and disputes are bound to get shriller as all the local, regional, and republican interests get sorted out. The scramble for control over the most valuable assets has tilted the odds in favor of the ex-Soviet oil field bosses in the local production associations.

Deals have been struck in the past year with local production associations where the latter has assumed the rights and title to the assets, including the underlying oil reserves, that had previously belonged to the

state. These organizations have assumed not only the rights and exclusivity to those rights, but they have also assumed the rights of access to assets further downstream, such as local storage tanks, local pipeline facilities and pumping stations, and local administration of the support infrastructure such as oil workers' hospitals, housing, and machine tool shops.

Already the jurisdictional disputes have increased wildly. Local "soviets" or township councils have claimed the benefits of the local assets. These are disputed with the *oblast* government or the government of the autonomous republic which in turn disputes these rights with the central Republican authorities.

To use just one example, the autonomous "country" of Khabarovsk (*kray* is neither a republic nor a province), has granted an exclusive exploration joint enterprise to a Western company on the continental shelf of the Sea of Okhotsk. The government of the province of Sakhalin claims that it has those rights. At the same time, the central Russian Republican government claims that offshore territories are the exclusive right of the Republican ministries. Someone surely stands to lose. The sad fact is that none of these jurisdictions can state categorically to whom the underlying resources belong, although they all recognize that oil should be applied to the greater good of the whole society.

This ownership problem becomes compounded when oil is produced. In the past, when the local production associations of Tyumen in western Siberia produced their oil, it was at every point the property of the state. Now it is unclear whether the production associations sell the crude into the pipeline so that title passes to *Glavtransnefte* which in turn disposes of it, or whether the association retains title until a sale is made to end-user markets, either exporters or Russian refineries. With the rapid rise of oil commodity exchanges throughout the Russian Republic, there is a clear presumption that organizations other than the state can buy, sell, and transfer allotments of crude; in some cases even futures sales are occurring.

This rule of "squatters' rights" is currently progressing far out in front of current legislation and policy formation. We expect that in the long run, the laws which are passed will ratify whatever evolves out of this present scramble for control of assets. In the near future, however, ownership, title, and jurisdictional disputes are going to worsen.

#### IV. SOCIAL AND CULTURAL OBSTACLES TO FOREIGN INVESTORS

Although the Soviet state as formulated by Stalin was not one where the rule of law reigned supreme, Soviet and Russian society believed in positivist law and an ideology where man could legislate and set up structures that would achieve certain sought after social ideals. We expect Russians will continue to expect that legislation will be enacted which will reinforce many of the most cherished Russian values and traditions. Many of these values and social norms are quite contrary to those we take for granted in the West.

For one thing, the Russian people genuinely distrust the economic differentiation of individuals by their skills or efforts. They fear and distrust someone who has "made it" and become rich because of his personal will, hard work, or exceptional talent and skill. Most immediately assume that an individual who has made money, has done so through corruption or criminal activity. Egalitarianism of this kind demotes initiative or personal responsibility and is only one of many explanations for that famous Russian characteristic, a poorly developed work ethic. Many Western oil company managers assume that the rigor of free market economics will instill a stronger work ethic in the Russian and Asian work force, but this is a dangerous and untested presumption.

As evidenced by joint enterprises signed and inaugurated to date, the Soviet practice of gross overstaffing will continue. The relatively small acid fracturing and well stimulation program run by the Frac-Master Joint Venture with *Yugansknefte* has more than 400 employees on the payroll. In the West, the operation would be considered excessively staffed if it had 100 personnel. The White Knights Joint Venture has more than 900 employees.

In addition to the large number of employees working directly for the joint ventures, there are expectations that the joint enterprise will finance and staff all sorts of social services and indirect support services. Additional personnel would include hospital staff, bus drivers, caterers, recreation specialists, and day care workers which in the West are provided by outside specialist firms.

Included in this large number of employees will be quite a few slackers and no-shows, perhaps even ghost employees, creating another social problem that will be exceedingly difficult for Western investors. Even with rigorous social welfare and labor laws, dismissal of a worker is almost impossible. For Russians, job security is of much greater value than economic return or a high quality professional job. Although the

labor unions have been subject to tight state and party control in the past, foreign investors will discover that the burden of fighting slothful labor practices and traditions and a rising union activism and anger is going to be thrust on them.

The absence of a healthy work ethic is matched almost equally by a profound distrust of the rapaciousness of Western companies. Distrust, compounded by Russian xenophobia and pride, is manifested by the caution and slowness that has characterized most negotiations. More and more it is illustrated by the harsh terms being demanded by Russian and Asian associations. The Azeris and Kazakhs were genuinely appalled when the notion was first explained to them that Amoco in the Azeri field or Chevron in the Tengiz field expected to earn more than ten percent of the net profits.

Some of the most successful entrepreneurs to date have overcome this distrust by their ability to speak fluent Russian or Turkic. There can be no doubt that language abilities and cultural sympathies greatly help to build trust and understanding. Building trust and confidence between the Russian and foreign partner will in the end be the strongest recourse and protection against future, intractable contractual disputes.

Just as often as language has been used to build trust with creditable companies, the Russians have responded favorably to some foreign companies with native Russian speaking abilities which have turned out to be little more than shysters. There have been literally scores of protocols signed in the RCIS in the past two years by individuals who possess absolutely no technical, financial, or managerial abilities to help the Russian partner. These protocols are all dead letters, although many of these mavericks will insist that they possess an exclusive right to explore, develop, or work over specific areas. Most of the authorities that signed these protocols were not actually entitled to grant exclusivities. Nevertheless, we can expect that some reputable Western oil companies will be sued in Western courts by these mavericks who claim to have signed an exclusive agreement or protocol in the confusion of 1990-1992.

## V. GREED AND THE SCRAMBLE TO GRAB FOR THE PIE

Acknowledgement is universal that the oil industry in Russia and the Asian Republics is in lamentable shape, and that it desperately needs massive amounts of new capital investment. Conservative estimates for Russia alone put the need for new capital investment at \$10 billion a year for the next twenty years. Both Western and Russian oil professionals

recognize the potential profits, since the wealth of the RCIS resource base is truly immense. It is not surprising that throughout the RCIS oil industry—the laws and policies governing it and the individuals or organizations controlling it—there is a strong odor of greed.

Certainly, Western oil companies have been enchanted by this strong stimulus; the Western oil industry has never been accused of too much altruism. But up until now, there has not been the gold rush stampede that uncontrolled greed engenders. What has happened?

In spite of the lack of legal guarantees and coherent policies, in spite of the distrust, in spite of the spate of laws and regulations which only compound the confusion, and in spite of the political disintegration of the former Soviet Union, the Western industry has proceeded cautiously because it has been scared off by the excessive expectations of greed compounded with pride of the Russians and Asians. In the past two years, there has been a steady progression of stiffer and stiffer terms and conditions imposed on potential foreign investors. The Russians and Asians continue to up the ante on fiscal terms and cash demands. After spending eight months developing and winning a competitive bid for the offshore Azeri oil field, Amoco was presented by the Azeri authorities with a demand for an upfront royalty payment of \$1.8 billion. Similarly, in the final round in late 1991, Chevron was given a final ultimatum: Pay \$800 million advance royalty on Tengiz and \$2.2 billion of the sunk costs incurred by *Embaneftegaz*, exchanging the ruble at parity to the dollar. Exploration terms have risen to where minimum obligations run at \$50 million, and signature bonuses of \$3 million or more are required.

Some of this “gouging” can be explained by the economic desperation of many of the participants. The living conditions of Siberian oil workers are truly appalling, and Gorbachev and other Communist leaders had promised many improvements which were never delivered. The production associations, the squatters on the resource, are looking to the West as a way to “cash in” on their assets and get what they believe is long overdue.

Some gouging can be explained by the sudden breakdown in the former Soviet operational infrastructure. In the past, the production associations were operating arms of the central ministries in Moscow and were wholly dependent on annual budgetary allocations. With the collapse of the Soviet state last year, the production associations in the poorer Republics suddenly found themselves without operating cash and uncertain income. But much of the greed and over-inflated expectations



can be explained by a genuine conviction that agencies, government authorities, or production associations are sitting on bonanzas, and that all they need is the minor assistance of Western firms, small infusions of capital, to unlock vast fortunes for all.

Most of these sentiments which are widely held, popular views are based on economic naivete. There is little understanding of common economic principals which are practiced by the oil industry everywhere else in the world. The Soviet system traditionally was a cost plus operation where none of the component participants—the producers, the pipeline transport companies, the refiners, or the marketers—had a true overall view of the costs and returns. Only a dozen or so officials and academicians in the exclusive corridors of the former Soviet Union's *Gosplan* and the Bureau of Fuels were privy to the true economics of some of the remote Siberian or Arctic oil and gas fields. The margins on some of that production must be sub-economic under conditions where oil fetches only eighteen dollars per barrel in world markets.

Key economic concepts such as economic rent, return on capital employed, reinvestment rate, and capital amortization are still not understood. Indeed one of the most glaring omissions in the 1987 Joint Enterprise Law and all of the subsequent enactments was the absence of any definition of what a profit is or how it should be calculated. This lack of economic or commercial understanding has made negotiations and talks with Russian or Asian partners difficult and has greatly inflated their estimation of their real or relative wealth.

Greed has been nurtured by this remarkable economic ignorance. Up until now there has been no opportunity for Russian production associations to see whether their operations could make a true profit. Economic ignorance or naivete appears at all levels of discussion right up to the top officials of the Russian Republican government. With persistence, foreign investors have come to some understanding of how hard it is to evaluate and negotiate a deal because of this. These Western oil companies have discovered that many of the large undeveloped oil and gas fields of central Asia, the Arctic, or Siberia are uneconomic even under the most optimistic of forecast oil prices. BP acknowledged as much by giving up its interests near Irkutsk deep in Siberia.

Price, as it is determined in free and open markets, is the only reliable indicator of economic viability. While there have been some reforms, Russian and Asian authorities have still not allowed the world oil market to determine oil and products prices inside the RCIS. This is a policy

issue that is closely related to ownership of the underlying assets and resources. Until there is an honest transfer pricing of oil throughout Russia's extensive production system, decision-making will not be based on economics, and profits cannot accurately be determined. These issues are fundamental to a wholesale reform of the entire Russian economy. The political difficulties of such reforms are sure to roil through the new republics for many years to come; they are issues of a constitutional nature.

If reforms occur in market price determination, and if jurisdictional claims can be settled, then the true measure of resource wealth can be assessed. Only then could foreign investors truly evaluate the future value of returns on capital invested, and the different jurisdictions and authorities decide how to allocate and share that wealth.

The fiscal rules, laws, and regulations being proposed now are premised on former Soviet operational traditions. They will not work. Under the traditional Soviet system, each phase of the oil production and processing chain was reimbursed for its incurred costs. No value added or profits were accrued. The economic rents from oil production and sales were collected by the central Soviet government and merged into the pool of general finances. Out of this general pool of funds a small portion was reallocated back to the ministries. Since the oil industry was governed by five different ministries, no one ministry could ascertain the profits from their investments.

The Russian Republic has inherited the Soviet ministerial organizations but is slowly adapting them and rationalizing them. The pressing issue is how the new Republican governments are going to be financed. Are they going to allow rents and profits to go to enterprises that are in turn taxed? Or will they collect all the rents and profits at the source as the Soviet state did? The Western oil industry is waiting eagerly to see if this fundamental issue can be solved in the next few months.

It appears that the habits of centralization are too strong for the time being. There are too many bureaucrats in Moscow and too few politically astute entrepreneurs. There are also strong political calls for greater direct sharing of rents with the local governmental agencies. The autonomous republics of the Russian Federation have been insisting that they get fifty percent of the revenues of their republics' output. Yakutsk has reached an agreement that current resource sharing will be fifty-fifty between the center and the local authorities, but that the revenues of any

future resource exploitation deals will be one-hundred percent for Yakutsk to claim and control. Tataristan claims it should have fifty percent of the rents, Moscow is only offering it twenty percent. These are not legal issues so much as fundamental political issues in which foreign investors can only get trapped in the cross-fire.

These debates over the allocation and sharing of rents and profits are bound to take more and more for the republican, regional, and local authorities, including the local production firm, and leave less and less for the foreign investor. In the process, the foreign investor will increasingly withhold making the necessary capital investments that will release the resource wealth in the first place. We expect that this combination of economic naivete, greed, and exaggerated expectations of vast wealth will effectively pose insurmountable barriers to foreign investors who will rightly view the paltry rewards offered to be incommensurate to the risks and undeniably high costs.

Short of a complete retreat by the Yeltsin government and those of other RCIS back to the Soviet operational system, we expect that all the RCIS will go through difficult political upheavals. They will all be subject to the internal pressures and cultural and social traditions and biases that will, in the short run, force them to construct terms and conditions and an investment environment that will chase away all but the hardest of long-term investors. We expect that there will be some notable failures: Chevron for instance will not succeed in getting Tengiz; one of the major deals already approved such as Amoco's in Azerbaidzhan or Gulf Canada's in Timan Pechora or Texaco's in the Arctic will not proceed. We also expect that some Western companies will simply choose to stay away altogether.

If there is not a conservative backlash, and if the democratic revolution of the Russian Republic is to succeed, there will need to be a complete politicization of the economy, and crucial to that economy is the operation of the oil and gas industry. Such politicization will, for an indeterminate period, erect strong foreign investment disincentives while not providing the legal or policy protections needed by the Western oil industry. This process will gain strength as deep seated Russian biases and social norms become more assertive. I do not see how any Western aid, advice, or capital infusion can prevent this process from occurring. While some Western companies that are underwritten by their national governments may be able to assume the risks and investment obstacles

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that are emerging in the RCIS, I do not see how privately owned, publicly traded oil and gas companies can afford to expose themselves to the ongoing uncertainties of the RCIS.

