

Janet Keeping

Where law does not rule

The Russian oil and gas sector

In countries where law is well developed—or where it “rules”—the institution plays many roles. One of the more important of these is to provide a reliably clear and predictable framework, on the basis of which people and organizations can plan their activities so as to minimize conflict and thereby maximize the return on their investments of time, energy, and money. Where law does not “rule” in this way, less is accomplished (returns are lower) than would otherwise be the case. In this article, these observations will be explored in the context of the Russian oil and gas sector.

THEIR SOVIET PAST: WHERE THE RUSSIANS ARE COMING FROM

In the former Soviet Union law mattered very little, for it was subservient to Communist party ideology. The ideology changed from time to time, but always had priority over law when the two collided. While he was leader of the country, Nikita Khrushchev called to complain of a court decision. When the judge concerned replied that the law required the decision given, Khrushchev was appalled: did the judge not realize that responsibility to the party (political correctness) always took precedence over the law?

Law sometimes mattered, but never in any important way for the oil and gas sector. This industry, like all others, was commanded from Moscow.

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There was no competition amongst producers: each had a monopoly in its own region and, to succeed, had only to fulfill the production quota demanded by Moscow. Losses through pipeline leaks and other wastes of resources were of no consequence as long as those production goals were met. Although law did not matter, since there was no competition, there was also no conflict of the kind we are concerned with.¹

THE TRANSITION TO SOMETHING ELSE

With the dissolution of the Soviet Union in 1991, the tempo of the transition from the command economy to something more marketlike, and competitive, picked up considerably. Significant change had been underway since Gorbachev became general secretary of the Communist party in 1985, but with the end of the Soviet Union, Russians were thrown into a dramatically different world, with a president—Boris Yeltsin—who urged Russians to seize the moment and make real change happen.² And some real change has occurred, of that there can be no doubt. But the rule of law has not emerged in any significant way and the absence of it severely limits the potential of the whole society, and of the Russian oil and gas sector, in particular.

THE CORRUPTION FACTOR

In its 2005 report on perceptions of corruption in 158 countries, Transparency International ranked Russia's level of corruption as 126, on a par with three other countries—Albania, Niger, and Sierra Leone.³ Indeed, corruption is so common in Russia that some people insist it is wrong to say that systems of Russian public life—for example, of that higher education—are corrupted, because corruption, not education, is the system.⁴

1 Of course, there was conflict. The Soviet Union festered with struggles for power and influence, but there was no commercial conflict because there was no commerce. For a taste of the atmosphere that prevailed in Soviet circles of power, see William Taubman, *Krushchev: The Man and his Era* (New York: Norton and Co., 2003).

2 For one of the better-known books written about the end of the USSR and birth of Russia, see David Remnick, *Lenin's Tomb: The Last Days of the Soviet Empire* (New York: Vintage Books, 1994).

3 See the "Corruption perceptions index 2005," in Transparency International, 2005, available online.

4 On crime and corruption in Russia, see Stephen Handelman, *Comrade Criminal* (New Haven: Yale University Press, 1995).

While this may be something of an exaggeration in connection with higher education, it is probably quite accurate as concerns some of the country's other institutions, such as the military.⁵

And it may be helpful to understand how corruption in one part of the society is interwoven with corruption in others. This is true, for example, between higher education and the military. Although there are other reasons for why both are highly corrupt, one source of the corruption in higher education is the desperate desire of many parents to keep their sons out of the military. While attending an institution of higher education, a young Russian man is not subject to the draft. And if he successfully completes an officer-training program at his university or institute, he is unlikely ever to be drafted. Parents are therefore motivated to ensure that their sons are accepted into and remain enrolled in both higher education and officer training. If their child cannot attain this on his own merits (females are not subject to the draft), parents with money or other enticements will buy the desired result.

And where corruption is rampant, there is constant conflict. Why? Because in a society pervaded by corruption there is no reason ever to accept a "no." There is an expression in Russia to the effect that "everything is forbidden [at least this was so during Soviet times], yet anything is possible." If you have the required degree of nerve, and keep pushing, you can probably achieve your goal. If you have not succeeded in convincing the first few people you approach, you persist, because you know that eventually you will succeed. Does this approach *always* work? No, but it usually does, and cumulatively in society this approach results in an aggressive pattern of bargaining—never accept a "no"—and in aggressive behaviour in general.

The constant conflict results from the operating assumption that if you just keep pushing, you will get what you want. For pushing is a form of conflict—one person pushes and the other resists, or gives way. It operates constantly at a low level and occasionally bursts into something you read about in the papers or hear talked of—or, increasingly again in Russia, whispered about—on the streets and in cafes.⁶

5 Although not likely as acute a problem as in the military, corruption in higher education is shockingly widespread. Not only are entries to university and marks in individual courses regularly purchased, so too are entire degrees.

6 Since Putin took office in 2000, fear is once again a palpable fact of Russian life. Nina Khrushchev, "A fatal desire for order," *International Herald Tribune*, 26 February 2006, available online.

This kind of conflict wears people down (thus, they eventually give in), and wastes their time. While a university president should be developing a strategic plan for further growth of the institution, or working on something else of president-like stature he (or she, but in Russia probably not) is hounded by threatening parents carrying plastic bags full of American cash. And this applies across the board: it is not just university or other officials who spend much of their time resisting the pushing and thus in conflict. Everyone is in the same boat. Whether it is entrance to university, or a place in a decent daycare for your child, or a fair division of property upon divorce, everyone is forced to plot out the course by which they will prevail over all those they encounter along the way, who are equally committed to making the achievement of this goal difficult, in order to extract some benefit for themselves. In a sense—which is difficult for people from a law-based society to imagine—life is a constant struggle to overcome the absence of the rule of law.

HOW DOES THIS APPLY IN THE OIL AND GAS SECTOR?

This section of the articles outlines some examples of how these patterns of Russian life play themselves out in the oil and gas sector. For although there are also other strong forces at work in the oil and gas sector, which is of huge importance to the Russian economy, much of what goes on can be explained on the basis of the absence of the rule of law and the resulting ubiquitous conflict.

Issuance of licenses by the state to oil and gas companies

Companies that want to develop oil and gas resources in Russia must obtain a license for this purpose from the state, which is their owner. In a country such as Canada, where oil and gas resources are also owned in large part by the government, such licenses are sold by auction to the company bidding the highest amount.⁷ Once such an auction is held and companies have made their bids, the government agency running the auction has no choice but to award the license to the company that has bid the highest amount. But under the current Russian legislation, the state may award licenses on the basis, not of a single-criterion auction (the highest bid), but

⁷ See website for the Alberta government's department of energy, where information on the system of auctioning licenses (called "land sales") can be found.

as a result of a tendering process, where companies put forward proposals on how they would develop the field.⁸ These proposals address a number of different issues, such as when and how the company would develop the field and what it would do to improve the infrastructure of the region.

There are two observations to be made here. The first is that, as opposed to a single-criterion system, a tender process invites conflict, for it is always possible to dispute that the “best” proposal has been accepted: the proposals submitted by companies cover several aspects of the field’s development, thus there can be—and often is—real uncertainty as to which proposal was better or whether in fact one could say that one was in fact better than all the others. Presumably one might be better on the question of how early production is to be started and another better on social contribution to the surrounding community. So, in adopting a tendering versus single-criterion auction process, the state has turned its back on a procedure that could have maximized clarity and certainty and endorsed one that is virtually certain to engender controversy. This is especially true since the commissions established to choose the winning proposal are made up of many people (often more than 30); the resulting opportunities for bribery are clear and probably intended. The law authorizing the conduct of tenders itself nurtures behaviour that undermines the rule of law.

Second, and worse, sometimes the result of the tender has been rejected and a company that has not even participated in the process has been awarded the license. In other cases, officials have decided that the company awarded the license by the tender commission is not the “right” one, the results of the tender have been annulled, and the license gone to the “politically correct” company. In such cases, all pretence of following the rule of law has been abandoned and the tender commissions are seen as the shams they are.

There is a bill before the state Duma that would amend the Law on the Subsoil—which requires that licenses be awarded according to the outcome of auctions and tenders—would no longer be used.⁹ The best guess now is that this legislation will not be passed in the near future, for reasons that probably have nothing to do with the auction versus tender issue.

⁸ See the law of the Russian Federation, “On the subsoil.”

⁹ Draft law no. 187513-4, “On the subsoil.”

One notes a significant difference between Russian and typical western attitudes towards the question of clarity in the law. From the western point of view, the rule of law is crucial to good governance and, without a high degree of clarity, one cannot say that the legal system in question embodies the rule of law. How can law rule when it is difficult to know what it is? But from the Russian perspective, the lack of clarity is often seen as a good thing. First, when the law is unclear, it is difficult to attribute legal responsibility. If the roof of a building collapses, killing people, and the law is unclear as to which official was responsible for ensuring the building's structural soundness, then accountability for that accident will either never be attributed or will be attributed on the basis of who is weakest and thus cannot avoid the assessment of responsibility. In this kind of legal tradition, the powerful will always seek a legal regime that is unclear in its attribution of responsibility, for they know that they will be able to defend themselves according to the law of the jungle, i.e. brute strength. The less powerful would prefer clear accountability—all other things being equal—but they are, by definition, less likely to see things develop according to their preferences.

The same thing applies in other contexts, including in the oil and gas sector: the powerful do not want or need clarity in the law according to which licenses are distributed by the state. They will get what they want in other ways and always benefit, or think they will benefit, from ambiguity. They tend to welcome the opportunities presented by lack of clarity because they expect to be able to prevail in times of conflict.

Production sharing agreements

In addition to the licensing processes described above, there is another distinctly different process by which companies can obtain the right to work minerals in Russia. This is through a production-sharing regime, which was adopted in the 1990s at the urging of some western oil and gas companies who sought greater certainty, especially in connection with taxation of their operations.¹⁰ Under production sharing, an agreement is signed between the Russian central government and the company or consortium of companies. Under the Russian production sharing regimes, instead of

¹⁰ The law of the Russian Federation, "On agreements for the sharing of production," went into effect January 1996.

the hundreds of different taxes that may otherwise be levied on oil and gas companies, they are liable to only two (both payable to the central government) and share the resources produced with the state according to the formula established in the agreement. Typically, the companies do not have to share that production until they have recouped their investment in the project, which may be a very long time after production commences. The regional administrations thus do not benefit significantly from projects developed under production sharing regimes until that breakeven point has been reached. And during the period in which they do not benefit, they may still see their burdens increased as more demands are made on the services they provide.

On the one hand, the Russian production sharing regime introduced considerably greater certainty to taxation, and an increase in certainty minimizes conflict and enhances the rule of law. On the other, a clear law that ignores the needs of regional administrations contributes to conflict in a different way. Russia has not yet devised a division of powers between the central and regional governments that can reliably protect regional concerns. Under Yeltsin, federalism in Russia was beginning to take shape, albeit in an often-chaotic fashion. Nevertheless, a distribution of decision-making power was evident, including in the sphere of subsoil resources: both the federal and regional levels of government had to sign off on the issuance of a license.¹¹ But this sharing of authority has disappeared under Putin's reign: now only the federal government need be involved in license issuance and this parallels what has been the case under production sharing.¹²

But real life issues do not go away just because the central authorities decide to withhold power from the regions, leaving them without the means to deal properly with those problems. Instead, the result is an intensification of those problems and thus conflict.

Let us consider an example. Several major oil and gas projects are under development offshore the island of Sakhalin in the Russian far east. The investment required for just one of these projects is estimated at about

11 This was often referred to as the "two-key" approach: it took two signatures to open the licensing door.

12 On the direction in which Putin is taking the country, see Anna Politkovskaya, *Putin's Russia* (London: The Harvill Press, 2004).

US\$20 billion.¹³ And yet Sakhalin has a population of under a million people, almost no infrastructure of any consequence, and a delicate environment, both on- and offshore. The production-sharing agreement, pursuant to which this \$20 billion project is being developed, is of the kind described above: the regional administration receives essentially no benefit from the projects until the payout point has been reached, but even with very high oil and gas prices, this date is still a long way off. The first exports of natural gas, bringing in the first revenues from the project, are scheduled for spring or early summer of 2008.

And yet the huge impacts of this project and the other Sakhalin projects started to be felt years ago and continue to become more pressing. Housing prices have soared as foreigners and Russians from other parts of the country have arrived to work on the projects, but the wages of most people living on Sakhalin have not risen at all. The airport in the major population centre on the island is hopelessly overloaded, but there is no money to expand or replace it. Roads are crumbling under the weight of trucks and other equipment brought in for the project, but no additional revenues are flowing to the regional administration that would permit repair of them. And the list goes on and on. Because the law does not reflect this imbalance, there is constant conflict as the regional administration and other levels of government, whose problems have not been taken into account under the production-sharing arrangement, prove as uncooperative as possible in the hopes of receiving attention they cannot get in the proper way.

There is much more conflict surrounding the Sakhalin projects than can be explained on the basis of the usual tendency of Russian officials to create delays and other obstacles in order to extort bribes. There is genuine anguish over the failure of the Russian federal government to take into account regional needs when negotiating with the companies. Since there is no hope of a remedy from the federal government, local officials try to get what they need from the companies. The same goes for environmentally concerned citizens and indigenous peoples who were also excluded from any kind of role in the process of negotiating the production sharing agreement. So, substantively bad law—law that neglects the legitimate interests of those who should have been participants in the agreement-making process—while it may still be law, invites conflict, indeed almost ensures that there will be conflict of a kind and scale that could have been avoided.

¹³ This is the Sakhalin 2 project. See Sakhalin Energy's website.

Such law does not “rule” in the way that law should because people are forced to resort to conflictual methods to try to ensure that their problems be solved. Without doubt, Russia’s failure as yet to formulate a workable federalism contributes to conflict across the country, including in the oil and gas sector.

Environmental protection

There are laws in Russia aimed at environmental protection, including laws setting maximum levels of dangerous emissions, and sometimes—rarely—these laws are enforced. But it does not matter if they are enforced, because the penalties are very low, so low that it is much cheaper to continue to pollute than it is to pay the fine levied. There is even reason to doubt that compliance was ever intended, as often the permissible level of emissions is so low that the industry in question could not possibly simultaneously operate and meet the legal standard.

But many Russians care passionately about environmental protection. After all, it is the cleanliness of the air they breathe and water they drink that is at stake. So the failure of the state to enact appropriate legislation and—most importantly—to enforce that legislation is a source of constant conflict, typically at the local and regional level. In the centre of Moscow where all real power is once again wielded in Russia, the silting up of a salmon-spawning river on Kamchatka or Sakhalin does not even register. On the ground in the regions across Russia, these are the issues that make or break local life, but in Moscow they just do not matter. Once again, the failure to take law seriously—this time, environmental law—leads to conflict, and the failure to take federalism seriously is at the root of the problem.

ACCESS TO PIPELINES

Some of the more acute conflicts in the Russian oil and gas sector centre around the natural gas monopoly, Gazprom, the majority of whose shares are held by the Russian government. One of the continuing sources of conflict arises from Gazprom’s refusal to allow independent producers of gas, which in total account for 15 percent of the annual production of gas from Russia, access to the export pipelines. Since the domestic prices for natural gas are but a fraction of the world price, it is enormously disadvantageous for independent producers to be denied the opportunity to sell into foreign markets.¹⁴

¹⁴ The independent producers are said to be more efficient than Gazprom, although this may be a case of damning with faint praise, since Gazprom is notoriously inefficient. All the same,

What does all this have to do with the rule of law? The law explicitly provides that Gazprom must allow other companies access to its pipeline network. But as is so often the case in Russia, the law just does not matter—Gazprom merely ignores it and is allowed by the authorities to do so.¹⁵ And so conflict ensues: the law says one thing that is encouraging to the independent producers, but reality dictates another—that they cannot sell into the European market at prices now about four to five times higher than those charged within Russia. Were there no such law, there would be less conflict, because expectations would be lower. But because there is law and it does not rule, conflict abounds.

THE DISMANTLING OF RUSSIA'S LARGEST OIL COMPANY:
THE DESTRUCTION OF YUKOS

Much has been written about the destruction of Yukos, which had become Russia's largest and by many accounts "best" oil company, in the sense of having the most transparent accounting and the most sincere commitment to modernization generally. The dismantling process began in full force in the fall of 2003, after a period of threats from the central government. There is no need, or time here, to tell the whole story. But one cannot write about the rule of law and the Russian oil and gas sector without at least alluding to what happened to Yukos.

The primary tool used to destroy both the leadership of Yukos and the company itself was criminal prosecution for tax evasion. Both the company and individuals from it were assessed billions of dollars for taxes alleged to have been owing, sums so large there was no possibility that they could be paid without the sale of company assets which would cause its demise. Ignoring the reasons behind this move on the part of the central government—which, it seems quite clear, were almost entirely political—and focusing on rule of law issues, two points need to be made. One is this: although for various reasons, including the typically ambiguous character

it is very unfortunate that the efforts of the small, independent producers are allowed to be frustrated. In a comparatively healthy oil and gas industry, such as that of Canada, small producers play key roles in developing deposits that are not of interest to the big companies in their greater dynamism and flexibility, as well as providing more diversity of employment.

¹⁵ It has been said that Gazprom *is* the law, in the sense that it is a separate state within the Russian Federation.

of Russian law, it is impossible to know whether the legal violations asserted by the prosecution actually were what they were alleged to be, apparently reliably informed commentators have said that Yukos was prosecuted under what I will call a “wishful thinking” interpretation of Russian tax laws. The authorities wished that the law had made Yukos’ conduct of its tax affairs—actively taking advantage of opportunities to minimize tax—illegal, and prosecuted them as though this were the case. So Yukos was, for example, roundly reviled for having hired handicapped people only because the law conferred significant tax breaks for doing so. That Yukos was doing what the law explicitly, but perhaps mistakenly (because it had significant unintended consequences) provided for, did not seem to be of import: in the view of the authorities, the company and its principals should not have taken advantage of what was a poorly thought-out provision.

From the western perspective, this approach to prosecution is terrifying: to go to jail for eight years as the former president of Yukos has done on such a basis is unthinkable. But coming from a Soviet past—where a minister of justice, Vyshinsky, once famously said “Give me the man and I will give you the case against him”—it is not. Russians know that when the political tides turn, there is no safe place. Your best chance is to keep your head down and hope that no one notices you. But if you were head of Yukos and determined to be your own man, you were not going to keep your head down. Indeed, just the week before his arrest, Khodorkovsky announced that he was not going to flee the country to avoid a confrontation with the authorities; they were going to have to put him in jail if they wanted to stop him. And in jail is where he has ended up. Do Russians expect the law to protect them? When the issue is a serious one—no. There is a Russian expression that claims that it is better to fall in the path of a bus than to fall in the path of a political campaign. The Russian government under Vladimir Putin was on a campaign to renationalize the oil and gas industry and Khodorkovsky fell in the path of it.

One cannot fail to note the issue of selective prosecution. The publicly available material seems to make clear that if Khodorkovsky and his colleagues were guilty as charged, then so were hundreds if not thousands of others who were never accused. The trial of Khodorkovsky and company was a show trial, fulfilling the same purpose as the notorious show trials of the Stalinist period. The message was: if we can crush him—and we can—we can crush anybody; take note and behave accordingly. The authorities did not have to go after everyone else; they have shown they can destroy at

will, and all the others have fallen into line. But although this may be *realpolitik* in what had been the battle between big oil and the Russian government, from a rule of law perspective the unfairness is palpable. The administration of real justice must be evenhanded. The Yukos affairs tells us, if we still needed telling, that it is far from evenhanded in Russia.

CONCLUSION

The Yukos affair has shown that law does not rule in the Russian oil and gas sector. Fear will keep people in line, to some extent, and thus, as during Soviet times, will work to deter conflict. But in other less dire circumstances, the failure to establish the rule of law in Russia will continue to stoke the fires of conflict. Where lines are not drawn in law, people will keep pushing to protect and advance their interests, transactions will be much more time consuming, uncertain, and tedious, and returns on all forms of investment lower than would otherwise be the case. The importance of establishing the rule of law is not an abstract one; the failure to adhere to the rule of law imposes costs of all kinds and constitutes a significant drag on Russia's development.¹⁶

¹⁶ See the interview with Yevgenny Yasin of the Higher School of Economics in Moscow in *Johnson's Russia List* 42, 14 February 2006, available online.

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