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## IN THE WAKE OF SAKHALIN II: HOW NON-GOVERNMENTAL ADMINISTRATION OF NATURAL RESOURCES COULD STRENGTHEN RUSSIA'S ENERGY SECTOR

Nowell David Beckett Bamberger<sup>†</sup>

*Abstract:* Russia's economically vital oil and gas industry is at a crossroads. Although foreign investment favored European nations in the wake of the Soviet collapse, in recent years American and European oil and gas companies have invested billions of dollars in Russia's energy development and export distribution sectors. However, the 2006 restructuring of the \$20 billion Sakhalin II project demonstrates that Russia's energy sector has still not stabilized from the turbulent privatization of the 1990s. This comment explores the legal structures and Government policies affecting Russia's oil and gas industry for evidence of the causes of institutional instability. It argues that to prevent political and business elites from continuing to manipulate the country's most profitable industry, Russia's energy resources should be administered by an independent entity, a Public Leasing Authority. By creating a new institution with transparent motives, Russia may be able to remove the historic temptation to use economic regulation to accomplish short-term political goals and thereby enhance the stability of its energy sector and its larger economy.

### I. INTRODUCTION

On September 18, 2006, the Russian government set off a firestorm of international criticism when President Vladimir Putin recommended the cancellation of permits for the controversial Sakhalin II development project in Russia's Far East.<sup>1</sup> The Sakhalin Project, managed by an international consortium including Royal Dutch Shell, Mitsubishi, and Mitsui, has been developing infrastructure for the removal of Liquefied Natural Gas ("LNG") off the coast of Russia's Sakhalin Oblast since forming in 1994.<sup>2</sup> The seeming collapse of the project, just short of its 2007 expected completion date, raises new questions for foreign investors in Russia's energy sector. Namely, how can positive, productive, and responsible foreign investment be encouraged?

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<sup>1</sup> *Criticism of Sakhalin Energy not grounds for halting Sakhalin II oil and gas project*, INTERFAX: POLAND BUSINESS NEWSWIRE, September 21, 2006.

<sup>2</sup> EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT, *Factsheet: Understanding the Project and Process*, <http://www.ebrd.com/pubs/factsh/themes/sakhalin.pdf>.

Like many foreign investments in Russia's energy sector, the Sakhalin II project was structured under a Production Sharing Agreement ("PSA") between the Sakhalin Energy Investment Corporation ("SEIC") and the government of the Russian Federation.<sup>3</sup> Russia's use of the PSA model was a response to the realization that the country's mainline economy was too unstable to attract more traditional forms of investment in an economic sector where profitability only follows from massive front-end capital expenditure.<sup>4</sup> Yet in Russia, the PSA model has failed to shield existing investment from domestic politics and consequently failed to encourage new international investment.

This comment will argue that the Sakhalin experience demonstrates deficiencies in Russia's current institutional structure for foreign energy investment. The current structure is unsustainable in a world economy that increasingly demands calculable risks and reliable expectations. A new model for pairing international expertise with Russian resources is necessary to develop a stable, predictable, and profitable domestic energy development and exploration sector.

Part II explores the collapse<sup>5</sup> of the Sakhalin II agreement in the wider context of Russia's search for foreign investment, economic and legal stability, and international acceptance as a dominant economic power. Part III addresses the shortcomings of the current approach to international energy contracting under PSAs. Part IV explores the need for Russia to take a new approach to achieve its goals for developing its energy resources through foreign investment. Finally, Part V prescribes a new institutional solution in response to the deficient institutions and political manipulation that led to Sakhalin's demise. The creation of a quasi-governmental Public Leasing Authority, which would stand as a buffer between international investors and the Russian government, would enable Russia to stimulate foreign investment by insulating international firms from the substantial risks and liabilities associated with doing business in Russia.

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<sup>3</sup> *Russia says to honor PSAs, as Sakhalin energy project woes mount*, RAI NOVOSTI [Russian Information Agency], September 19, 2006.

<sup>4</sup> *Id.*

<sup>5</sup> It has been suggested that the Sakhalin II agreement did not, in fact, collapse but was rather restructured under government pressure to create a new framework for development. When addressing such a politically charged issue as government interference in private investment, word choice can be determinative. It is the author's suggestion that, while the Sakhalin II *project* continues (albeit in a radically new iteration) the Sakhalin II *agreement* (the legal framework under which the project was developed) did collapse of both its own insufficiency and strong government pressure.

## II. FOREIGN INVESTMENT IS INDISPENSABLE TO DEVELOP RUSSIA'S ENERGY SECTOR AND TO DRIVE RUSSIA'S ECONOMIC RESURGENCE

In the last several years Russia has profited from historically high energy prices and an unquenchable demand for the 40% of the world's natural gas that underlies its enormous territory.<sup>6</sup> The economic independence generated by energy wealth has prompted an ambiguous government approach to foreign investment in the energy sector.<sup>7</sup> Yet mismanaging foreign investment opportunities threatens to cut off the flow of foreign technology, expertise, and capital, which have been the drivers of increasing production since post-Soviet privatization. In the long term, Russia must develop stable institutions for regulating foreign energy investment to fortify its economy against economic and energy-price instability.

### A. *In the Long Term, Russia Cannot Rely on Profitable Oil Exports to Underpin its Economy or to Ameliorate the Problems in its Energy Sector*

In spite of very real development problems, Russia is an extractive energy powerhouse. The territory of the modern Russian Federation boasts the world's eighth largest proven reserves of oil and is the world's second-largest oil producer after Saudi Arabia.<sup>8</sup> It is home to the world's largest natural gas reserves,<sup>9</sup> which when included in its overall production make Russia the world's leading hydrocarbon exporting state.<sup>10</sup> However, even extraordinary energy-sector performance has proven barely sufficient to sustain the country's oil and gas-dependent national economy.<sup>11</sup>

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<sup>6</sup> In 2004 the chairman of Shell's Russia operations commented that "[a]ll natural-resources companies have to go where the natural resources are . . . Russia is by definition very important. It is where the opportunities lie." Tracy Boles, *Special Report: Make or Break for Shell in Russia*, THE TIMES (LONDON), March 12, 2006.

<sup>7</sup> Foreign investment, particularly in the technology-dependent oil and gas industry, has historically undermined the development of domestic industrial capacity because foreign multinational firms tend to be more competitive than their domestic counterparts. See Quan Li & Adam Resnick, *Reversal of Fortunes: Democratic Institutions and Foreign Direct Investment Inflows to Developing Countries*, INTERNATIONAL ORGANIZATION, Vol. 57, No. 1 (2003), at 183.

<sup>8</sup> *Russia: Back to the Future? Hearing Before the S. Comm. on Foreign Relations*, 109th Cong. (June 29, 2006) (statement of Amy Myers Jaffe, Wallace S. Wilson Fellow in Energy Studies, James A. Baker III Institute for Public Policy, Rice University), available at <http://www.senate.gov/~foreign/testimony/2006/JaffeTestimony060629.pdf>.

<sup>9</sup> Tomas W. Waelde, *International Energy Investment*, 17 ENERGY L. J. 191, 210 (1996).

<sup>10</sup> *Russia: Back to the Future?*, *supra* note 8.

<sup>11</sup> Symposium, *The Russian Petroleum Legislation Project at the University of Houston Law Center*, Gary B. Conine, *Petroleum Licensing: Formulating an Approach for the New Russia*, 15 HOUS. J. INT'L L. 317, 327-329 (1993).

State control of energy resources is vitally important to the Russian government.<sup>12</sup> Russia's \$975 billion (US) (2006) national economy, the tenth largest in the world,<sup>13</sup> is precariously perched on a branch held by its three largest national energy companies: privately-held OAO Lukoil<sup>14</sup> and state-controlled OAO Gazprom and OAO Rosneft. Of the three, Gazprom, in which the Russian government holds a 38.37% controlling stake,<sup>15</sup> has shown itself to be the most aggressive in attempting to monopolize Russian gas production.<sup>16</sup>

Russia would be in dire financial straits without a strong energy sector for two reasons. First, Russia has not benefited from the same foreign investment as its former communist neighbors. From 1988 through 1994 Russia's share of Foreign Direct Investment amounted to just \$3.5 billion (US), less than half of the total investment in Hungary and six times less than in Slovenia on a per-capita basis.<sup>17</sup> During the same period, foreign investors completely forewent opportunities to invest in the western-style oil and gas concessions offered by the Russian government. Second, because energy sales provide the only reliable source of foreign hard currency, a rapid decline in oil and gas profits could lead to defaults on foreign development loans, and consequently to economic collapse.<sup>18</sup>

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<sup>12</sup> It was estimated that in 2002, each dollar increase in the world market price for crude oil generated between \$1.5 and 2 billion (US) in oil export revenues for the Russian government. Clifford G. Gaddy, *Has Russia Entered a Period of Sustainable Economic Growth?*, in *RUSSIA AFTER THE FALL* 130 (Andrew C. Kuchins, ed., 2002) Given Russia's significant increase in oil exports since that time, the value of high oil prices is likely even greater today.

<sup>13</sup> World Economic Outlook Database for September 2006, INTERNATIONAL MONETARY FUND, <http://www.imf.org/external/pubs/ft/weo/2006/02/data/> (last visited Jan. 22, 2006) (Download "By Countries," "All Countries" by "Gross Domestic Product, current prices (U.S. dollars)").

<sup>14</sup> Lukoil is the world's second largest non-state holder of proven oil reserves. Andrew E. Kramer, *Lukoil*, N.Y. TIMES TOPICS, <http://topics.nytimes.com/top/reference/timestopics/organizations/l/lukoil/index.html> (last visited Jan. 22 2006).

<sup>15</sup> *Gazprom in Figures 2002-2004*, 13 (fact book prepared by the company for the 2005 OAO Gazprom annual General shareholders meeting), available at <http://www.gazprom.com/documents/Statistika%20En.pdf>.

<sup>16</sup> Although Lukoil is the larger producer of petroleum, Gazprom's roughly 110 billion proven barrels of natural gas reserves, the largest in the world, gives the company, and through it the Russian Government, a virtual monopoly on Russian natural gas production. See Laura A. Wakefield, Note, *The Need for Comprehensive Legislation in the Russian Oil and Gas Industries*, 29 CASE W. RES. J. INT'L L. 149, 160 (1997).

<sup>17</sup> Conine, *supra* note 11, at 431.

<sup>18</sup> Daniel Kimmage, *The Fog Before the War*, RFE/RL BUSINESS WATCH, 5 Nov. 2002, reprinted in JOHNSON'S RUSSIA LIST 6536 #16 (David Johnson, ed., 6 Nov. 2002), available at <http://www.cdi.org/russia/johnson/6536.cfm>; Abigail Chiodo & Michael T. Owyang, *A Case Study of a Currency Crisis: The Russian Default of 1998*, THE FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, Vol. 84, No. 6 at 12 (2002) (explaining the root causes of Russia's 1998 loan default and resulting economic consequences). See also Mark A. Stoleson, *Investment at an Impasse: Russia's Production-Sharing Agreement Law and the Continuing Barriers to Petroleum Investment in Russia*, 7 DUKE J. COMP. & INT'L L. 671, 674 (1997) (explaining the fragility of Russia's reliance on energy to underpin its economy).

The current regime in Moscow believes foreign capital investment to be largely unnecessary, as it uses its foreign income from oil and gas exports to underwrite its economic expansion.<sup>19</sup> This economic situation, somewhat reminiscent of the Soviet situation in the late 1980's, is momentary at best.<sup>20</sup> Oil prices are at historic highs.<sup>21</sup> As Mikhail Gorbachev did in the late 1980s, President Putin has used the money from oil and gas sales to pay off foreign debts, infuse cash into the major economic centers of Moscow and St. Petersburg, and reinforce Russia's economic clout on the international stage.<sup>22</sup> Yet, all is not as rosy as the Kremlin likes to suggest. Russia is currently producing oil and gas at capacity, while its main competitor, Saudi Arabia, is producing at less than two-thirds of capacity.<sup>23</sup> Future increases in production must therefore necessarily come from new exploration and development. Those efforts are completely dependent on foreign expertise, equipment, and investment.<sup>24</sup> Gazprom lacks the resources, both technical and managerial, to effectively develop a growing portfolio of enterprises.<sup>25</sup>

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<sup>19</sup> *A Deal is a Deal*, THE TIMES (LONDON), Sept. 22, 2006, at 23.

<sup>20</sup> Russian energy policy has always been used as an instrument to accomplish larger political objectives. During the main of the Soviet expansionist period, oil production rose each year, buoyed mainly by new exploration and new production, because Soviet technology continued to lag behind that of competing Western firms. Conine, *supra* note 11, at 324-25. This increasing production helped insulate the Soviet economy from the energy shortages and economic vulnerabilities of the late 1960s and early 1970s. In the late 1980s central planners used Russia's 440 billion (US) in oil export revenues to reinforce the communist system, but little was reinvested in exploration, diminishing future development capacity. *C.I.S. Oil Woes Laid at Feet of Underspending for Exploration*, OIL AND GAS JOURNAL 44 (May 4, 1992).

<sup>21</sup> It was estimated that in 2002, each dollar increase in the world market price for crude oil generated between \$1.5 and 2 billion (US) in oil export revenues for the Russian government. Gaddy, *supra* note 12, at 130-136.

<sup>22</sup> Kevin O'lynn, *Too Much Money*, NEWSWEEK INTERNATIONAL, Sept. 12, 2005 available at <http://www.msnbc.msn.com/id/9191050/site/newsweek/>. See also Arkady Ostrovsky, *Kremlin Makes Life Difficult on Sakhalin*, FINANCIAL TIMES: FT.COM, Nov. 22, 2006, available at [www.sakhalinenergy.com/docs/media/en/194/FT\\_22-11-06\\_en\\_no%20map.doc](http://www.sakhalinenergy.com/docs/media/en/194/FT_22-11-06_en_no%20map.doc) (arguing that the benefits of Sakhalin development are not being shared with the local community).

<sup>23</sup> James Schofield, *Russia's Oil Renaissance*, BBC NEWS WORLD EDITION, June 24, 2002, <http://news.bbc.co.uk/2/hi/business/2058214.stm> (last visited Jan. 23, 2007).

<sup>24</sup> *Id.*

<sup>25</sup> *Gazprom's Gas Grab*, FINANCIAL TIMES, Dec. 12, 2006, at 14. Non-development aspects of the Russian energy industry are similarly in need of Western investment. In particular, Russia's pipeline infrastructure, important in times of high oil prices but critical for efficient oil and gas transport when prices fall, is completely inadequate. Transneft, the State pipeline monopoly, has proven unable to meet the international and domestic demand for export capacity, and the nation has begun to look to international sources for pipeline development assistance. Bernard A. Gelb, *CRS Report to Congress: Russian Oil and Gas Challenges* (RL33212), U.S. CONGRESSIONAL RESEARCH SERVICE, Jan. 3, 2006, at 3 (on file with the Pacific Rim Law & Policy Journal).

*B. The Production Sharing Agreement Structure Has Successfully Encouraged Investment in Developing Countries*

In post-Soviet Russia, it quickly became clear that the Soviet-era laws “On Foreign Investment”<sup>26</sup> and “On Subsoil Resources,”<sup>27</sup> signed in 1990 and 1992 respectively, provided insufficient guarantees against political and economic uncertainty to attract foreign investors.<sup>28</sup> As Russia evolved from a command economy to a capitalist economy, the most formidable challenge to foreign investors was the risk of unforeseeable legislative changes.<sup>29</sup> In response to a lack of foreign investment in oil and gas, President Yeltsin signed a decree “on Production Sharing Agreements for the Use of Underground Resources” in late 1993.<sup>30</sup> Lacking statutory credibility because the State Duma refused to ratify the Decree, this initial framework was not successful in attracting favorable foreign investment.<sup>31</sup> Some agreements, like the Sakhalin II Agreement, were concluded, although on internationally non-standard terms that tended to strongly advantage the foreign party.

The use of PSAs is a relatively straightforward way of allocating the political and economic risks inherent in foreign oil exploration. They were first introduced as a vehicle for foreign investment in energy exploration by Indonesia in 1966<sup>32</sup> which, at that time, was responding to many of the same problems that Russia currently faces.<sup>33</sup> The principle characteristics that make the PSA structure acceptable to both an autocratic regime and foreign investors are: 1) continued state-ownership of the underlying natural resource (rather than concession to a foreign entity), 2) a self-contained

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<sup>26</sup> Decree of the President of the Union of Soviet Socialist Republics on Foreign Investments in the USSR (Oct. 26, 1990).

<sup>27</sup> Federal Law No. 2395-1 on Subsoil Resources (Feb. 21, 1992).

<sup>28</sup> PAUL CHAISTY, LEGISLATIVE POLITICS AND ECONOMIC POWER IN RUSSIA 175 (2006).

<sup>29</sup> Yuri Petrov, former director of the State Investment Corporation (SIC) was quoted in 1993 commenting that “change in legislation is the biggest risk facing potential investors [in Russia]”. Stoleson, *supra* note 18, at 679.

<sup>30</sup> Decree of the President of the Russian Federation on Production Sharing Agreements for the Use of Underground Resources, No. 2285 (Dec. 24, 1993). This decree was invalidated by later executive action. See Decree of the President of the Russian Federation on Invalidating Decree No. 2285, No. 1275 (Aug. 28 1996).

<sup>31</sup> Stoleson, *supra* note 18, at 675.

<sup>32</sup> The Indonesian Government nationalized foreign-owned property during the early 1960s, and offered foreign oil companies an alternative to the ordinary oil concession: a new self-contained agreement whereby foreign firms could extract oil from State-owned fields in exchange for a percentage of the developed oil. See David N. Smith & Louis T. Wells, Jr., *Mineral Agreements in Developing Countries: Structures and Substance*, AM. J. OF INT’L L., Vol. 69, No. 3, 560, 586 (1975).

<sup>33</sup> Kristen Bindemann, *Production Sharing Agreements: An Economic Analysis* 1 (1999) (on file with the Pacific Rim Law & Policy Journal).

agreement, entirely insulated from the domestic regulatory regime, and ostensibly guaranteed against further state expropriation, and 3) payment to the host regime in crude oil, rather than currency, providing both a guarantee against under-pricing of oil in sale by the development company to its foreign affiliates<sup>34</sup> and State access to a strategic resource.

Under a typical agreement, the host country bears the risk of political instability<sup>35</sup> while the foreign investor shoulders the entire exploration risk.<sup>36</sup> The inclusion of all relevant terms within the four corners of the agreement insulates the foreign investor from changes to the domestic regulatory or legal environment.<sup>37</sup> At the same time, the foreign investor must front the entire cost of exploration, yet receives no compensation if no oil is found.<sup>38</sup> PSAs are typically signed for a fixed period and disputes are typically assigned to the jurisdiction of an international arbitral forum rather than the national courts of the host country.<sup>39</sup>

Unlike ordinary mineral concessions, the State only profits under a PSA if resources are actually recovered. After exploration is complete and development begins, the “production-sharing” element of the agreements kicks in. The oil found is first divided into “cost oil” and “profit oil.”<sup>40</sup> The former is retained by the foreign investor to recoup the cost of development. In this way, the foreign investor (or, more correctly, its creditors) is paid first.<sup>41</sup> The remaining profit oil is then divided between the host country and the foreign investor according to a predetermined proportion with the government virtually always receiving a greater percentage of the profit oil.<sup>42</sup> Finally, according to the terms of the agreement, the foreign investor typically pays taxes on its operations, including export, income, and profit repatriation taxes.<sup>43</sup> The taxes are paid in hard currency, in contrast to the share of production, which is provided in oil or gas.<sup>44</sup> It is important to note that these are the elements of a typical agreement, and many countries have introduced additional elements, such as royalty payments and caps on cost

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<sup>34</sup> See Smith & Wells, *supra* note 32, at 587.

<sup>35</sup> Bindemann, *supra* note 33, at 1.

<sup>36</sup> *Id.*

<sup>37</sup> Stoleson, *supra* note 18, at 682.

<sup>38</sup> *Id.*

<sup>39</sup> Ian Rutledge, *The Sakhalin II PSA – A Production ‘Non-Sharing’ Agreement, Analysis of Revenue Distribution*, Sheffield Energy & Resources Information Services, November 2004, at 13 (on file with the Pacific Rim Law & Policy Journal).

<sup>40</sup> *Id.*

<sup>41</sup> See *id.* at 14.

<sup>42</sup> *Id.* at 13.

<sup>43</sup> Stoleson, *supra* note 18, at 678.

<sup>44</sup> Smith & Wells, *supra* note 32, at 587.



recovery, that alter the financial relationship slightly but leave the allocation of risk intact.<sup>45</sup>

### III. RUSSIA'S AD-HOC PSA STRUCTURE HAS UNDERMINED EFFORTS TO COURT STABLE INTERNATIONAL INVESTMENT

In a country of unorthodox investments, the Sakhalin II Production Sharing Agreement is truly outstanding. The idea of international development of the Sakhalin Project<sup>46</sup> began during the late Soviet period. In 1991 the Soviet Ministry of Oil and Gas was approached by Marathon Petroleum, MacDermott International Investment, and Mitsui and Co. about the prospects for development of explored gas reserves off the coast of Sakhalin Island.<sup>47</sup> The successor Yeltsin government signed a PSA formalizing the agreement on June 22, 1994, without legislative approval.<sup>48</sup> By the time that the PSA legislation was passed, Royal Dutch Shell had become the majority stakeholder and the Sakhalin project was well underway.<sup>49</sup>

#### A. *The Non-Standard Profit Structure of Sakhalin II Provided Financial Incentives for Government Manipulation*

The Sakhalin II PSA is extraordinarily non-standard in both process and substance. From a procedural perspective, it was enacted prior to

<sup>45</sup> See generally Bindemann, *supra* note 33, at 13.

<sup>46</sup> The Sakhalin II Project is actually a number of infrastructure improvement and development projects necessary to develop the Astokhskiye and Lunskoye natural gas fields off the coast of Sakhalin Island, just north of Japan. The most important improvements are the construction of off-shore oil rigs, an export terminal for Liquefied Natural Gas ("LNG") at the town of Korsakov on the southern tip of Sakhalin, and many miles of undersea and overland pipeline to connect them. Also necessary are improvements to area roads, electricity infrastructure, the resettlement of those people and businesses that will be displaced by the development, and the mitigation of extensive environmental impacts. EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT, *supra* note 2, at 1.

<sup>47</sup> Report of the Auditing Chamber of the Russian Federation *in response to* Decision of the State Duma of the Federal Assembly of the Russian Federation No. 3994-P GD (May 20, 1999) [hereinafter "Auditing Chamber Report"] § 2.1 (Decision No. 39994-P GD authorized the State Auditing Chamber to audit both the Sakhalin I and Sakhalin II Production Sharing Agreements, including the activities of the parties (including the Russian Federation government) under those agreements).

<sup>48</sup> *Id.* at § 2.11.

<sup>49</sup> Controversially, the first phase of the development was backed by a 116 Million (US) loan from the European Bank for Reconstruction and Development ("EBRD"). *EBRD Delays Financing of Sakhalin-2 Second Stage*, THE RUSSIAN OIL AND GAS REPORT NO., Nov. 15, 2006, at 116. The EBRD, an institution created to support private enterprise in ex-Soviet countries struggles under a split mandate of profitable yet socially responsible investment. In the wake of the Gazprom restructuring, the international financier concluded "it is not feasible for the EBRD to pursue the current project." Clare Watson, *EBRD Withdraws Support for Sakhalin II Project*, ENERGY BUSINESS REVIEW, Jan. 12, 2007, available at [http://www.energy-business-review.com/article\\_news.asp?guid=6FC97F09-6BFC-4AEC-B76C-12EED528DCF8](http://www.energy-business-review.com/article_news.asp?guid=6FC97F09-6BFC-4AEC-B76C-12EED528DCF8). As of publication, this remains the Bank's official position.

legislative authorization of PSAs. A 1999 audit by the State Duma determined that because the authorization process was not standardized “insufficient measures were taken in the interests of the State on questions of ecology, resource use, tax and customs legislation, and state control . . .”<sup>50</sup> The Duma concluded that by entering into a contract without competitive bidding, the agreement violated Russian Federation Law No. 2395-1 “On Resources.”<sup>51</sup> However, a “grandfather” clause in the 1995 legislation “On Production Sharing Agreements” gave Sakhalin II ex post facto validity and made it enforceable.<sup>52</sup>

Also unusual is that the Sakhalin II agreement guarantees a profit for SEIC, the foreign investor. Typically, the investor bears both the risk that no oil will be discovered and the risk that the oil discovered will not be sufficient to cover costs, including payments to the host country.<sup>53</sup> For Sakhalin II, however, there was no exploration risk. Prior exploration by the Russian Government and Russian companies had already revealed 96 trillion cubic feet of natural gas reserves.<sup>54</sup> In addition to ameliorating exploration risk, the PSA's peculiar revenue structuring scheme removed any risk that development itself would be prohibitively expensive. Under the PSA, SEIC would retain all initial proceeds from development, until the capital investment was recovered and a 17.5% rate of return was realized.<sup>55</sup> With a capital investment projected at \$20 billion (US), the PSA assured SEIC a minimum \$3.75 billion (US) profit. The Russian Federation would have begun to share in revenue only after SEIC recovered its initial investment and profit.<sup>56</sup> For the first two years thereafter, the Russian government would have received 10% of the gas, while SEIC was to retain 90%. After that two-year period, the Russian government was to receive 50% of the gas until SEIC realized a 24% internal rate of return on its initial investment.

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<sup>50</sup> Auditing Chamber Report, *supra* note 47, at § 3.2.

<sup>51</sup> *Id.* at § 3.4.

<sup>52</sup> *Id.* at § 3.1.

<sup>53</sup> Bindemann, *supra* note 33, at 1.

<sup>54</sup> Sakhalin Island, U.S. ENERGY INFORMATION ADMINISTRATION, COUNTRY ANALYSIS BRIEFS, Sakhalin Island, <http://www.eia.doe.gov/emeu/cabs/Sakhalin/Background.html> (last visited Jan. 23, 2007).

<sup>55</sup> Rutledge, *supra* note 39, at 15.

<sup>56</sup> To be fair, the Russian government does receive money as a result of the project during the whole of the development process from its taxes on corporate profits, extraction, profit repatriation, and the value-added tax. These, however, are taxes recovered on all commercial activity within the Russian Federation and should be distinguished from the profits which are to be expected when the State gratuitously provides the commodity underlying the commercial activity. Under a lease/concession system, the host government also recovers taxes in addition to royalty payments. The Production Sharing Agreement is designed to substitute production sharing for royalty payments.

Only then would the Russian government begin to recover its permanent 70% share of production.<sup>57</sup>

The problem inherent with this particular agreement is that the risk was entirely allocated to the State, providing the foreign investors with little incentive to guarantee a profitable enterprise. Because initial investments were to be deducted dollar for dollar from initial production, the money spent on exploration came from the State share of production, providing little incentive for SEIC (which was guaranteed a minimum 24% return) to limit expenses.<sup>58</sup>

*B. Although the Government Claims that Privatization of Russian Industry Has Ended, Economic Instability Remains*

The collapse of the Sakhalin II PSA illustrates the problem with long-term investment in the Russian Federation's energy sector: massive investments in an economic sector that attracts such strong government scrutiny continue to be subject to government manipulation even after privatization has nominally been concluded.<sup>59</sup> Since the early 1990s and to this day, the Kremlin has demonstrated that it is willing to follow the politically-expedient course of economic intervention to secure short-term profits at the expense of long-term stability.

The trend first emerged in the energy context when, in 1993, U.S.-based Amoco became the single largest foreign investor in Russia by purchasing a 50% stake in development at the Priobskoye oil field, the largest undeveloped oil field in Russia.<sup>60</sup> The partner in the deal was Russia's leading oil producer at the time: OAO Yukos. All went well until

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<sup>57</sup> Rutledge, *supra* note 39, at 15.

<sup>58</sup> *Id.*

<sup>59</sup> For more information about Russia's turbulent post-Soviet privatization process, see Maxim Boyceko, Andrei Shleifer, Robert W. VishnyVichney, Stanley Fischer & Jeffrey D. Sachs, *Privatizing Russia*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY, Vol. 1993, No. 2 at 140 (1993). The true cost of privatization during the 1990s is just now becoming apparent. It is manifest in a real and apparent rift in the fabric of Russian society, a consequence of the upset of the Soviet social contract that guaranteed all citizens a minimal level of subsistence. Judyth L. Twigg, *What has Happened to Russian Society? in RUSSIA AFTER THE FALL* 148 (Andrew C. Kuchins, ed., 2002). With the concentration of wealth that followed on post-Soviet privatization, by 1997 1.5% of the population controlled 65% of the private national wealth. The rampant inflation that precipitated the devaluation of the Ruble caused nominal incomes and pensions to shrink as well, to 46% and 56% of their pre-collapse values respectively by 1996. STEPHEN WHITE, *RUSSIA'S NEW POLITICS* 145 (2000). For many Russians, the promise of capitalism has been a lie: only one in six Russian families is better off today than they were in 1992. Twigg, *supra* note 59, at 149.

<sup>60</sup> Paul Klebnikov, *Russian Roulette*, FORBES, April 20, 1998, at 136.

Yukos was acquired in 1995 by Menatep Bank.<sup>61</sup> Menatep's principle shareholder, Mikhail Khodorkovsky, recognized an opportunity to take advantage of Amoco's initial \$300 million (US) exploration investment and the significant expertise that had already been transferred to Yukos.<sup>62</sup> Setting aside previous arrangements, Yukos offered to renegotiate the deal, giving itself a greater stake in production and requiring Amoco to make a significantly greater investment.<sup>63</sup> Although there was a previous agreement, Yukos subsidiary Yuganskneftegaz<sup>64</sup> held the government lease to the Priobskoye field,<sup>65</sup> and Amoco was ultimately forced to write off its investment.<sup>66</sup>

What is particularly disturbing for the foreign energy investor is the extent to which this pattern, first seen in the private sector,<sup>67</sup> has been adopted by the government<sup>68</sup> and used to force the restructuring of more critical national investment projects even after the national privatization process has supposedly ended.<sup>69</sup> This strong-arm approach to regulation is an eerie apparition of Russia's reposed Soviet central administration.<sup>70</sup>

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<sup>61</sup> Lee S. Wolosky, *Putin's Plutocrat Problem*, FOREIGN AFFAIRS, Mar.-Apr. 2000, at 18. Yukos was acquired by Menatep Bank, controlled by now-infamous oligarch Mikhail Khodorkovsky, in 1995 under a very complicated and highly suspect structured transaction. Because the Russian government relied on the banking infrastructure to manage auctions of State property, registered banks were not permitted to bid in the auctions. Ira W. Lieberman & Rogi Veimetra, *The Rush for State Shares in the "Klondyke" of Wild East Capitalism: Loans-For-Shares Transactions in Russia*, 29 GW J. INT'L L. & ECON. 737, 750 (1996). Yet, by establishing wholly-owned front companies to enter bids, Menatep was able to acquire Yukos for the staggeringly low price of \$300 million (US). Before being liquidated by the Russian Government in 2003, Yukos was valued at \$15 billion (US). Marshall I. Goldman, *The Oligarchs Overstep Their Bounds*, BOSTON GLOBE, July 31, 2003, reprinted in CDI RUSSIA WEEKLY, 267, #8 Aug. 1, 2003), <http://www.cdi.org/russia/267-8.cfm>.

<sup>62</sup> Paul Klebnikov, *The Oligarch Who Came in from the Cold*, FORBES, Mar. 18, 2002.

<sup>63</sup> Wolosky, *supra* note 61, at 18.

<sup>64</sup> Yukos: Exploration and Production, Priobskoye Oil Field, Yukos corporate website, [http://www.yukos.com/EP/Priobskoe\\_Oil\\_Field.asp](http://www.yukos.com/EP/Priobskoe_Oil_Field.asp) (last visited Jan. 23, 2007).

<sup>65</sup> Erik Kreil, *Oil and Gas Joint Ventures in the Former Soviet Union*, report for the U.S. Department of Energy, Aug. 1996 (on file with the Pacific Rim Law & Policy Journal).

<sup>66</sup> Klebnikov, *supra* note 60.

<sup>67</sup> In other industries, examples such as Minutka Limited's 1994 expropriation of a St. Petersburg Subway sandwich shop illustrate the pattern. During the 1990s it was particularly common for foreign partners to visit Russia only to find that their investments no longer existed. See Ethan S. Burger, *Russian Legislation on Enforcement of Judicial and Arbitral Decisions*, in A LEGAL GUIDE TO DOING BUSINESS IN RUSSIA AND THE FORMER REPUBLICS OF THE U.S.S.R. 91 (Aviva Yakren, ed. 2000) (citing A. Belousov, EKONOMIKA I ZHIZN' (No. 33, August 1997)).

<sup>68</sup> To some observers it may seem that the Russian Government has taken the place of the Russian oligarchs, like Yukos' Mikhail Khodorkovsky, who took an exceedingly cynical approach to the accumulation of economic influence. See Klebnikov, *supra* note 62 (referencing Khodorkovsky's defense of the lawlessness of the 1990s).

<sup>69</sup> The pattern of expropriation is quite explicit. First, foreign joint investment with a Russian company is encouraged. The foreign investor brings hard currency and world-class expertise. Second, there is a transfer of expertise to the Russian partner. The Russian partner becomes increasingly competent in the industry, eventually believing its own expertise to be equal to that of the foreign investor. Third,

From the beginning, Sakhalin II was a potential target for State action because it was not a joint venture; all of the partners were foreign.<sup>71</sup> Russia's state gas monopoly was understandably hesitant about the prospect of a giant foreign competitor in the gas exporting business. In July 2005 Gazprom approached SEIC and offered a swap: in exchange for a 25% plus one share stake in Sakhalin II, Gazprom offered Shell a 50% stake in Gazprom's Zapolyarnoye-Neocomian field.<sup>72</sup>

A few days later, SEIC announced a significant cost overrun and significant development delays for the Sakhalin II project.<sup>73</sup> The overall costs for development were doubled from \$10 billion (US), to just over \$20 billion (US), a cost increase slated to significantly put off when the Russian Government could share in production.<sup>74</sup> Then, on September 18, 2006, the Russian government decided that the project had become undesirable, and began the process of removing foreign investors from the Sakhalin equation. Citing environmental concerns that had been raised by NGOs years earlier,<sup>75</sup> but about which nothing had previously been done, the Ministry of Natural Resources revoked key environmental permits, bringing the project to a halt.<sup>76</sup>

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some roadblock is created to the project. The books might be cooked to show an unprofitable enterprise, or needed land or commodities might become unavailable, or government permits might be withheld. Fourth, the Russian company offers to purchase the foreign-held shares at severely sub-market prices. The foreign investor, faced with no other option, typically accepts this offer. In many cases, the offer is not even necessary. The foreign investor simply takes a loss on the enterprise and leaves the Russian market. See Burger, *supra* note 67, at 92.

<sup>70</sup> As one pro-Kremlin journalist explains, "Vladimir Putin slowly but steadily centralized the key branches of the economy." Vladimir Shlapentokh, *Intoxicated by High Oil Prices: Political Dutch Disease Afflicting the Kremlin*, OIL & GAS JOURNAL, Nov. 6, 2006, at 18. An anonymous American investor adds, "[State-controlled] Gazprom thinks of itself as the Ministry of Gas. Its partners are supposed to shut up and do as they are told." Klebnikov, *supra* note 60.

<sup>71</sup> Klebnikov, *supra* note 60.

<sup>72</sup> Because of the structure of the deal, with Shell reducing its Sakhalin holdings substantially, Gazprom was poised to become the lead shareholder in the project. *Gazprom to pay cash for Sakhalin-2*, RosBusinessConsulting (Russia), [http://top.rbc.ru/english/index.shtml?news/english/2006/12/20/20145537\\_bod.shtml](http://top.rbc.ru/english/index.shtml?news/english/2006/12/20/20145537_bod.shtml) (last visited Jan. 23, 2007).

<sup>73</sup> Andrew E. Kramer, *Kremlin Revokes Oil Project Approval*, INT'L HERALD TRIBUNE, Sept. 19, 2006, at 1.

<sup>74</sup> *Minister Orders Report on Sakhalin II Eco-damage, Operator admits Admits Guilt*, RIA NOVOSTI, Oct. 25, 2006. In the face of these costs, state-controlled Gazprom attempted to renegotiate its former understanding with Shell, asking that Shell's regasification assets in North America be included in the exchange. Shell refused, ending the Russian Government's hopes to participate as a partner in the Sakhalin project. Suzanne McElligott, *Russia Pulls Permits on Nearly Complete Sakhalin LNG Project*, GASIFICATION NEWS, Oct. 15, 2006, Vol. IX, No. 10.

<sup>75</sup> Statement of Common Demands by Environmental NGOs Regarding the Sakhalin-1 and Sakhalin-2 Oil and Gas Projects, *reprinted by* Pacific Environment, Jan. 4, 2003, <http://www.pacificenvironment.org/article.php?id=258>.

<sup>76</sup> *A Funny Shade of Green*, THE ECONOMIST, September. 20, 2006, available at [http://www.economist.com/agenda/PrinterFriendly.cfm?story\\_id=7939167](http://www.economist.com/agenda/PrinterFriendly.cfm?story_id=7939167).

This was no Russian environmental epiphany. When asked about the future of other environmentally questionable oil production projects in the country, Deputy Prime Minister Alexander Zhukov tipped his hand, commenting “I do not think accords concluded on the basis of production-sharing agreements should be revised. Production-sharing begins once costs have been recovered. But permanently increasing expenses impose onerous terms.”<sup>77</sup> Russian Minister of Trade and Economic Development German Gref agreed that the main factor prompting government action was the rising cost of development.<sup>78</sup> With significant foreign investments in jeopardy, the Russian government ratcheted up the pressure, threatening criminal prosecutions for environmental non-compliance.<sup>79</sup>

With no choice and with the memory of Amoco's complete loss in mind, Shell finally concluded that some cost recovery from Sakhalin II was preferable to a total loss. On December 11, 2006, Shell offered a controlling stake in the project to Gazprom.<sup>80</sup> On December 21, 2006, Gazprom acquired a 50% plus one share stake in SEIC, with Shell retaining a 27.5% stake, Mitsui holding 12.5%, and Mitsubishi 10%.<sup>81</sup> The real beneficiary of the new accord was the Russian government, which will continue to collect tax revenues on the Sakhalin project, and, as the principle shareholder in Gazprom, also stands to increase its share of cost recovery from 0% to just over 19% during the initial recovery period.<sup>82</sup>

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<sup>77</sup> *Existing PSA Agreements Will Remain in Force – Vice Premier*, RIA NOVOSTI, Oct. 24, 2006.

<sup>78</sup> Ostrovsky, *supra* note 22.

<sup>79</sup> *Prosecutors May Launch Criminal Case Against Sakhalin II*, RIA NOVOSTI, Oct. 27, 2006. At the same time, the same bureaucratic infighting that shaped the 1995 legislation “On Production Sharing Agreements” was again working to reshape governmental influence over the energy sector. In mid-October, officials of Russia's law enforcement department, the Interior Ministry, searched the Ministry of Natural Resources offices of the officials responsible for the cancellation of the Sakhalin II permits. Martyn Wingrove, *Russia Police raid environmental Raid Environmental Agency*, LLOYD'S LIST INTERNATIONAL, Oct. 19, 2006.

<sup>80</sup> Douglas Busvine, *Shell Offers Control of Sakhalin-2 to Gazprom*, REUTERS, Dec. 11, 2006, <http://today.reuters.com/news/articlebusiness.aspx?type=tnbusinessnews&storyID=nL11674060>.

<sup>81</sup> Gazprom, Shell, Mitsui, Mitsubishi Sign Sakhalin II Protocol, SHELL NEWS & MEDIA RELEASES, Dec. 21, 2006, [http://www.shell.com/home/Framework?siteId=media-en&FC2=&FC3=/media-en/html/iwgen/news\\_and\\_library/press\\_releases/2006/sakhalin\\_protocol\\_21122006.html](http://www.shell.com/home/Framework?siteId=media-en&FC2=&FC3=/media-en/html/iwgen/news_and_library/press_releases/2006/sakhalin_protocol_21122006.html).

<sup>82</sup> While the status of SEIC's up-front investment in Sakhalin II is presently unknown, it is likely that foreign investors will either have to write off half of that investment, or increase the period during which they can expect its recovery, diminishing the project's ultimate profitability. Foreign firms are likely to think twice before committing resources on the scale of Sakhalin II where profitability and cost recovery are not assured.

C. *The Post-Soviet Legislative Reform of the 1990s Was Flawed and Continues to Hamper Efforts to Attract and Secure Foreign Investment*

The current legal framework for PSA contracting came into existence on December 19, 1995 when President Yeltsin signed a compromise version of legislation “On Production Sharing Agreements.”<sup>83</sup> The passage of a comprehensive statutory framework for PSAs is a relatively unusual feature of the Russian experience.<sup>84</sup> The law was widely seen as an interim measure, and further amendment was expected.<sup>85</sup> Although it provided a general framework, the details of individual agreements were left to be negotiated on a case-by-case basis by Federal and regional authorities.<sup>86</sup>

A major revision in 1998<sup>87</sup> centralized the contracting process and removed regional control over project administration. The Ministry of Energy,<sup>88</sup> expecting to gain significant power from its new role as the agency authorized to negotiate PSAs, supported these amendments.<sup>89</sup> Meanwhile, the Communist Party, drawing much of its support from the former Soviet administrators who still controlled regional governments,<sup>90</sup> joined with the Ministry of Natural Resources and finance, customs, and tax authorities to oppose the legislation. Because of political posturing,<sup>91</sup> Russia’s PSA regime is not representative of a national consensus or established policy,

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<sup>83</sup> Federal Law No. 225-FZ on Production Sharing Agreements (Dec. 30, 1995), as amended 2004.

<sup>84</sup> Samir Z. Gasimov, Pre-Legislative Formation of Petroleum Agreements in Azerbaijan in Comparison to Legislative Framework in Russia: Legal, Economic and Political Implications 37 (2004) (LL.M. Thesis, University of Washington School of Law).

<sup>85</sup> CHAISTY, *supra* note 28, at 176.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 188.

<sup>88</sup> The Ministry of Energy had introduced and strongly lobbied for its own version of Production Sharing legislation in 1995, naturally granting primary contracting authority to itself. In yet another intra-governmental turf battle, the State Duma elected to pass its own version of the legislation, granting the legislative branch greater authority over the agreements. After a veto of the initial legislation by the Federation Council (the upper house of Russia’s Parliament), the compromise 1995 legislation was adopted, leaving much of the detail to federal and regional executives. Stoleson, *supra* note 18, at 679-682.

<sup>89</sup> CHAISTY, *supra* note 28, at 180.

<sup>90</sup> The original 1995 legislation followed a compromise “two-key” model of decision-making. With a relatively weak central Government after the Soviet collapse, the Kremlin was required to court the support of regional powerbrokers to accomplish anything, especially in the outlying territories of Russia’s far east. Thus, under the 1995 regulatory model, the Kremlin had to seek the support of regional government leaders before concluding new Production Sharing Agreements. This requirement was excised from the 1998 amendments, undercutting the politically influential members of the Communist Party of the Russian Federation (CPRF) and costing the bill Communist support. *Id.* at 184.

<sup>91</sup> Paul Chaisty’s superb analysis of the factionalism of 1990s Russian lawmaking indicates that Russia’s pro-reform *Yabloko* party enjoyed a consistently higher cohesion rate on PSA legislation, as the legislation was much less a source of internal disharmony within the pro-reform *Yabloko* party than within other factions. See CHAISTY, *supra* note 28, at 179 (Table 7.2).

but rather a snapshot of the relative strength of a particular political faction during the volatile period from 1995 through 1998. As a result, the legislation specifically disadvantages those groups that were politically weak in the 1990s, such as regional governments, creating incentives for those groups to undermine the resulting agreements in which they have no vested interest.

As a result of a haphazard legal framework, Russian PSAs are a legislative splitting of a contractual baby. Fundamentally, the agreements are based on the Civil Law of the Russian Federation.<sup>92</sup> While they are to “provide for all necessary terms and conditions related to the use of subsoil,”<sup>93</sup> many elements of the development relationship, such as land use and natural resources management, remain subject to the law of the Russian Federation.<sup>94</sup> Thus, Production Sharing Agreements with the Russian Government are not the sort of “self-contained” contracts found elsewhere.<sup>95</sup> While in other countries the PSA structure is the “preferred form of foreign investment,”<sup>96</sup> in Russia only mineral deposits that cannot be licensed under a traditional concession are eligible for development under a PSA.<sup>97</sup> Finally, Russian PSAs are not entered into for a fixed term. The term of exploration may be extended at the discretion of the foreign investor, provided that the project is in compliance with the agreement.<sup>98</sup>

Particularly peculiar to the Russian experience, the government is authorized to make available no greater than 30% of known mineral reserves under a PSA scheme.<sup>99</sup> Because of this requirement, much of the initial prospecting and exploration is done at State expense. In recognition of this, the PSA legislation provides that the foreign investor must reimburse the State for the costs of surveys and geological subsoil information associated with the particular project.<sup>100</sup> This seems to be a mechanism for the foreign investor to “buy down” the initial exploration costs, but fails because foreign investors are not likely to pay the exploration costs associated with

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<sup>92</sup> Federal Law No. 225-FZ on Production Sharing Agreements (Dec. 30, 1995), as amended 2004, art. 1 § 3.

<sup>93</sup> *Id.* art. 2 § 1.

<sup>94</sup> *Id.* art. 1 § 2.

<sup>95</sup> Stoleson, *supra* note 18, at 683 (“... any contract formed pursuant to PSA law will be shackled to the same problems foreign investors face under the current legislative environment.”).

<sup>96</sup> Smith & Wells, *supra* note 32, at 586.

<sup>97</sup> Gasimov, *supra* note 84, at 42.

<sup>98</sup> Federal Law No. 225-FZ on Production Sharing Agreements (Dec. 30, 1995), as amended 2004, art. 5 § 2.

<sup>99</sup> *Id.* art. 2 § 3.

<sup>100</sup> *Id.* art. 13 § 2.



geographic regions found not to contain oil or gas deposits. Thus, the risk of non-discovery is entirely allocated to the State.<sup>101</sup>

Without apparent justification, and further complicating an already non-standard agreement, the drafters abandoned the ordinary principle that the agreement itself preempts conflicting national law. Instead, the PSA statute provides that changes to domestic law that materially impact the agreement should result in the mandatory amendment of the agreement “to ensure that the investor obtains the commercial results which he could have obtained” if the legislation had not changed.<sup>102</sup> Consistent with its lack of specificity, the statute leaves to the parties the definition of a process for making such a radical change, potentially making the agreement very unstable.<sup>103</sup>

A decade after Russia’s legislative framework for the creation of PSAs was adopted, all of the debate surrounding that legislation seems to have been for naught. Since 1995, not a single PSA has been signed in Russia under that statutory scheme.<sup>104</sup> Those few PSAs negotiated prior to the enactment of the legislation, including Sakhalin II, remain subject to the provisions of the law but are themselves of questionable legal status.<sup>105</sup> Ultimately Russia’s failure to use PSAs as a way to encourage foreign energy investment—where so many less stable countries have succeeded<sup>106</sup>—is a cautionary tale for future investors and a prescription for institutional change to encourage healthy market activity.

#### *D. Russia’s Expropriation of the Sakhalin II Investment Has Broader Ramifications for Future Investment and International Trade*

The true test of Russia’s approach to foreign investment regulation, for which no empirical predictive formula can be applied, is Sakhalin II’s impact on new investment and international trade,<sup>107</sup> rather than its impact

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<sup>101</sup> See, Rutledge, *supra* note 39, at 15 (“Since both the PA and Lunskeye fields had already been discovered by Russian companies, the [Sakhalin Energy Consortium] did not need to worry about the existence of *in situ* oil and gas. So the initial element of risk was removed from the outset.”).

<sup>102</sup> Federal Law No. 225-FZ on Production Sharing Agreements (Dec. 30, 1995), as amended 2004, art. 17 § 2.

<sup>103</sup> Art. 17 § 2 foresees changes in the legislative framework not only of the Russian Federation, but also statutory changes enacted by subdivisions and local self-government bodies. Although untested, this seems to suggest that a complete renegotiation of an agreement with the national government can be forced by legislative action at the regional or even municipal level—a strange sort of inverse preemption.

<sup>104</sup> CHAISTY, *supra* note 28, at 192.

<sup>105</sup> Auditing Chamber Report, *supra* note 47, at § 3.1.

<sup>106</sup> For an in-depth analysis of the successful implementation of Production Sharing Agreements in Indonesia, Angola, Azerbaijan, India, Iran, and Peru, see Bindemann, *supra* note 33, at 67-82.

<sup>107</sup> Once upon a time foreign investors in Russia were willing to write off losses due to political maneuvering and instability. Investments were comparatively small, profits (when realized) were

on existing projects and ventures.<sup>108</sup> As of 2007, Russia is fast exhausting the pool of potential foreign firms with adequate expertise that have not already lost significant previous investment in Russia. Investment is only practical where the risk associated with doing business is adequately represented in the expected rate of return.<sup>109</sup> Sakhalin II's collapse demonstrates to the international community that the Russian government is willing to play politics with some of the largest and most influential multinational companies providing the largest source of foreign income in the country. Foreign firms are likely to reach the reasonable conclusion that if Russia's highest-profile foreign investment is not secure, the bureaucracy might also take action that would destabilize smaller and less noteworthy projects.

In addition to energy-sector instability, Russia's pending WTO application<sup>110</sup> provides a pressing macro-political reason for the country to not alienate foreign investors. Russia's long term economic interests demand WTO membership to promote market diversification.<sup>111</sup> With raw materials comprising an ever decreasing percentage of Russia's exports, the nation's industries are growing increasingly sensitive to anti-dumping and countervailing tariff penalties imposed by developed countries against Russia's exports, penalties that would be illegal under the WTO framework.<sup>112</sup> The World Bank estimates that the overall impact of WTO

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enormous, and many Russian firms could be pressured into compliance with international contract enforcement by the prospect of limited access to foreign markets. This period of somewhat fringe investment in Russia is over. The sheer magnitude of the agreements entered into dictate their importance. Burger, *supra* note 67, at 92.

<sup>108</sup> Some have suggested that Shell's choice to remain in a minority position within SEIC highlights the fact that large energy companies will continue to invest in Russia, including risk as a cost of doing business. This misses the point entirely. Sakhalin II is a legacy project: it was begun prior to the enactment of the current investment regime and was virtually entirely developed by Shell and its partners prior to government meddling. Shell's choice in December of 2006 was between taking a partial loss on its up-front investment and taking a total loss approaching \$20 billion (US). Given this circumstance, it is understandable that this company would elect to remain in the Russian market, if only to mitigate what it could of its development costs.

<sup>109</sup> See SCOTT L. HOFFMAN, *THE LAW AND BUSINESS OF INTERNATIONAL PROJECT FINANCE* 37 (2001).

<sup>110</sup> On the Current State of Russia's WTO Accession Negotiations, Ministry for Economic Development, <http://www.wto.ru/russia.asp?f=dela&t=11> (last visited Jan. 23, 2007).

<sup>111</sup> It is estimated that WTO membership will increase bilateral trade between Russia and its largest trading partner, the European Union, from \$187 billion (US) (2005) to \$352 billion (US). *Russia's WTO Accession, Hearing before the European Parliament Committee on Int'l Trade* (Nov. 21, 2006) (testimony of Anders Åslund, Peterson Institute) available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=686>.

<sup>112</sup> *Id.*

accession on the Russian economy is between 3.3% and 11% of GDP.<sup>113</sup> Yet, Russia's unstable and often corrupt economic regulatory system threatens to short-circuit ongoing accession negotiations. Additionally, a collapse of massive foreign investments in the highly-visible energy sector is likely to give support to those countries that oppose Russian membership.<sup>114</sup>

#### IV. RUSSIA NEEDS A NEW MODEL FOR INVESTMENT TO ENCOURAGE FOREIGN FIRMS TO INITIATE NEW ENERGY PROJECTS

Russia needs foreign investment as much as the world market needs Russian natural resources. Particularly troublesome, both the Russian government and Russia's burgeoning capitalist class have demonstrated that they are unsuitable partners for foreign firms wishing to make significant investments in the Russian economy. Both Russian and foreign actors have begun to look outside of the formal legal framework to fashion a system of economic interaction that suits the particular purpose of each. The ultimate problem is that the participants in this system are playing by a different set of rules. Because foreign laws and international expectations prevent foreign firms from playing by Russian rules, the Russian government must erect institutions that will ensure that both it and its domestic companies act in accord with international standards and expectations.

The burdens of Russian instability fall disproportionately on foreign investors. Compared with Russian firms, foreign investors find themselves in a regulatory and public relations straightjacket. Actions that come without consequences for domestic investors in Russia often either violate the corporate regulations of the country where a foreign firm is incorporated, or would lead to damaging public relations problems with more squeamish foreign constituencies. For companies incorporated in the United States, the long reach of Federal extraterritorial jurisdiction statutes provide remedies for violation of U.S. law that are not available against Russian companies

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<sup>113</sup> Jesper Jensen, Thomas Rutherford, & David Tarr, *Economy-Wide and Sector Effects of Russia's Accession to the WTO*, WORLD BANK, 2004, at 3, available at <https://www.gtap.agecon.purdue.edu/resources/download/1735.pdf>.

<sup>114</sup> See Edward Gresser, *A view from Outside: Russia And the Case For the WTO*, RUSSIAN-AMERICAN CHAMBER OF COMMERCE, -RUSSIAN COMMERCE NEWS (2003), available at <http://www.russianamericanchamber.org/newsletter/aviewfromthe.html> ("Less well known, and especially relevant in considering the WTO accession, are microeconomic and regulatory troubles. Ministries, finding revenue uncertain and inexperienced with new roles as regulators rather than producers of goods, issue vast numbers of unnecessary regulations and license requirements simply to raise money. This fosters corruption among big businesses and officials, and plagues less-connected small-scale Russian entrepreneurs and foreign businesses with long approval processes, unnecessary fees, and occasional absurdities.").

engaged in the same activity.<sup>115</sup> Fraud schemes erected by corporations that do business in the United States are particularly likely to elicit U.S. enforcement action regardless of where the firm is incorporated.<sup>116</sup> This is because fraud tends to transcend international boundaries, especially within vertically-integrated multinational firms, and tends to have a domestic impact regardless of where committed.<sup>117</sup> To avoid foreign jurisdiction, many Russian oil and gas companies prefer to operate through smaller subsidiary companies with no foreign assets, shielding the parent from foreign judgments through the unusually strong corporate veil associated with a Russian Joint Stock Company (“JSC”).<sup>118</sup> When the Russian Federation Government enters the marketplace, either directly or through subsidiaries, the doctrine of sovereign immunity restricts enforcement to a significant degree.<sup>119</sup>

Foreign investors will only continue to invest in Russia's energy sector if they can be assured that they and their domestic partners will be playing by the same set of rules within a defined and predictable legal environment. Regulation must be freed from the control of the treacherous

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<sup>115</sup> Particularly applicable, the U.S. Foreign Corrupt Practices Act (“FCPA”), 15 U.S.C. §§ 78dd-2, 78dd-3 (1998), prohibits companies and officers of companies governed by U.S. securities regulations from financial dealings intended to bribe or otherwise influence foreign government officials or political candidates. Such financial dealings are common practice, especially within the lower levels of the Russian regional bureaucracy. Although there have been no U.S. prosecutions for Russian FCPA violations as of publication, the U.S. Justice Department recently has become aggressive in investigating FCPA allegations and forcing criminal penalties. See *United States v. Titan Corp.*, 05 CR 0314-BEN (S.D. Cal. Mar. 1, 2005) (imposing a \$13 million (US) criminal fine on top of substantial profit disgorgements for a \$2 million (US) contribution to the re-election campaign of Benin President Mathieu Kerekou). In addition, the Lanham TradeMark Act, 15 U.S.C. § 1064, allows suits in U.S. Federal court to enforce trademarks infringed abroad, a mechanism only practically applicable to international firms with assets in the United States. See *Steele v. Bulova Watch Co.*, 344 U.S. 280, 282 (1952). Under 18 U.S.C. § 1513(d), Americans who conspire to kill or harm witnesses or participants in official proceedings are subject to criminal prosecution in the United States regardless of where the offense was committed. In extreme cases, the Alien Tort Claims Act, 28 U.S.C. § 1350, provides domestic jurisdiction over any “civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States,” again limited by the caveat that recovery is only likely against entities with significant assets in the United States.

<sup>116</sup> See Harold G. Maier, *Extraterritorial Jurisdiction at a Crossroads: An Intersection Between Public and Private International Law*, 76 A.J.I.L. 280, 298 (1982).

<sup>117</sup> See *SEC v. Kasser*, 548 F.2d 109, 114 (3d Cir. 1977) (holding the Securities Exchange Act of 1934, 15 U.S.C. § 78a-§78hh, to have extraterritorial application).

<sup>118</sup> Unlike in the United States, the inviolability of a Russian JSC corporate veil is based not on a balancing of factors, but on a set of affirmative and clearly-defined corporate actions that create parent liability. In the absence of these actions (which include commingling funds, management structures, and directorships) there is no basis for parent liability for subsidiary actions. See KENNETH A. CUTSHAW & IGOR D. ARKHIPOV, *CORPORATE COUNSEL'S GUIDE TO DOING BUSINESS IN RUSSIA* 43.002 (West 2000).

<sup>119</sup> See *National City Bank v. Republic of China*, 348 U.S. 356 (1955) (discussing the policy reasons underlying the doctrine). See also *Berizzi Bros. Co. v. Steamship Pesaro*, 271 U.S. 562 (1926) (declining to differentiate between the commercial and military activities of a foreign state in extension of sovereign immunity to prevent the arrest of a sovereign's vessel for purposes of *in rem* jurisdiction).

State bureaucracy,<sup>120</sup> agreements must be given meaning through predictable and functional enforcement, and investment must be secured against unofficial expropriation through economic manipulation. However, for such a framework to have credibility with Russian constituencies, it must assure that Russia retains meaningful control of its natural and energy resources, that the proceeds of development are shared equitably, and, importantly, that the country is able to project the image of a great power and not of a third-world client State. No legal institution can, of itself, solve the crisis of trust in the Russian politic. Yet, by properly understanding the legal, political, and cultural factors that have influenced Russia's development, the country can craft institutions that take account of these factors, rather than labor against them. History demonstrates that economic isolation, exploitation of momentarily successful industry, and alienation of foreign confidence are not in Russia's long-term interest.

V. A PUBLIC LEASING AUTHORITY SEPARATE FROM THE RUSSIAN GOVERNMENT COULD PROVIDE ADEQUATE STABILITY TO ENCOURAGE FOREIGN FIRMS TO INVEST IN RUSSIA

In approaching the reform of Russia's PSA framework, leaders should look to non-traditional approaches that have been successful in the management of important public resources in emergent political environments. On examination, the very problems Russia faces in the administration of its oil and gas fields have been faced by numerous local governments in the development and management of their public resources. Many have chosen to administer those resources by establishing a single-purpose quasi-governmental authority, a model that Russia should explore.

A. *Public Authorities Successfully Manage Public Resources in Sectors that Require "Business-Like" Administration*

Political insulation of resource managers through the establishment of a quasi-governmental management authority has historically been effective in political situations somewhat similar to that currently faced in Russia. For instance, the cultivation of the dry western United States created disputes over water, a resource that was indispensable for irrigation and thus for the economic viability of most rural areas.<sup>121</sup> A major problem was that water

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<sup>120</sup> One Russia observer has commented, "Russia suffers not from too free a market but from corruption thriving on the excessive regulations erected by a large and pervasive state." Anders Aslund, *Russia's Collapse*, FOREIGN AFFAIRS, Sept.-Oct. 1999, at 64.

<sup>121</sup> JOHN BOLLENS, SPECIAL DISTRICT GOVERNMENTS IN THE UNITED STATES 142 (1957).

resources, much like oil and gas, tended to transcend local and regional administrative districts.<sup>122</sup> Lack of cooperation between state and local entities meant that upstream water resources were often mismanaged, to the detriment of downstream users.<sup>123</sup> For many western states and western landowners, the solution was the development of special irrigation districts: local administrative bodies that overlay the existing administrative map and are managed by professional administrators under the supervision of an elected or appointed board.<sup>124</sup> Beginning in the early 20<sup>th</sup> Century, many American states created "Public Authorities," charged by statute with a singular purpose, insulated from political influence, subject to suit at law, and often run by professional administrators.<sup>125</sup>

Public authorities are now regularly created<sup>126</sup> to develop projects (such as sport stadiums, utilities, or transportation infrastructure) and to administer public resources (such as ports, public parks, and irrigation).<sup>127</sup> At the most basic level, these entities are designed to serve as quasi-public corporations incorporated for the benefit of the public. They are conceived with the twin aims of insulating a business-like function from political manipulation while benefiting from the professional managerial expertise that many politicians lack.<sup>128</sup>

Although the public authority owes its existence to the State, it is, in many cases, freed from the process-oriented requirements of the bureaucracy and can therefore operate more efficiently.<sup>129</sup> It is impossible, and in any

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<sup>122</sup> *Id.* at 140.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.* at 141-49.

<sup>125</sup> OSBORNE M. REYNOLDS, LOCAL GOVERNMENT LAW, 2D 26-32 (West 2001). Although voluntary irrigation districts had existed since the late 1800s, the Port Authority of New York is widely recognized as the first quasi-governmental district in the United States. The Port Authority was created in 1921 by the States of New York and New Jersey to administer and develop the port.

<sup>126</sup> For an example of an early approach to public authorities internationally, see SIDNEY WEBB, ENGLISH LOCAL GOVERNMENT, Vol. 4, 239-241 (1963). In 1662, the cities of London and Westminster, England, pioneered such an entity with Parliament's statutory authorization of "Improvement Commissioners" to regulate the building of roads and sewers between the two cities as well as to authorize the removal of interfering structures and provide for "rakers" to clear the roads. In authorizing the Commissioners, Parliament recognized that the competing parochial interests of the London and Westminster governments had resulted in the mismanagement of road construction and maintenance, and that this problem could be addressed by building an entity that could adequately encompass the interests of both cities.

<sup>127</sup> *Alternative Financing Mechanisms for Environmental Protection*, OFFICE OF ADMINISTRATION AND RESOURCES MANAGEMENT, U.S. ENVIRONMENTAL PROTECTION AGENCY, Aug. 7, 1992, at 14.

<sup>128</sup> See Jameson W. Doig, "If I See a Murderous Fellow Sharpening a Knife Cleverly . . .": *The Wilsonian Dichotomy and the Public Authority Tradition*, PUBLIC ADMINISTRATION REVIEW, Vol. 43, No. 4 (1983), at 292. ("Many government agencies and their officials have aspired to these twin goals of political insulation and sophisticated managerial competence, but few have achieved either in a significant degree.")

<sup>129</sup> See *id.* at 92-93.

case undesirable, to entirely insulate any public institution from the forces of politics. The purpose of the public authority is not to supplant either the state or private enterprise, but rather to complement both, serving as both a conduit for interaction and a buffer against manipulation.<sup>130</sup> The particular advantage of vesting an economic entrepreneurial enterprise with a quasi-governmental status is that such a body can exercise government-like functions. Some of these functions include the issuance of public credit, the exercise of eminent domain, the conference of tax exemptions, and the creation of monopolies. All of these tasks would be proscribed to ordinary business entities, but are necessary for the proper administration of a public resource.<sup>131</sup>

In terms of political legitimacy, a public authority benefits from the fact that its constituency (and its level of accountability to that constituency) can be specifically and strategically prescribed.<sup>132</sup> While managers that are directly elected are likely to be no less independent than other elected officials from the same district, those appointed by the executive for extended terms are likely to have a greater degree of political independence.<sup>133</sup> Often, however, the purpose of creating a public authority is to balance the competing interests of various government entities, such that the controlling political objectives of each are weighed against the costs to the others. In irrigation districts, for instance, supervising directors were typically elected from amongst riparian land owners according to the number of parcels owned.<sup>134</sup> By contrast, authorities for the management of public housing usually answer to other government entities rather than to the electorate, and directors are typically appointed by a number of other local elected officials.<sup>135</sup>

Importantly, because public authorities are created by the government, they are often given policy as well as economic mandates.<sup>136</sup> The State of

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<sup>130</sup> Gerald Fetner, *Public Power and Professional Responsibility: Julius Henry Cohen and the Origins of the Public Authority*, THE AMERICAN JOURNAL OF LEGAL HISTORY, Vol. 21, No. 1 (1977) at 22-24. A key characteristic of the special district is that it can be legislatively required to undertake endeavors or projects that are either so risky or so unprofitable that private enterprise would be unwilling to do the same. By publicly absorbing this risk, the special district can, in effect, manufacture a stable or healthy market situation, creating space for private industry to engage in profitable management or administration of public resources. At the same time, the special district can fulfill a regulatory role, answering to a public mandate to provide services required or desired by the state. *Id.*

<sup>131</sup> ROBERT G. SMITH, PUBLIC AUTHORITIES, SPECIAL DISTRICTS, AND LOCAL GOVERNMENT 91 (1964).

<sup>132</sup> See BOLLENS, *supra* note 121, at 142.

<sup>133</sup> Doig, *supra* note 128, at 297.

<sup>134</sup> *Id.* at 146.

<sup>135</sup> *Id.* at 31.

<sup>136</sup> For the implications of these split mandates, see SMITH, *supra* note 131, at 56-57.

Washington, like other states, vests public irrigation districts with the split purposes of stewarding watersheds, leasing water rights, and managing hydroelectric public utilities.<sup>137</sup> These are diverse and often countervailing purposes which the district directors are empowered to weigh and balance independent of State or local interference.

*B. The Many Benefits of Non-Governmental Administration Could Add Predictability, Efficiency, and Transparency to Russia's Oil and Gas Sectors*

While never before used on such a scale, the public authority structure could plausibly be adapted to the administration of exploration and development of Russian oil and gas. To accomplish the goal of investment stability, the management of energy concessions must be removed from the direct control of the legislature and the executive. While the state Duma and the President should be involved in setting general policy for energy exploration, the granting and regulation of specific concessions should be vested in an independent quasi-governmental Public Leasing Authority ("PLA"). That authority, governed by an independent board of directors, would be competent to administer energy concessions within a designated geographic region of Russia.

The PLA should be authorized under federal legislation for the split purposes of administering a geographically-defined oil or gas interest; granting concessions to foreign and domestic companies for exploration and development; setting environmental, health, and safety regulations not lower than those established in Federal law at the time that the concession is granted;<sup>138</sup> interpreting and applying those regulations; and granting all necessary permits and authorizations within the defined area related to the project. As part of the arrangement, the Russian Federation would lease the mineral resources within the defined area to the PLA in exchange for royalty payments calculated to include all revenues not necessary for the administration of the PLA, including PLA-sponsored exploration and

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<sup>137</sup> See WASH. REV. CODE §§ 87.84.005 (1963), 87.03.013 (1979), 87.03.010 (1923).

<sup>138</sup> The importance of setting a baseline of social regulation below which oil and gas concessions cannot fall is obvious: because the externalities of oil and gas development (including environmental costs, resettlement of populations, and public safety) have the greatest impact on the Russian people as a whole, their elected representatives must have a role in defining the minimum standards in each area. Yet, because Russian politicians have demonstrated that they are willing to use such regulation to accomplish political goals, the minimum standards must remain stable throughout the life of the concession. At the same time, recognizing that changes in technology and international standards may precipitate a need to make those standards more stringent, the board of the PLA, insulated from countervailing incentives, must be empowered to make regulatory changes.



development costs. By creating such an entity, the Russian government would create a political “buffer” between the state and the international investor, ameliorating many of the causes of instability in the current regime.

While removal of public resource administration from the elected organs of government may raise republican ire, a government’s goals can sometimes best be accomplished with recognition that elected leaders are not themselves best qualified for dispassionate administration. Even in the ostensibly most democratic societies, the leasing of subsoil resources has traditionally been removed from politically-sensitive institutions, in recognition of the opportunity for political manipulation and favoritism in the granting of development rights.<sup>139</sup> By delegating administration of leases to administrative agencies, these countries separate the “policy” aspect of leasing (which is retained by the legislature) from the “administrative” aspect, which is delegated to a disinterested third party.

While the United States and Britain allow leasing decisions to be made by executive departments, they are also countries with long and established histories of separating the ministerial and political functions of those departments.<sup>140</sup> Russia, by contrast, has no such history.<sup>141</sup> It is therefore unrealistic to suggest that the Russian bureaucracy should act like its American or British counterparts. Political manipulation is a fact of

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<sup>139</sup> Indeed, in much of the world it has been recognized that traditionally democratic institutions may not be best suited for the management of commercial enterprises. In an 1887 article, Woodrow Wilson aptly summarized the propriety of borrowing commercial and monarchic structures for republican public purposes: “If I see a murderous fellow sharpening a knife cleverly, I can borrow his way of sharpening the knife without borrowing his probable intention to commit murder with it; and so, if I see a monarchist dyed in the wool managing a public business well, I can learn his business methods without changing one of my republican spots.” Woodrow Wilson, *The Study of Administration*, POLITICAL SCIENCE QUARTERLY, Vol. II No. 2 (June 1887) 197, 220. In the United States, management of outer-continental shelf oil leases (those outside of the jurisdiction of the states) is vested in the Secretary of the Interior. See Outer-Continental Shelf Lands Act, 43 U.S.C. § 1334(a). Similarly in the United Kingdom, leasing of North Sea oil reserves is controlled by the Department of Trade and Industry under a delegation from the Secretary of State. Christopher F. Richardson, *The Influence of Offshore Leasing Regimes on Commercial Oil Activity: An Empirical Analysis of Property Rights in the Gulf of Mexico and the North Sea*, 17 GEO. INT’L. ENVTL. L. REV. 97, 105 (2004).

<sup>140</sup> See, e.g., *Entick v. Carrington*, (1765 KB) 2 Wils. K.B. 275, 95 Eng. Rep. 708 (holding the Earl of Halifax amenable to suit at common law for illegal issuance of a warrant, and explaining the distinction between ministerial and discretionary functions of public officials), available at [http://www.constitution.org/trials/entick/entick\\_v\\_carrington.htm](http://www.constitution.org/trials/entick/entick_v_carrington.htm); *Osborn v. Bank of the United States*, 22 U.S. 738, 839-846 (1824) (recognizing the authority of the federal courts to issue injunctions against state ministers when their actions are or threaten to be in contravention of federal law).

<sup>141</sup> Under both the Tsar and the Soviet Union, government ministers acted subject to either the direction of executive authority or their own self-interests, often giving little thought to whether their actions comported with established legislative policy or the statutory functions of their offices. See Anastasia Nesvetailova, Lecturer in International Relations, University of Sussex, *Putin and the Return of Empire? Reconstituting Russia’s Political Economy after Crisis* (Apr. 18-20, 2001) (unpublished article, on file with the Pacific Rim Law & Policy Journal, quoted with permission of the author).

Russian bureaucratic administration. The only way to separate resource administration from the political equation is to separate it entirely from the Government.

*C. A Successful PLA Must Be Both Politically Responsive and Economically Responsible to Capture Domestic Political Legitimacy and Attract Foreign Investment*

In order to meet its split mandates of profitably developing energy resources while safeguarding the environment, workers, and communities, the PLA must manifest 3 important features: 1) it must be self-contained,<sup>142</sup> solely empowered to grant energy concessions, administer all attendant matters within its realm, and authorized to make findings of fact subject to judicial deference; 2) it must be truly independent, governed by directors appointed by multiple government levels for extended fixed terms,<sup>143</sup> and 3) it must be subject to suit and authorized to bring suit in a designated court of international arbitration, the decisions of which must be made enforceable in Russia notwithstanding incongruence with domestic public policy.

*1. A Self-Contained Entity Will Be Less Susceptible To Outside Political Pressures*

The primary rationale for encapsulating oil and gas concessions within the authority of a single quasi-governmental body is the same as that for which developing countries around the world look to PSAs: stability and predictability. Namely, ordinary PSAs are self-contained agreements governing all aspects of the development relationship, and providing predictability for foreign investors who rely upon explicitly defined future rights and obligations. In the Russian context, however, companies invested through PSAs remain dependent on the Russian government and various departments within the bureaucracy for permits, financial authorizations, and development permissions. These disparate parts of the bureaucracy are less concerned with profitable development, future investment, and sustainable management than they are with elevating their own influence. Like an

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<sup>142</sup> The reader will recall that a "self-contained" entity was a principle rationale behind the adoption of the PSA framework to begin with. See Stoleson, *supra* note 18, at 672. This principle is particularly important in the context of an otherwise unstable political environment, but was never fully realized in the Russian context. Through removal from Government control, the Public Leasing Authority is likely to be more successful in achieving this goal.

<sup>143</sup> For a perspective on the importance of independent directors, and their relative scarcity in the context of public authorities, see Jonathan Rosenbloom, *Can a Private Corporate Analysis of Public Authority Administration Lead to Democracy?*, 50 N.Y.L. SCH. L. REV. 851, 891-92 (2006).

irrigation district or port authority, a PLA would be a forum for consideration of all interests. It would balance the desire for current profit and production against the future interest in sustainable and socially-responsible development. Perhaps most importantly, the PLA would provide a single entity with which the international investor could interact, allowing for the development of relationships and understandings to transcend the political immediacies of the day.

2. *Independence from the Central Government Will Diminish the Likelihood that Oil and Gas Contracts Will Be Used to Accomplish Unrelated Political Objectives*

In Russia, government involvement in a private enterprise has become synonymous with executive control.<sup>144</sup> Where the government has gained a controlling share in domestic corporations, it has used that stake to filter Government policy through entities that have become private in name only. Because of this track record, it is important, for both appearances and function, that the directors of the PLA have the freedom to act independently of the Russian government. Yet, those chosen to administer the industry supporting Russia's fragile economy must be charged to act in the country's long-term interest. Leadership must be both insulated from and responsive to political pressures. This seemingly oxymoronic end can be met, to a degree, by providing for the appointment of PLA directors by the national, regional, and local governments for extended fixed terms.

Creating an independent entity to administer oil and gas leasing presents an opportunity for the development of political legitimacy through federalism. Russia is a federation of 88 regional governments, including 3 autonomous republics.<sup>145</sup> Given the widespread environmental, public health, and labor implications of immense infrastructure investments, it is important from a democratic perspective that local voices be represented. Popular acedance can be enhanced and regionalism overcome by reversing the centralization of the 1998 PSA legislation amendments and designating director positions to be appointed by the regional and local governments in the effected areas.

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<sup>144</sup> PETER BAKER AND SUSAN GLASSER, *KREMLIN RISING* 125 (2005). One should also note that there are few examples, either contemporary or historical, of a truly independent institution in Russia, particularly in the government sector. President Putin's efforts of the last several years, aimed at consolidating and centralizing government power and influence, have further diminished the likelihood of the emergence of such an institution. This Comment does not, therefore, purport to suggest what is likely to occur organically, but rather posits a suggestion for what may work if prudently adopted.

<sup>145</sup> CIA World Factbook: Russia, <https://www.cia.gov/cia/publications/factbook/geos/rs.html> (last visited Jan. 23, 2007).

For too long, the regulators of the energy sector have been beholden to the central government and to their own conflicting interests. Independence, to the extent achievable, must be premised on freedom to make decisions counter to the political and economic expediencies of the short term without economic or political conflicts of interest.

### 3. *In the Wake of Sakhalin II, International Investors Will Demand Robust Enforcement Mechanisms*

Ultimately, any structural solution is meaningless without a significant mechanism for enforcement. One of the primary obstacles to foreign investment in Russia's energy sector is the lack of recourse in the event of contractual breach. Foreign investors' fears are likely to be exacerbated by the heavy-handed way in which the Russian government has dealt with regulation of the Sakhalin II project. As Mikhail Khodorokovsky's generation has shown itself to be both financially and politically savvy, and because the Russian courts have shown themselves to be unable to enforce judgments to a meaningful degree,<sup>146</sup> a new and sophisticated mechanism of enforcement must be crafted to meet international standards and demands.

In developing an effective enforcement mechanism, Russia should take advantage of the increasing credibility and gravitas of international arbitration. Allowing international arbitration as the dispute resolution tribunal of first instance for disputes arising between the PLA and the foreign investor has several significant advantages over relying on domestic enforcement. First, it provides a strong mechanism for Russian enforcement against the foreign investor. Because the international arbitrator's award is more likely than a domestic Russian award to be enforced in the foreign jurisdiction where the oil or gas company is incorporated,<sup>147</sup> the foreign investor is more likely to be responsive to arbitrator's decisions.<sup>148</sup> Second, because the PLA will inevitably be engaged in international commerce, resort to international arbitration provides a significant means of enforcement even if an award cannot be recovered against the PLA's assets

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<sup>146</sup> According to information provided by Russia's Ministry of Justice, fewer than half of Russia's domestic court judgments are enforced. Burger, *supra* note 67, at 91.

<sup>147</sup> See generally Alla Naglis, *The Status of Foreign Judgments and Arbitration in Russia*, in A LEGAL GUIDE TO DOING BUSINESS IN RUSSIA AND THE FORMER U.S.S.R. 110, 120 (Aviva Yakren, ed. 2000) (discussing the enforceability of international arbitration awards in Russia and abroad).

<sup>148</sup> Currently, 141 nations are signatories to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. See UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW, STATUS: 1958 – CONVENTION ON THE RECOGNITION AND ENFORCEMENT OF FOREIGN ARBITRAL AWARDS, available at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/\\_NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/_NYConvention_status.html).

in Russia. With an arbitrator's award in hand, an aggrieved party is more likely to be able to attach the PLA's foreign assets, as well as to garnish revenue generated by other foreign investors before it is paid to the Russian party.<sup>149</sup> Finally, international arbitration in a mutually agreeable forum will provide necessary external oversight and bring a level of transparency to the agreements that is not present in the current system.

## VI. CONCLUSION

Russia is at a turning point no less significant than that which it faced in 1991. As the world marches toward a borderless international free trade zone, Russia is deciding just what type of power it wishes to be. The energy sector, while admittedly unique in many ways, provides insight into the future development of Russia's foreign investment prospects. In the near term, Russia will not be a model of American or European liberal democracy. Similarly, its oil and gas industry should not be expected to organically follow the relatively laissez-faire model of the West. The blatant and highly-public expropriation of the Sakhalin II project is likely to make this realization clear to international observers.

One way to expose the Russian public to a transparent, responsible, and predictable political institution is to create one in Russia's most important economic sector. At the same time, the temptation for Russian politicians eager to manipulate the energy sector may simply be too great. For the same reasons that make energy an obvious test-bed for the development of responsible institutions, the sector is prone to political manipulation by those seeking to capitalize on Russia's new-found prosperity. By demonstrating that it is willing to expropriate successful projects, even high profile projects, without significant compensation, the Russian Government has essentially indicated that private investment in Russia is not secure. This threatens to undermine Russia's efforts to attract the foreign expertise that it still needs to modernize its economy, and threatens to destabilize Russia's efforts to join the international marketplace, including the World Trade Organization.

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<sup>149</sup> For a foreign perspective on recovering international arbitration awards that are not recognized by Russian law, see Jeffrey M. Hertzfeld, *Russian Corporate Governance: The Foreign Direct Investor's Perspective*, presented at the Conference on Corporate Governance in Russia, sponsored by the Organization for Economic Co-operation and Development, United States Agency for International Development, and World Bank 7, available at <http://www.oecd.org/dataoecd/55/47/1921803.pdf> (even when the Russian courts will not recognize an arbitrator's award, it is possible to recover a judgment against foreign assets located in a country that will recognize it).

Establishment of a Public Leasing Authority could be an essential component of Russia's new approach to energy administration. Removed from the volatile Middle East, a major economic player, and the world's leading exporter of energy, Russia is in a unique position to be a world leader in attracting foreign investment. With that investment could come infrastructure improvement, economic diversification, greater industrialization in the Far East, and, ultimately, greater political stability. Yet, to realize this promise, Russia must set aside its traditional skepticism of foreign investment and engage the world marketplace on international terms. By establishing a mechanism to professionally and independently manage Russia's energy resources, the country would signal to the world that it is finally serious about developing a predictable and stable legal environment for regulating its most essential industry.