

Emerging State Centralism in the Russian Energy Sector: Precedents from the Gulf

Justin Dargin

Harvard University - Dubai Initiative

Introduction: Russia-GCC Cooperation - The Giants Meet

In February 2007, President Putin made a historic tour of the Arabian Gulf. This visit followed the Moscow visit of King Abdullah, then Crown Prince, in 2003.¹ Officially, the goal of the Russian President's tour was to discuss the many regional and international issues of importance, such as the Iraqi crisis, and the Palestinian-Israeli peace process.² However, other issues came to the fore and illustrated that there was much more at stake in the visit than regional peace-making.

President Putin immediately set about laying the groundwork for a strengthened Gas Exporters Countries Forum (GECF).³ He also reached agreements with the major Gulf Cooperation Council (GCC) members – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates – to defend the global petroleum price, while urging the Gulf leaders to provide enhanced investment opportunities for Russian energy companies.⁴

1. See "Putin Visits Saudi Arabia," MSNBC, February 11, 2007, available at <<http://www.msnbc.msn.com/id/17106519/>>

2. Ibid.

3. Ibid.

4. See Igor Tomberg, "On Vladimir Putin's Arab Middle East Tour," Strategic Culture Foundation, February 26, 2007.

This tour illustrated the potential for cooperation between the two largest energy exporting regions in the world, Russia, through the Commonwealth of Independent States, and the GCC. Putin dispelled any doubts as to the purpose of his visit when he stated that, contrary to popular belief, Russia and Saudi Arabia are not energy rivals, but “in fact, allies and partners.”⁵

The first stop of the Putin tour was in its historical rival in oil production, Saudi Arabia; it was the first time a Russian president had visited any GCC country.⁶ Putin had been cultivating the Saudi Arabians since the May 2003 terror attacks in the Kingdom, initially asserting the commonalities between the two nations in Islamic heritage and the shared threat of Islamic extremism.⁷

Another goal of the Kremlin was to strengthen bilateral economic ties, which proved successful, and Russian exploration companies⁸ Lukoil and Stroytransgaz returned home with exploration and production agreements. Lukoil developed plans to invest \$2 billion in Saudi gas fields.⁹ Further, President Putin hinted that Russia would welcome any Saudi desire to invest in Gazprom and Lukoil, thus leaving the stage open for future cooperation.¹⁰

Russia and Qatar: The Road to a Gas Opec?

After Saudi Arabia, Putin's next stop was in the gas giant, Qatar, and he sought to promote cooperation between Russia, holding the number one position in gas reserves, and Qatar, the leader in LNG production and export. The idea of a more vigorous, slimmed down, version of the GECF, based on the Organization of Petroleum Exporting Countries (OPEC), had been floated by President Putin to Iran and Qatar long before his visit. All three countries have multiple reasons to cooperate in gas production; they hold the top three natural gas reserves, and would conceivably dominate the world gas

5. In fact, Russia had cooperated with OPEC in 2000 to voluntarily restrain production and increase world oil prices. See Juan Carlos Boue, “Will Russia Play Ball with OPEC,” Oxford Energy Comment, January 2004.

6. See Andrew Hammond, “Putin, Saudi King Meet in Landmark Visit,” *The Boston Globe*, February 12, 2007.

7. See Mark A. Smith, “Russia and the Persian Gulf, The Deepening of Moscow's Middle East Policy,” Conflict Studies Research Center, August 2007.

8. Supra note 4, “On Vladimir Putin's Arab Middle East Tour.”

9. See Dr. Robert O. Freeman, *The Putin Visit to Saudi Arabia, Qatar, and Jordan: Business Promotion or Great Power Maneuvering?*, Johnson's Russia List. (February 15, 2007).

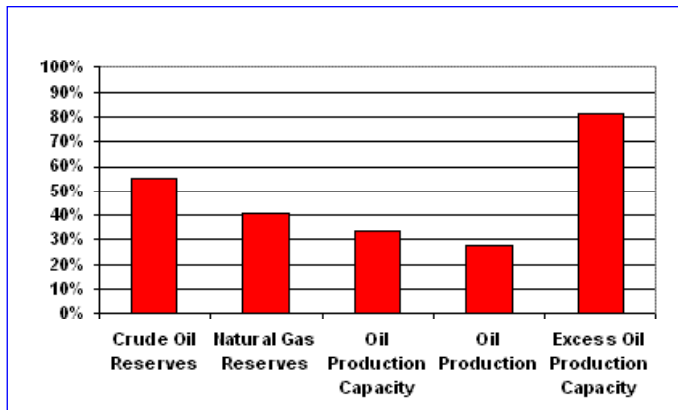
10. Ibid.

market, as collectively they sit on almost 60 percent of the global gas reserves.¹¹

Although Qatar initially played coy and publicly announced that the idea was not viable, on April 9, 2007, the GECF announced that it would form a study group to determine how best to coordinate production and other related issues.¹² The Algerian Minister of Energy and Mines, Chakib Khelil, stated, “[I]n the long term, we are moving towards a gas OPEC.”¹³ However, he added, “It will take a long time.”¹⁴

While Qatar, Iran, and Russia would form the core group, Algeria and Venezuela expressed an initial desire to join as well, which set the gas-consuming West on edge.¹⁵ Putin’s Qatar visit also yielded energy agreements signed between Lukoil and QP for joint ventures in oil and gas exploration.¹⁶

Figure 1: Arabian Gulf as a Percent of World (2006)



Sources: Oil and Gas Journal and EIA Term Energy Outlook

However, before any type of “Gas Opec” could emerge, it would need to develop the fundamentals of a production cartel in order to be effective. Collective production restraint and a “swing producer” able to rapidly match the demand of the market with either increased or decreased production are the necessary prerequisites

11. See Energy Information Administration, Country Analysis Briefs, available at <http://www.eia.doe.gov/emeu/cabs/contents.html>.

12. See “Natural Gas Producers Take Step Toward OPEC-Like Cartel,” *International Herald Tribune*, April 9, 2007.

13. Ibid.

14. Ibid.

15. See Daniel Dombey, “NATO Fears Russian Plans for a Gas Opec,” *Financial Times*, November 14, 2006.

16. See Neil Buckley, “Putin Visits Qatar Amid Talk of ‘Gas Opec,’” *Financial Times*, February 13, 2007.

to be able to influence the global gas market. But natural gas does not have the same characteristics as oil, and it is still difficult to transport it over long distances. Most of the gas exported internationally is transported through regional pipeline networks. If liquefied natural gas becomes more inexpensive and widely used the development of a “Gas Opec” would be much more feasible

Russia and the GCC Energy Picture - A Sharpening Paradigm

Gulf Oil and Gas Production

The Gulf region, which produced 28 percent of the world’s oil in 2006, holds 55 percent of the world’s crude oil reserves or 728 billion barrels.¹⁷ The OECD oil imports from the Gulf countries averaged 10.4 billion barrels per day (bbl/d), and its overall crude oil production was 23.6 million bbl/d in 2006. Spare capacity in the region was 25.4 million bbl/d at the end of 2006, which equalled 33 percent of the global total.¹⁸ In addition to vast reserves of petroleum, the Arabian Gulf contains 2,509 trillion cubic feet (TCF) of natural gas, which is about 41 percent of the total proven world gas reserves (as seen from Fig. 1 above).¹⁹ As illustrated by Fig. 2 below, Qatar, Saudi Arabia, and the United Arab Emirates hold the world’s third, fourth and fifth largest reserves, respectively and Russia is number one globally.²⁰

Russian Energy Production

Russia is a major oil and gas exporter vying with Saudi Arabia annually to be the foremost global oil exporter.²¹ According to the respected Oil and Gas Journal, Russia holds proven oil reserves of 60 billion barrels, most of which are located in the Western Siberia region, between the Ural Mountains and the central Siberian Plateau.²²

17. In this energy outlook, the Gulf region is taken as a whole including Bahrain, Iraq, Iran, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates. See *Country Analysis Brief: the Persian Gulf*, Energy Information Administration, available at http://www.eia.doe.gov/emeu/cabs/Persian_Gulf/Background.html

18. Ibid.

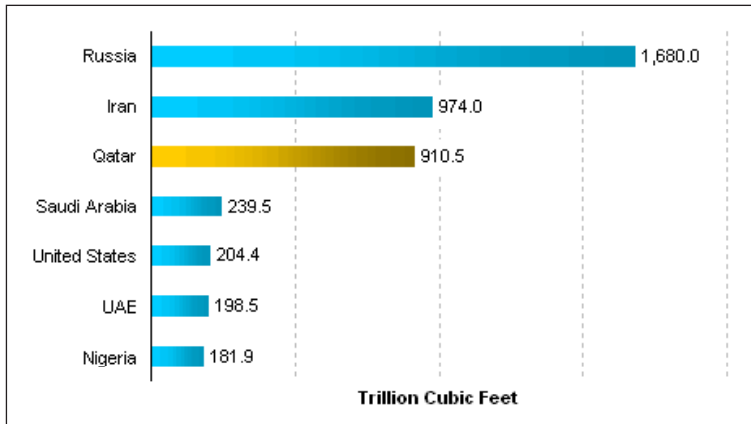
19. Ibid.

20. Ibid.

21. Periodically the two countries switch roles, with Saudi Arabia being in the forefront, or as is the case currently, Russia in the forefront. See Andrew Osborn, “Russia Oil Production Overtakes Saudi Arabia,” *The New Zealand Herald*, August 23, 2006.

22. See *Country Analysis Brief: Russia*, Energy Information Administration, available at <http://www.eia.doe.gov/emeu/cabs/Russia/Oil.html>.

Figure 2: Top Proven Natural Gas Reserves, Jan. 1, 2007



Source: Oil & Gas Journal, Jan. 1, 2007

In the 1980s, Siberian oil production made Russia a dominant producer, peaking at 12.5 million barrels per day (b/d), in 1988.²³

However, oil production dropped to 6 million b/d²⁴ during the final years of the Soviet Union and in the transition period immediately following.²⁵ Russia's oil field production rebounded from the low period of 1998-1999, when financial crisis rocked a country that was already struggling to regain its footing after the chaotic fallout from neoliberal reform.

However, privatization and the newly adopted international best practices by some of Russia's private oil and gas companies (notably Yukos) precipitated a more technology-driven oil production, and encouraged best oil field operational practices which helped to increase oil and gas production.²⁶ In spite of these projects, meteoric oil prices and the rejuvenation of mature fields contributed the most significant boost to increased production.

Russian Gas Outlook

Russia's vast gas reserves are the key to its true geopolitical potential.²⁷ With the

23. Ibid.

24. Although many industry analysts think that Russia's decline is not just attributable to the political collapse of the Soviet Union as an entity, but to poor oil field management practices catching up. See *Country Analysis Brief: Russia*, Energy Information Administration, available at http://www.eia.doe.gov/emeu/cabs/Persian_Gulf/Background.html.

25. Ibid.

26. Ibid.

27. It has been analogized that if nuclear weapons formed the core of the Soviet Union's power, then

world's largest natural gas reserves,²⁸ Russia is also the largest natural gas exporter, with an extensive gas pipeline network to Western Europe.²⁹ The state-run gas monopoly, Gazprom, produces approximately 90 percent of Russia's natural gas, preserving the majority of it for export.³⁰ Russian gas exports travel through an extensive pipeline network stretching throughout the EU, and comprise 25 percent of the EU's imports, which creates a co-dependent environment for both consumer and producer.³¹

Because Russia's current economic boom is connected to the rising global commodity prices, especially of oil and gas, energy reserves naturally figure prominently in its foreign policy stance.³² Oil revenue accounts for 20 percent of the Russian GDP, nearly 60 percent of its export revenue, and more than 40 percent of the government's fiscal revenue.³³ The utilization and monetization of Russia's vast energy resources stands at the forefront of Russian economic planning, and the administration is developing a coherent strategy to more equitably redistribute the proceeds to the populace.³⁴

GCC Energy Policy

The energy policy of the GCC differs in form, if not in content, from the state consolidation that marks the Russian energy sector. Before the GCC was formed in 1981, the Gulf countries' pursuit of nationalization of their oil industry had little viability. This changed in the 1960s 'OPEC revolution,' when the Gulf nations renegotiated, partially expropriated, or bought out the foreign international oil companies (IOCs).

the Russian elite view the vast energy resources at the crux of Russia's newfound might. See Liam Fox, "Energy: The New Cold War," *The Sunday Times*, July 15, 2007.

28. The proven reserves are at 1,680 trillion cubic feet.

29. Ibid.

30. See supra note 24, Energy Information Administration.

31. Ibid.

32. See Simon Marks, "Russia's Economic Boom Strengthens President Putin's Government," PBS Online News, December 22, 2006, available at http://www.pbs.org/newshour/bb/europe/july-dec06/russiaenergy_12-22.html.

33. See Kevin C. Smith, "Russian Energy Politics in the Baltics, Poland, and Ukraine: A New Stealth Imperialism?" *The Center for Strategic and International Studies*, January 10, 2005.

34. One of the forms of redistribution that the government is attempting is the regional regasification project which was developed to bring gas resources to the underserved regional industrial and private consumers. See "Kovykta Regional Gasification Project Gets New Momentum as Regional Gasification of Russia," TNK-BP website, April 7, 2006.

For the most part, the Gulf countries instituted a policy of energy nationalization and expanding state control that responded to the West's sensibilities by conducting 'phased buyouts' of the IOCs' equity stakes.³⁵ A chief aim of the Gulf States was to forge good relationships between the nascent National Oil Companies (NOCs) and the foreign IOCs.³⁶ The Gulf States realized that they lacked the technical expertise, established downstream markets, and, in many cases, financial capital, to be able to maximize production from their oil reserves.³⁷

From Arab Nationalism to Oil Nationalization

The impetus behind the Gulf States' drive to nationalize their oil reserves was intimately connected with the philosophical underpinnings of Arab nationalism, which itself echoed the broader movement of Third World solidarity and anti-colonialism.³⁸ Ironically, OPEC's birth in 1960 dealt a blow to the Arab nationalist agenda of redistribution of Gulf oil wealth to their poorer [non-producing] brethren. As the Arab nationalists soon discovered, OPEC served to align Arab oil-producing nations with non-Arab oil-producing nations (Venezuela, Nigeria, Indonesia, and later, Gabon and Ecuador) for increased leverage in the international oil market; in other words, it was strictly a "gentleman's" club.³⁹ Any analysis of the GCC energy policy and state empowerment should be understood within the context of the "OPEC revolution."⁴⁰

The Gulf nations sought reform of the hated concession system in operation during the pre-WWII era of oil exploration and production in the Gulf. A concession, which was a legal right granted to IOCs, generally lasted for several decades, and bestowed the IOC with ownership and production rights of the subsurface minerals in a specified area. In practice, however, the concession generally extended over the entire oil-producing nation.⁴¹

35. See Frank Church, *The Impotence of Oil Companies*, Foreign Policy, no. 27 (Summer 1977): 27-51.

36. Ibid.

37. See Irvine H. Anderson, "Aramco, the United States, and Saudi Arabia: A Study of the Dynamics of Foreign Oil Policy, 1933-1950," *Reviews in American History* 10, no. 2 (June 1982): 259-264.

38. Gamal Abd-Nasser saw petroleum as the "vital nerve of civilization" and the key to unlocking the economic potential of the Arabs. See Gamal Abd al-Nasser, *Philosophy of the Revolution* (Buffalo, N.Y.: Smith, Keynes and Marshall, 1959), 61.

39. See Ian Seymour, *OPEC Instrument of Change* (Macmillan Press, 1980).

40. It should be noted that OPEC is not necessarily coextensive with the GCC, OPEC as an organization has aims that although they may coincide with the GCC, are not necessarily simpatico with it. However, in terms of this analysis, it is useful to see the rise of the Gulf oil states through the OPEC lens.

41. The concession system resulted in a number of problems between the GCC nations and the IOCs

Concession rights allowed IOCs the right to control pricing and production decisions, and granted the host government the right to a certain percentage of the differential between the production cost and the price of crude oil.⁴² However, as the Gulf rulers soon discovered, the concession system indirectly gave the IOCs control over the host government's budget, and, to a large extent, dictated its form of governance.⁴³ This ability to determine domestic and foreign policy gave the IOCs enormous power which led the Gulf States to seek renegotiation of the prevailing structure.⁴⁴

Stumbling towards State Participation

When the Gulf States first attempted to exercise control over their energy resources, they began with a mix of tax/royalty increases, price increases, and a return to the host state of unused concessions, and then, with increased boldness, demanded increased portions of used concessions.

Energy nationalization in the Gulf generally resulted in an amicable split or buyout, where the IOCs negotiated a mutually-agreed upon sale price for their equity shares.⁴⁵ Even though the Gulf States were relatively sensitive to the IOCs, the latter initially fought the host states' increasing power.⁴⁶ After the IOCs concluded that the process was inevitable and irreversible, they sought to secure the most favorable leverage for later negotiations.

IOCs in the Gulf region were never as antagonized as in other oil-producing

operating there: the level of production, the components of the cost of production, the hiring of nationals, the relinquishment of underutilized concession areas, and the price of crude oil. See Abbas Al Nasrawi, *OPEC in a Changing World Economy* (John Hopkins University Press, 1985). Dr. George Stocking commenting on the main features of the concession system wrote that "never in modern times have governments granted so much to so few for so long." See George W. Stocking, "The Economics of Basing Point System," *Law and Contemporary Problems* 15, no. 2 (1950): 159-180.

42. In most of the original Middle Eastern concession agreements, payments to the host governments were set at a fixed royalty, which at the time was equal to around 22 cents a barrel. See *supra* note 40, *OPEC Instrument of Change*, 13.

43. As King Abd' Al Aziz's personal advisor, the British H. St. John Philby quoted from the King during the great depression, "If anyone offers me a million pounds now, he would be welcome to all of the concessions he wants in my country." See Robert Lacey, *The Kingdom: Arabia and the House of Saud* (New York: Avon Books, 1981), 229.

44. See Howard Lax, *Political Risk in the International Oil and Gas Industry* (Atlantis, Inc., 1984).

45. See Theodore H. Moran, "Managing an Oligopoly of Would-Be Sovereigns," *International Organizations* 41, no. 4. (Autumn 1987): 575-607.

46. *Ibid.*

regions where there were more contentious ‘divorces.’ As the oil-producing nations gathered strength for more state control of their oil operations, OPEC experienced a philosophical split, which became a conduit for increased state participation. Saudi Arabia headed the moderate camp, which included Kuwait, UAE, and Qatar, and sought to negotiate with the concessionaires for increased participation rights and equity shares.⁴⁷ The second group, made up of the more radical wing, the “Rejectionist Front,” most notably Algeria, Libya, and Iraq (Iran was sometimes in this group), sought immediate nationalization, albeit on an incremental basis.⁴⁸ Doing away with the concessions was the ultimate goal, and OPEC was the vehicle, through which the Gulf States exercised individual state control over critical energy resources.

Role of the State in the GCC Energy Sector

As former colonies, the Gulf States’ increased control of the energy sector provided a different context than it did in Russia. Russia, having travelled the opposite course, started the early 20th century with total state control of natural resources, and then turned to rapid privatization.

Because the Gulf governments gained access to enormous sums of wealth without domestic taxation, state centralism was inextricably linked to the inflow of revenue from oil and gas sales on the international market directly into state coffers. With resource inflows, enormous power was funnelled and concentrated through the state apparatus, which then determined how to distribute the money in society.⁴⁹

In the GCC, the state owns the bulk of the industrial sector, although there may be minority joint ventures with Western companies. The GCC states structured their respective National Oil Companies (NOCs) to function as levers through

47. See supra note 40, *OPEC Instrument of Change*.

48. See Nathan J. Citno, *From Arab Nationalism to OPEC* (Citno Press, 2002). The Shah of Iran, a staunch American ally at the time, expressed the popular outrage at what the OPEC nations viewed as exploitation by the West: “Of course [the world price of oil] is going to rise,” the Shah told the *New York Times* in 1973. “Certainly! And how...; You [Western nations] increased the price of wheat you sell us by 300%, and the same for sugar and cement...; You buy our crude oil and sell it back to us, refined as petrochemicals, at a hundred times the price you’ve paid to us...; It’s only fair that, from now on, you should pay more for oil. Let’s say 10 times more.” See Walter LaFeber, *Russia, America, and the Cold War* (New York, 2002), 292.

49. The issue of taxation and the state independence in decision making will be explored in detail later. However, it is worth mentioning, that as opposed to many Western countries where the power to tax is considered to give citizens a stake in the political process, the lack of taxation thus makes citizens dependent on state largesse.

which the state exercised authority in the energy sector.⁵⁰ None of the GCC states outright nationalized the Western IOCs in their respective territories, as did other governments in the Middle East. Nationalization was an amicable and gradual process, which encouraged the IOCs to remain and provide technical assistance and consulting services. Even today, many Western expatriates sit on the governing boards or hold executive positions in these NOCs.⁵¹

However, Saudi Arabia was one of the first GCC nations to recognize the danger of economic dependence on a single commodity.⁵² Thus Saudi Arabia initiated a process of economic diversification, as reflected in the Saudi Arabian Basic Industries Corporation (SABIC), to penetrate more deeply into the downstream petroleum value chain. The other GCC states then followed, either in using their tremendous wealth to build diversified portfolios overseas or by branching out into natural gas production.

The GCC governments used oil wealth as a springboard into other industrial sectors to set a foundation for enhanced expansion.⁵³ The confluence between individuals of the ruling hierarchy and the state is significant; before a private sector project may succeed, the owners often need personal access to the decision-makers.⁵⁴

The 1973 oil embargo was not only in large part responsible for the enormous growth in the state apparatus in most of the Gulf States, but it provided the wherewithal for the state to stake out a dominating position in other economic sectors.⁵⁵ The transfer of wealth from Northern-tier states to the South during the OAPEC oil embargo was the largest in modern times.⁵⁶ One of the most profound

50. And sometimes, as is the case of Aramco, they can be considered miniature states within states.

51. Saudi Arabia's Aramco, for example, has about 2,000 American employees, called "Aramcons," and English is the official working language. However, pressure has been building for the company to "Saudiize" the workforce. Further, out of a total population of 24 million, about six million are foreign workers from Asia who perform service jobs. See "Saudi Aramco Is Not a State Within a State," *Alexander's Gas and Oil Connection* 9, issue #7 (April 7, 2004)

52. See Helen Chapin Metz, ed. *Saudi Arabia: A Country Study* (Washington: GPO for the Library of Congress, 1992).

53. The presence of the state differs in each GCC country, but it can be said that almost all financial and industrial concerns have an active government presence.

54. Middle East expert Jill Crystal noted that in the cases of Kuwait and Qatar, the major merchant families have worked hard to place their members in powerful positions in the state bureaucracy. See Jill Crystal, *Oil and Politics in the Gulf* (Cambridge: Middle East Library, 1995).

55. This can be most clearly seen in the extensive welfare state that has appeared after 1973 in the GCC. Many GCC citizens have an active need to see the dominance of the state, if they want to have the continuance of their benefits.

56. Before 1973, the flow of global capital was generally an outflow from the oil-producing Gulf

effects of state dominance in the Gulf has been the marginalization of historically powerful social groups that traditionally balanced the ruler's power.⁵⁷ Post-1973 saw the traditionally influential social groups such as merchants, tribes, religious scholars, and labor hampered with seriously reduced bargaining power.⁵⁸

While the oil revenue bypasses the local economy and comes directly into the state coffers, corporate suitors must remain on good terms with the state or ruling families for preferred distribution of oil rents. The GCC states built ever-increasing bureaucracies to distribute rents to society and control political expression, while Russia promoted redistribution generally through the demand side, with its regional regasification program to bring energy to rural areas.

The GCC expression of state centralism appears as an edifice of the state built around the ruling families, which makes all the important decisions. Because the political/socioeconomic groups that traditionally controlled power in the pre-industrialized Gulf societies had been severely constrained, GCC states have attempted to build new socio-economic groups with interests intimately tied to the state.⁵⁹ The costs of opposing the state are crippling, since the state has at its disposal economic levers sufficient to discipline any firm or group thought disloyal. Firms that oppose government procedures would likely find the costs inconceivable.⁶⁰

GCC states generally take a conservative line *vis-a-vis* the international energy market. Since the state owns all subsurface minerals,⁶¹ the GCC nations are

States, but after the oil embargo, the flow reversed and the oil-producing countries acquired vast wealth. See Hammes, David and Douglas Wills, "Black Gold: The End of Bretton Woods and the Oil-Price Shocks of the 1970s," *The Independent Review* IX, no. 4 (Spring 2005): 501-511. Further, after the shocks of the 1973 embargo, and the 1979 Iranian revolution, the price of oil in the early 1980s was 10 times higher than in the pre-1973 period. See Jad Mouawad, *Oil Prices Pass Record Set in 80s but Then Recede*, *The New York Times* (March 3, 2008)

57. See Lewis W. Snider, "Comparing the Strength of Nations: The Arab Gulf States and Political Change," *Comparative Politics* 20, no. 4 (July 1988): 461-484.

58. Ibid.

59. In Saudi Arabia after the oil boom built up, a new commercial class coming from the Central (Najd) region of Saudi Arabia acted as a counter-balancing force of the more traditional commercial elites from Hejaz (the Western Area of the kingdom) as well from Al-Ahsa (the Gulf Coast). See Chaudry, *The Price of Wealth* (Cornell University Press, June 1997).

60. See F. Gregory Gause III, *Oil Monarchies' Domestic Security Challenges in the Arab Gulf States*, (New York: Council on Foreign Relations Press, 1994).

61. For example, Saudi Arabia completed the nationalization of its upstream energy sector in 1973, the only exception being a Japanese investment through the Arabian Oil Corporation in the Neutral Zone, a shared area between Kuwait and Saudi Arabia. See Philip Robins, "Slow, Slow

generally content to provide a comfortable atmosphere for IOCs in tightly monitored spheres, to serve as technical consultants or in limited oil field maintenance roles.

The GCC nations take their role as reliable producers quite seriously, and apart from the 1973 oil embargo, seek to depoliticize oil production for manifold reasons that include foreign policy concerns, principally a desire to connect themselves politically with the US and West. Even though the 1973 oil embargo initiated an enormous currency shift in the international financial markets, the GCC nations remained wedded to the West through GCC import demand for finished Western goods, enormous financial investments, “recycling” of petrodollars in the West, and by massive weapons purchases from the US and the EU.⁶²

Since the 1960s, Gulf nations have feared both Iraq and Iran due to their perceived geopolitical ambitions. After the British forces officially withdrew to east of the Sinai in 1971, the security-conscious Gulf nations sought to shelter themselves under the American security umbrella.⁶³ The Gulf nations hesitated before nationalization, firstly, because they believed they needed the IOC’s access to technology and the downstream market system, and secondly, because they were fully aware of the punishment meted out to Mexico as one of the first developing nations to nationalize Western oil companies.⁶⁴

The Current Investment Environment for IOCs

After the GCC states successfully negotiated with the IOCs to deconstruct the concession framework and obtain total equity holdings over oil resources, state

Quick, Quick, Slow: Saudi Arabia’s ‘Gas Initiative,’ *Energy Policy* 32 (2004): 321.

62. See Richard F. Grimmett, “Conventional Arms Transfers to Developing Nations. 1996–2003,” *DISAM Journal* (Fall 2004). Further, President Bush proposed to the US Congress to structure an arms sale to Saudi Arabia worth approximately \$20 billion. See “US Plans Huge Saudi Arms Sale,” BBC News, July 28, 2007.

63. This process speeded up with the Iranian revolution in 1979 and the Iran–Iraq war which put in danger GCC oil exports in the Strait of Hormuz. See Harold Lee Wise, *Inside the Danger Zone: The US Military in the Persian Gulf 1987–1988* (May 2007). For a detailed analysis of the beginnings of US and Saudi petro-diplomacy and the intersection of security guarantees, see Daniel Yergin, *The Prize: The Epic Quest for Oil, Money and Power* (Free Press, 1991).

64. Aramco, the Saudi Arabian national oil company, employs many Americans in its production capacity, as well as in numerous consultation jobs. Further, the GCC nations did not want the same result as occurred with Mexico and Iran’s enforced nationalization of the oil sector, which led to their oil being quarantined by the international oil system. For a detailed history of the National Oil Company, see Valarie Marcel and John Vincent Michel, *Oil Titans, National Oil Companies in the Middle East* (Brookings Institute Press, 2006).

control was implemented through their respective NOCs.⁶⁵ Yet, several factors upset the initial expansion of the state monopoly and foreshadowed the return of the IOCs. One of the most devastating crises for the GCC nations was the infamous 1985-86 oil glut in which the price of crude, which then averaged \$27, fell dramatically below \$10 within the space of a year.⁶⁶ This precipitous drop of international oil price substantially reduced the budgetary inflows of the GCC states⁶⁷ and set the stage for subsequent expanded opportunities for the IOCs in the Gulf.

This crisis persisted intermittently until early 1999, when the oil market began to revive. Because most petro-states are not sufficiently diversified to survive a prolonged slump in their main revenue source, many lacked the financial strength to maintain their current production, leave alone increase capacity.⁶⁸ What also exacerbated the situation is that many GCC nations lacked the latest oil field technology and skilled human resources.⁶⁹ These factors led to the early push for many oil-producing nations to amend their legal regimes to allow more IOC participation in the upstream sector and reduced the state's hold on the energy sector.⁷⁰

The "rejectionist wing" that initially took a more radical line in negotiations with the IOCs paid dearly for their early expropriation efforts. The more hard-line oil producing states, when faced with rapidly declining federal revenue during the crisis, had to implement more radical liberalization programs to encourage Foreign Direct Investment (FDI) than did the GCC states.⁷¹ As the GCC states never completely exiled the IOCs, they were not unofficially severed from the international capital market or subjected to international economic sanctions.

65. Ibid.

66. See M.A. Adelman, "The Real Oil Problem," *Regulation* 27, no. 1 (Spring 2004): 16-21. One view of the cause of the glut was that Saudi Arabia, at the behest of the Reagan administration, rapidly increased oil output to decrease the international price of oil in order to deprive the Soviet Union of crucial foreign currency inflows. For an expanded discussion on that viewpoint, see Peter Schweitzer, *Victory* (Atlantic Monthly Press, 1996).

67. For a detailed discussion of the ramifications of the price drop, see *OPEC and the World Oil Market: The Genesis of the 1986 Price Crisis*, Oxford Energy Seminar (ed. By Robert Mabro) (1986)

68. Ibid.

69. See Gawdat Bahgat, "Foreign Investment in Saudi Arabia's Energy Sector," *Middle East Economic Survey* XLVII, no. 34 (August 23, 2004).

70. Although these factors only apply partially to Saudi Aramco, as when the oil prices stabilized in late 1999, it was under less restraint to seek funding of its oil resources.

71. The states that undertook large-scale liberalization of their oil sectors were Algeria, Indonesia, Iran, and Venezuela. And as a result, they had to formulate more attractive offerings than the GCC states.

With greater access to Western technology, manpower, and expertise, the GCC states were able to weather the economic storm. In economic parlance, the GCC states were the “low absorbers” of the oil-producing countries. “Low absorbers” are oil-producing states that have small populations and an insignificant industrial base and are not able to utilize productively most of their oil export revenue.⁷² While the “low absorbers” experienced economic vertigo during the price collapse, they were not in as precarious a position as the OPEC nations that had large populations and many competing demands on oil revenue, and were known as the “high absorbers.”⁷³

The oil crisis of 1985-1986 diminished funding for the high absorbers’ federal budgets and led to economic chaos.⁷⁴ While they faced financial difficulties, the GCC states never required a wholesale restructuring of their energy legal framework, as in Russia’s neoliberal reform or Venezuela’s *apertura* (the opening).⁷⁵

The Politics of Natural Gas Production

However, the natural gas market significantly differs from the petroleum market, and these differences have compelled the GCC nations to open up their markets more drastically than would be possible with the upstream oil sector. The need to open markets and attract IOCs is because natural gas development requires substantial capital investment for distribution and export facilities, which include liquefaction units, gas processing plants and/or pipelines. The substantial capital costs and long lead times before a project comes on line means that it will require a period of time before investments generate profit. Some of the relatively less wealthy GCC members, Qatar and Oman, accessed the international capital market, and presented extremely attractive tenders to IOCs.⁷⁶

The GCC states implemented their gas development programs as tools to diversify their economic base, and to fulfil their ever-increasing natural gas demand for desalination projects, industrial power use, and electricity. Because they lacked experience in producing their vast natural gas holdings, the GCC states contracted

72. For a detailed discussion on the concept of “low” and “high” absorbers, see Richard P. Mattione, *OPEC’s Investments and the International Financial System* (Washington D.C.: The Brookings Institute, 1985).

73. Ibid.

74. See Mohammed E. Ahrari, *OPEC and the Hyperpluralism of the Oil Market in the 1980s* (Royal Institute of International Affairs, 1985).

75. See Faeed Mohamedi, “Oil, Gas and the Future of Arab Gulf Countries,” *Middle East Report*, July-September 1997.

76. See Special Supplement: “Qatar – Enjoying its Power,” *The Banker Journal*, May 01, 2005.

foreign IOCs to assist with the process, providing lucrative contractual arrangements to encourage the process.

The UAE was the first of the GCC states to grant foreign gas companies a tender to build its Liquefied Natural Gas (LNG) facilities in the 1970s.⁷⁷ This was almost immediately followed by Qatar's North Field project in the early 1980s and the rapid expansion of its LNG infrastructure in the mid-1990s.⁷⁸ Shell was granted opportunities to construct LNG facilities in Oman, while Yemen – which is seeking GCC membership – is working closely with Total to establish LNG export infrastructure.⁷⁹

Saudi Arabia perhaps caught the world by surprise when it announced the Saudi Gas Initiative (SGI). The then Crown Prince Abdullah met personally with and sought to persuade top executives from US oil companies in 1998 to invest in the country's lagging natural gas sector.⁸⁰ This agreement would have been the first reopening of the Saudi energy sector to foreign IOCs since the 1970s. However, the two sides failed to come to agreement, and in June 2003, Saudi Oil Minister Ali Al-Naimi dismissed the negotiations and offered another round of bids with extremely reduced rates of return.⁸¹

What is significant about the second round of bidding is that non-US companies were favored, with Chinese and Russian energy companies being in the forefront.⁸² The modified tender process perhaps signalled a shift in Saudi Arabian political orientation, or at the very least it may have sought to prove to the West that Saudi assets are still an attractive enough proposition for other suitors.⁸³

Rent-seeking behavior in the energy sector is usually cyclical; when energy prices are elevated, the oil- and gas-producing states generally attempt to renegotiate the legal/tax regime to gain increased rent.⁸⁴ When the international

77. Ibid.

78. See "Persian Gulf Oil and Gas Exports Fact Sheet," *Country Analysis Briefs*, Energy Information Agency, April 2003, available at http://www.parstimes.com/library/persian_gulf_doe_2003.pdf.

79. Ibid.

80. This meeting initially led to the signing of an agreement in 2001 between the Saudi leadership and eight IOCs, most of them American.

81. See *supra* note 62, "Slow, Slow Quick, Quick, Slow: Saudi Arabia's Gas Initiative."

82. Ibid.

83. See Simon Romero, "Saudi Arabia, Foreign Concerns Make Deals to Search for Gas," *New York Times*, March 7, 2004.

84. For a detailed study of rent seeking in the oil industry, see Cyrus Bina, "The Laws of Economic Rent and Property: Application to the Oil Industry," *American Journal of Economics and Sociology* 51, no. 2 (April 1992): 187-203.

oil and gas prices are low, these states tend to offer attractive rates to secure FDI in lagging production and to enhance government revenue.⁸⁵ However, the advent of gas as a global bridge fuel has upset the traditional equation. Even in an elevated price environment, the GCC states generally lack technical expertise for development of gas reserves which causes them to turn to the IOCs for assistance and investment.⁸⁶

Russia faces many of the same issues with exploitation of its hard-to-produce gas reserves i.e. Shtokman field, Sakhalin One and Two. However, the national energy giant, Gazprom, has more significant expertise in domestic gas production and, thus, is not overly dependent on the IOCs for developmental assistance for easy-to-tap gas fields.⁸⁷ Additionally, the GCC and Russia wish to be integrated into the international financial system, for example, the WTO, and this may compel liberalization of their formerly closed energy sector.⁸⁸

The Re-emergence of the State Hand

“The Question of Russia, in all respects, is without doubt the only really worldwide question of our time.”

(A.S. Khomyakov, in a letter to Samarin, June 23, 1845)⁸⁹

Russia has had a long history of state direction and control of its energy industry. For brief periods during the 20th century, it experimented with privatization of its energy industry and an open environment for foreign direct investment. However, most of the Russian energy sector has remained under the firm and unwavering guidance of the state for the major part of the past century.⁹⁰

85. Ibid.

86. See *Persian Gulf States: Country Studies*, Library of Congress Online: Country Studies Program, available at <http://www.country-studies.com>.

87. See Bernard A. Gelb, *Russia Oil and Gas Challenges*, CRS Report for Congress, Congressional Research Service, January 3, 2006.

88. The WTO requirements have progressively focused more attention on the energy sectors of oil- and gas-producing nations. The ascension requirements are forcing many aspiring entrants to the WTO to liberalize their energy sectors and open it up to market competition. However, there has been understandable resistance from oil- and gas-producing countries towards this shift. See Meyer-Reumann Legal Consultancy, “The Endeavors of Gulf Countries to Meet WTO Requirements,” *Arab Law Quarterly* 16, no. 1 (2001): 49-54.

89. Quotation supplied from Hans Kohn, “The Permanent Mission: An Essay on Russia,” *The Review of Politics* 10, no. 3. (July 1948): 267-289.

90. The industry was under the control of the Soviet Ministry of Oil.

Even though the Soviet Empire has vanished, many Russians yearn for the glory days of Russia's historical political/social influence, and the state's pre-eminence in matters of importance.⁹¹ While many Russians were pleased at the dissolution of the ideological aspects of the empire, such as the enforced adherence to Marxist-Leninist ideology, the loss of international prestige led to apprehension about Russia's place in the yet undefined 'New World Order.'⁹² The psychological trauma of a lost empire and the yearnings of a vulnerable people cannot be discounted in an analysis of popular support for the state's control over energy resources.⁹³

Russian resource nationalism is intimately connected with the more basic form of nationalism and the creation of a national identity.⁹⁴ The current movement towards state dominance in energy affairs is not anomalous when viewed through the peculiar lenses of Russian history. Unlike the West European nations, Russia was an empire long before it had a national identity.⁹⁵ The concept of an orderly empire in the Russian mind required a strong titular head, without which the periphery would slip away.⁹⁶

The beginning of the 21st century saw the Russian state becoming more assertive in most affairs, but in particular, in the management of its energy resources. The

91. The attitudes relate to Russians living in the now national boundaries of Russia, and perhaps the more extreme views of the 25.2 million Russians who at a stroke of a pen became minority members of the now 14 independent states. See Timothy Heleniak, "Migration of the Russian Diaspora after the Break-Up of the Soviet Union," *Journal of International Affairs*, March 22, 2004.

92. See Sergei Medvedev, "Conspiracy Theory in the Construction in the New Russian Identity," CEEISA 4th Convention Tartu, June 25-27, 2006.

93. In February 2004, President Putin stated that the collapse of the Soviet Union was a 'national tragedy of enormous scale.' This statement tends to reflect the prevalent mood of the populace. See, "Putin Says Collapse of the USSR National Tragedy," Interfax, February 12, 2004.

94. There has been a phenomenal growth in Russia of nationalistic parties; the 2003 election results showed that the populist aspect of resource control by the State in a public trustee position for the people proved to be a popular bid. The program of the neo-nationalists is not that different from the communist parties when it comes to the ownership of the mineral resources. See Marshall L. Goldman, "Putin and the Oligarchs," *Foreign Affairs* (November/December 2004).

95. See where, "[R]ussia has been a state-nation rather than a nation-state... identity has been centered on the state, which became an empire long before the population consolidated as a nation." See Paul A. Goble, "Regions, Republics, and Russian Reform: Center-Periphery Relations in the Russian Federation," in *The Successor States to the USSR*, ed. John W. Blaney (Washington: Congressional Quarterly, 1995), 163.

96. For a comprehensive study on how Russia's extensive borderlands shaped its national personality, see Joseph L. Weiczynski, *The Russian Frontier: The Impact of Borderlands upon the Course of Early Russian History* (University Press of Virginia, 1976).

state's re-involvement in the energy sector and other "strategic" sectors has garnered most of the attention in the international market.⁹⁷ However, private sector activity in "non-strategic" sectors, such as housing, consumer goods, and retail has been increasing significantly as well.⁹⁸ It is evident that private investment in certain sectors of the Russian economy will either remain outside of the scope of FDI or subject to strict criteria.

Instead of nationalizing energy assets outright, the primary restructuring of the Russian energy sector occurs through increased control over gas and oil export networks, and through granting enhanced production and asset acquisition opportunities to national industry leaders such as Rosneft and Gazprom in which the state owns a majority equity interest.⁹⁹

Does Russia Mean Business?

The Russian state's consolidation of the energy industry differs from the Soviet method, in that while the federal government is increasingly exercising control, the energy companies are predicated on the profit motive.¹⁰⁰ Amid high-profile Russian renegotiations and buyouts of previously privately held companies, the foreign press has remained largely critical of the growing state intervention in the economy.¹⁰¹ Besides, there has been domestic criticism in Russia alleging aggressive state expansion and a roll-back of the nascent democracy.¹⁰²

The Yeltsin-era saw state energy appendages sold off with amazing rapidity.¹⁰³

97. A designation of strategic sector in Russian law limits foreign investment in that particular industry. See Marat Terterov, *Business and Investment Review: The Russian Investment Climate under Putin's Second Term* (GMB Publishing, 2005).

98. Ibid.

99. The Russian state has reallocated development and exploration opportunities on a discretionary basis giving rights to the national giants, Rosneft and Gazprom.

100. See a general theory of state capitalism in Walter E. Grinder and John Hagel III, "Towards a Theory of State Capitalism: Ultimate Decision making and Class Structure," *Journal of Libertarian Studies* 1 no. 1, 59-79.

101. For an example of the more strident opinions outside of Russia, see Ariel Cohen, "Russia: Kremlin Takeover of the Russian Oil Industry," *Capitalism Magazine*, April 21, 2005.

102. Former economic advisor to President Putin, Andrei Illarionov, resigned in protest against what he alleged were the cronyism and the increasing state role in the private sector. After his resignation he increasingly spoke out against the cult of personality and the state adulation that was occurring in Russia. See Andrei Illarionov, "When the State Means Business," *International Herald Tribune*, January 25, 2006.

103. Post Soviet economic restructuring encompassed three principles: (1) Liberalization, (2) Privatization, and, (3) Stabilization. All three were founded on neo-liberal principles, otherwise

In the controversial “loans for shares” program, the Yeltsin government auctioned substantial packages of stock shares in the most desirable industries, especially energy, as collateral for bank loans.¹⁰⁴ Intrepid entrepreneurs, often with stealthy business practices, acquired mammoth financial power.¹⁰⁵ The “loans for shares” period nurtured the meteoric rise of the Oligarchs, whom the state implicitly supported.¹⁰⁶

The nascent capitalists used the state as a vessel for their unrelenting pursuit of economic interests and leveraged their contacts with government officials to secure the control over the most lucrative state enterprises.¹⁰⁷ The state facilitated hostile takeovers, which further stripped assets from state enterprises. This private sector/state relationship formed a neo-patrimonial capitalism, which is classically illustrated when patrons use state resources to secure the loyalty of clients in the general population.¹⁰⁸

Although some elements of the private sector complained about the state’s reassertion of power, at a historic July 2000 meeting Putin retorted: “[they—the oligarchs] to a great degree formed the present state, through the political and quasi-political structures under [their] control.”¹⁰⁹ He concluded: “Perhaps what one should do least of all is blame the mirror.”¹¹⁰

However, there are key differences between the state’s role in the energy sector during the Yeltsin and Putin eras. Under Yeltsin, the state essentially enabled

known as the Washington consensus. The policies as developed by Yeltsin’s Deputy Prime Minister, Yegor Gaider, were premised on radical economic reform or “shock therapy.” See Pekka Sutela, “Insider Privatization in Russia: Speculations on Systemic Changes,” *Europe-Asia Studies* 46:3 (1994): 420-21.

104. For a detailed look at the Loans for Shares underbelly and its operations, see Orlando Figes, “Russia’s Robber Barons,” *The Telegraph*, UK, March 3, 2002.

105. Ibid.

106. Ibid.

107. Ibid.

108. See Tony Wood, “Contours of the Putin Era,” *New Left Review* 44 (March-April 2007). For a more general discussion on the growth of the neo-patrimonial state, see Gero Erdmann and Ulf Engel, “Neopatrimonialism Revisited, Beyond a Catch-All Concept,” German Institute of Global and Area Studies, February 2006, available at http://www.giga-hamburg.de/dlcounter/download.php?d=/content/publikationen/pdf/wp16_erdmann-engel.pdf.

109. See William Tompson, “Putin and the ‘Oligarchs’ A Two Sided Commitment Problem,” in *Leading Russia: Putin in Perspective* edited by Alex Pravda (Oxford University Press, 2005), 179-202.

110. Putin alluded to the fact that while the private sector complained of an alleged lack of state protection of property rights, these very same entrepreneurs worked against, either directly or indirectly, the ability of the state to develop a transparent financial system during the Yeltsin era. Ibid.

the Oligarchs, who, after gaining power, dictated policy to government.¹¹¹ In a 1996 campaign for his second term, Yeltsin required financial and media support to undercut the resurgent communists. To achieve his objectives, Yeltsin had to acquiesce greatly to the prerogatives of the private sector.¹¹²

Not only did President Putin make it increasingly clear that he intended the state to dominate the strategic energy sector, he quietly and surely, or sometimes forthrightly, appropriated private assets to the energy companies in which the Kremlin has “Golden Shares,” such as Gazprom’s and Rosneft’s acquisition of Yukos’s assets. The leading industrialists now consider themselves “quietists” after the highly intimidating sell-off of Yukos and the jailing of its founder, Mikhail Khodorkovsky, and, therefore, do not mix politics with business.¹¹³

Because the interests of the state and the business sector are now in many ways indelibly meshed, expanded state power suggests increased leverage for the favored business groups. Thus, while the business class does not have the same ability for diktat as under Yeltsin, as long as they do not oppose the Kremlin, they will have increased business opportunities. In other words, the energy sector has experienced a decrease in relative power, but an overall increase in real power.¹¹⁴

Rejection of the Production Sharing Agreements

During the neo-liberal sell-off of state energy assets in the 1990s, Russia allowed a form of contract that eventually engendered the antipathy characteristic

111. This can be seen with the formerly highly influential Russian Union of Industrialists and Entrepreneurs (known informally as the Oligarchs Trade Union), composed of the leading industry leaders in the energy sectors, among others. During its founding 15 years ago, it nearly dictated policy to the Russian government. Now it is widely acknowledged to take marching orders from President Putin. See Anna Smolchenko, “Putin Plans Meeting With Oligarchs,” *Moscow Times*, February 5, 2007.

112. The candidate for the Communist Party of the Russian Federation, Gennady Zyuganov, ran on the seductive platform of regaining lost Soviet prestige in the international arena, and a strong socialist domestic order. During that period it seemed as if Yeltsin would lose, so the government leaned heavily on Oligarch support, and Anatoly Chubais, speeded up privatization in order to hand lucrative shares to the inner clique of oligarchs in exchange for financial support. See Daniel Treisman, “Blaming Russia First,” *Foreign Affairs* (November/December 2000).

113. This became clear to all those involved in the fateful “Oligarchs meeting” where President Putin set out clear terms for the tycoons who controlled Russian industry that they were expected to remain outside of politics.

114. The decrease in relative power is when compared to the state, and the increase in real power is through expanded acquisitive opportunities provided by the state domestically and internationally.

of the earlier concession system in the GCC states. While the Soviet Union had the distinction of being one of the primary oil-producing countries in the world,¹¹⁵ the collapse of its political structure brought about a sharp fall in oil output.¹¹⁶ Bequeathed with the old Soviet oil field infrastructure, Russia's vulnerable economic situation caused it to encourage foreign investment in its "strategic sector."

On December 30, 1995, President Boris Yeltsin signed Russia's Law of Production Sharing Agreements,¹¹⁷ modeled on the Production Sharing Agreements (PSAs) increasingly used since the 1960s in oil- and gas-producing countries.¹¹⁸ The basic feature of a PSA requires the host-state to grant the IOC a legal right to explore and produce from a delineated area for a limited period of time, in exchange for a percentage of the produced oil. The essential characteristic of the PSA is that the monetary flows of the concession system are reversed, which means that the state essentially pays the IOC to develop and produce the oil and gas deposits through resulting revenue streams, from which the IOCs recoup expenses.

The PSA regime is generally more complex than the concession system; the state has ownership of all subsoil minerals, while the IOC extracts it under a contractual arrangement. The IOC then advances seed capital for exploration and production. The first oil or gas produced is allocated to the company to recoup costs and capital investment; the remaining oil, known as profit oil, is subsequently split between the host-state and investor under a prearranged formula.

However, one of the most important features of the PSA constrains the state through stabilization clauses, which effectively "freeze" the current legal regime, and places the PSA into a self-contained legal environment, with specified rights and privileges.¹¹⁹ Theoretically, the state is constrained in promulgating new laws that

115. By 1987 Russia became one of largest petroleum producing countries with a production rate of 11.38 million barrels per day. See generally, James W. Skelton Jr., "Investing in Russia's Oil and Gas Industry: The Legal and Bureaucratic Obstacles," 8 *Natural Resources & Environment* 26 (1993)

116. The impact of the dissolution was quite significant during the twilight years of the Soviet Union as Gorbachev neglected the oil industry and used the export profits to subsidize failing industries and to purchase desperately sought Western goods. See "Investment at an Impasse: Russia's Production Sharing Agreement Law and the Continuing Barriers to Petroleum Investment in Russia," 7 *Duke Journal of Comparative and International Law* 675 (1997).

117. Law of the Russian Federation "On Production Sharing Agreements," which was approved by the Federation Council on December 19, 1995. Thereafter Law on Production Sharing Agreements.

118. See *Supra* 117, "Investment at an Impasse: Russia's Production-Sharing Agreement Law and the Continuing Barriers to Petroleum Investment in Russia."

119. A PSA is self-contained contract that it is governed strictly by its own provisions and by the articles of the country's PSA law. Investors tend to like this contractual arrangement as it allows

would impact the agreed-upon contractual arrangement.¹²⁰

Although the concessionary system fostered in the Gulf States and the PSA regime in Russia appear different on the surface, the basic distinctions tend to be political, i.e., with the PSA being an agreement where the state retains ownership to assuage nationalistic interests. The financial and economic implications are generally the same between the two systems.¹²¹ For IOCs entering Russia during the turbulent 90s, the PSAs had clear political advantages. Professor Thomas Walde, an expert on oil law and policy, stated that:

A convenient marriage between the politically useful symbolism of the production-sharing contract (appearance of a service contract to the state company acting as master) and the material equivalence of this contract model with concession/licence regimes in all significant aspects the government can be seen to be running the show – and the company can run it behind the camouflage of legal title symbolising the assertion of national sovereignty.¹²²

The three PSAs, used in Russia during the early to mid 1990s, were then targeted by the Kremlin for renegotiation, with the headline-grabbing Sakhalin Two oil and gas project being first. Located on the Sakhalin Island in Russia's Far East, this project represented the combined efforts of a consortium led by Shell, and two Japanese companies, Mitsui and Mitsubishi. Russia viewed these PSAs as unfeasible due to its weak position as a signatory.¹²³ In many ways, the method in which the Kremlin reacted to the PSA system echoed the earlier political movements in the Gulf vis-a-vis the concession system.¹²⁴ What was particularly galling to the Kremlin is that the PSAs were negotiated when oil was approximately \$15 a barrel

a certain amount of predictive value to legal rights and responsibilities before undertaking significant capital investments. States generally find themselves against the PSA in a rising commodity market, when there is popular political pressure to revise the fiscal/legal regime, and the host state then finds its hands tied in the face of popular pressure.

120. The stabilization clauses would also theoretically prevent the host state from promulgating new environmental or fiscal laws.

121. Daniel Johnston, *International Petroleum Fiscal Systems and Production Sharing Contracts* (Pennwell, 1994), 39.

122. Thomas Wälde, "The Current Status of International Petroleum Investment: Regulating, Licensing, Taxing and Contracting," in *CEPMLP Journal* 1, no.5 (July 1995) (published by University of Dundee).

123. See "Foreign Investment in Russia," *Platts News*, December 12, 2006, available at <http://www.platts.com/Natural%20Gas/Resources/News%20Features/sakhalin2/index.xml>.

124. See Sabrina Tavernise, "Russia Wants to Restrict Incentives to Seek Oil," *The New York Times*, February 20, 2003.

in the mid-1990s, but peaked at \$92 a barrel in late October of 2007.¹²⁵ As stated previously, under the PSAs, the government can only obtain its revenue once the project operators recover their massive cost outlays.

However, Exxon-Mobil and Shell have consistently presented the Kremlin with cost overruns running into billions of dollars, meaning that Russia's coffers would have been unlikely to see any revenue from these projects in the near future.¹²⁶ Considering that the price of oil had nearly reached \$80 per barrel before 2008, Russia felt righteous indignation. Consistent with the GCC concession parallel, Russia would like to revoke all three surviving PSAs with any legal or strategic means available.¹²⁷

Adversity on the Eastern Front: Russia Confronts the PSAs and the Oligarchs

Following his rise to power at the turn of the century, President Putin instituted an extensive overhaul of the laws governing the Russian domestic energy sector. The Putin administration will be remembered for two crucial actions: the Yukos affair and the Sakhalin Two equity restructuring, each of which represented the state's forward drive to reverse the Yeltsin-era privatization and PSAs.¹²⁸ In August of 2006, the Kremlin announced that it sought to review the three major PSAs that were signed with Western and Japanese energy companies in the early 1990s.¹²⁹ This includes Sakhalin One and Two, as well as the Kharyaginsk development project in Siberia led by France's Total.¹³⁰

125. See "Oil Prices Close at Record High," Associated Press, October 26, 2007, available at <http://www.msnbc.msn.com/id/12400801/>.

126. See Joseph Ferguson, "Sakhalin Oil and Gas Projects: What is behind Russia's Coercive Behavior?" *Eurasian Daily Monitor*, October 03, 2006.

127. There are three surviving PSAs after the government decided to roll back the PSA law. These are the two Sakhalin projects and one Total-led Arctic project.

128. There may be another aspect to this where Putin's move towards centralization in the energy realm had domestic and foreign aspects. Putin's move to solidifying the Russian state had a dual aspect as well: limiting the power of the regional governors, which he did when he changed the essence of Russian fiscal federalism in 1999, thus ending decisively the regions' bid for autonomy. And further, he has recommitted Russian troops to the separatist republic of Chechnya. See Vladimir Popov, "Russian Redux?" *New Left Review* 44 (March-April 2007).

129. See Supra 127, "Sakhalin Oil and Gas Projects: What is Behind Russia's Coercive Behavior?"

130. See "Total Declines Comment on Report Russia May Cancel Kharyaginsk Field Contract," *Forbes Magazine*, September 18, 2006, available at <http://www.forbes.com/home/feeds/afx/2006/09/18/afx3023529.html>.

Resurgent state power prompted proactive strategies to control those independent business magnates, sometimes perceived as arrogant and contemptuous of the government, who had become independent centers of power and amassed massive wealth and influence during the chaotic years of the Soviet break-up.¹³¹ As the state became more powerful, it sought to renegotiate the conditions of the previous contracts signed with the IOCs to exact more favorable terms. The constant cost overruns announced by Shell from the Sakhalin Two venture exacerbated the Kremlin's frustration in not having a direct say over a potentially major export project oriented towards Asia.¹³²

Lying at the center of the Kremlin's moves against the domestic private oil companies and the IOCs are the Yeltsin economic reforms and the sell-off of state energy assets that many Russian authorities considered illegitimate.¹³³ The anger at being unfairly treated is a very powerful component of the Russian psyche, which sensed national humiliation in the dissolution of the Soviet empire and the later precipitous drop in the Ruble in 1998.¹³⁴ The trauma that these events engendered provided political momentum, and the necessary public and elite support, for the state to restructure its relationship with corporate entities in the energy industry.

The Dismantling of Yukos

When the Russian federal authorities jailed Mikhail Khodorkovsky, the founder of one of Russia's most lucrative privately-owned oil companies, Yukos, it constituted a gigantic step for the state's incorporation of energy assets under its control. In mid-September of 2004, President Putin announced a radical overhaul of Russia's political relationship with domestic centers of power that, essentially, would centralize political power in the Kremlin.¹³⁵

131. See Bernard Black, Reinier Kraakman, and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong," *Stanford Law Review* 52, no. 6, 1731-1808.

132. See "Sakhalin Two-Environmental Violations Confirmed, Probe Extended, Criminal Prosecution Possible," Global Insight, available at <http://www.globalinsight.com/SDA/SDADetail7300.htm>.

133. See Catherine Locatelli, "The Russian Oil Industry between the Public and Private Governance: Obstacles to International Oil Companies' Investment Strategies," *Energy Policy* 34 (2006): 1075-1085.

134. Some scholars argue that national humiliation is an essential component of the Russian metanarrative. See, for example, Julia Brun-Zejmis, "Messianic Consciousness as an Expression of National Inferiority: Chaadaev and Some Samizdat Writings of the 1970s," *Slavic Review* 50, no. 3. (Autumn 1991): 646-658.

135. See Peter Baker, "Putin Moves to Centralize Authority," *Washington Post*, September 14, 2004, Page A01.

The Kremlin's moves against Yukos commenced in October 25, 2003, when Mikhail Khodorkovsky was arrested and charged with tax evasion, fraud, forgery, and embezzlement. His company, Yukos, was later auctioned off to pay its tax arrears; with state-led energy companies assigned a leading role in the process.¹³⁶ After the judicial authorities sentenced Khodorkovsky to eight years in a Siberian prison for fraud and tax evasion, the implication was clear to those who may have sought to form independent power linkages outside of the Kremlin.¹³⁷

Yukos was a product of the 1990s when the Yeltsin administration integrated several state-owned production, refining and distribution companies. The company's name is a combined acronym of the original constituent companies: Yuganskneftegaz, one of the largest oil producers in the Tyumen' region of Western Siberia, and KuybyshevnefteOrgSintez, a major refinery and petrochemical plant in Kuybyshev (now Samara), a city on the Volga.¹³⁸

Even though formed and acquired in the turbulent days of the post-Communist Soviet Russia, where shadowy financial deals were the norm, Yukos has evolved the furthest from the mores and practices that typified the 1990s.¹³⁹ In 1999, Yukos became the first of Russia's large firms to utilize international accounting standards, and in 2001, it became the first Russian energy company to publish its quarterly financial statements in accordance with the US Generally Accepted Accounting Practices (GAAP).¹⁴⁰

What initially was characterized as a battle between Russia's president and its wealthiest businessman has progressed into a larger struggle between the Oligarchs who dominated key, strategic industries, and the Kremlin, which desired to reassert state control of certain levers of the economy. After the jailing of Khodorkovsky, the Kremlin ordered the company to pay \$3.4 billion in back taxes dating from 2000, while signalling that the ultimate amount may range between \$7 billion to \$10 billion in fines and taxes combined.¹⁴¹ Although the dismantling of Yukos

136. Ibid.

137. Rosneft's Bogdanchikov, a key Putin ally, bragged that "three days in Butyrke Prison and [Khodorkovsky and his aide Roman Lebedev] will understand who is the master of the forest." See Marshall L. Goldman, "Putin and the Oligarchs," *Foreign Affairs*, op. cit.

138. See Leon Aron, *The Yukos Affair: Russian Outlook*, American Enterprise Institute, October 29, 2003.

139. Ibid.

140. See C.J. Chivers, "New Charges against Imprisoned Yukos Founder," *The New York Times*, February 5, 2007.

141. See Nelson D. Swartz and Doris Burke, "Russia's Trial of the Century," *Fortune* magazine, September 20, 2004.

was condemned in Western political circles amid predictions it would chill foreign investment in Russia, no such thing has occurred. In fact, as a Bear Stearns analyst stated, “Big Oil has to go where big oil is, and that’s Russia.”¹⁴²

The auctioning of Yukos’ assets to satisfy its tax claims gave a large boost to Kremlin-dominated oil and gas companies. During one of the later rounds of bidding, Rosneft, the state oil company, acquired 37 subsidiaries of the bankrupt Yukos and enlarged its already formidable influence in the sector.¹⁴³ The only other bidder during this round was a little known company, Yunitex, believed to be affiliated with Gazprom.¹⁴⁴ Gazprom actually did not participate directly in the auction, but subsequently bought assets from an Italian joint venture of Eni and Enel – Enineftgaz – that won the auction with a \$5.83 billion bid.¹⁴⁵

The lot contained significant Yukos assets including the Arcticgaz and Urengoil gas companies, and a bundle of smaller assets.¹⁴⁶ Despite the apparent lack of authentic competition, the Kremlin saw the Italian joint venture as adding “legitimacy and prestige” to the process.¹⁴⁷ And as will be covered in the conclusion, Russia will offer IOCs that play by the Kremlin rules ample opportunities for investment in Russia.

While seemingly motivated by many different factors, the Kremlin campaign against Yukos is not simply a desire to ‘punish’ Khodorkovsky or to consolidate state power. The Kremlin may also want the wealthiest businessmen to restrain themselves, and to behave according to the Western civic model by paying taxes on time, since “a very effective way of doing that is to make an extreme example of the richest one.”¹⁴⁸ The decisive conclusion of the Yukos affair encouraged other Oligarchs to demonstrate speedy compliance.

The Equity Shake-Up of Sakhalin Two

While the Yukos affair played itself out, state expansion focused its unwavering eye on international investors in Russia’s oil and gas sector. IOCs were believed to have profited from the state’s weak position, as with the PSAs granted to IOCs to

142. Ibid.

143. See Andrew E. Kramer, “Rosneft Buys Yukos Assets Including Oil Refineries,” *The New York Times*, May 4, 2007, C5.

144. Ibid.

145. See Alex Nicholson, “A Yukos Auction with a 2nd Act,” Associated Press, October 5, 2007.

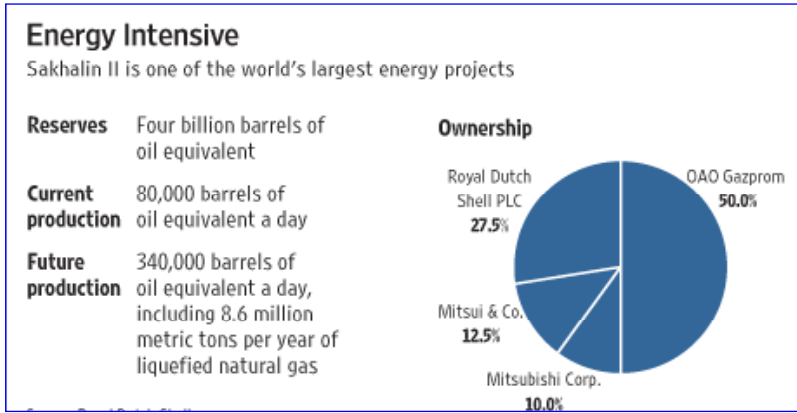
146. Ibid.

147. Ibid.

148. See *Supra* note 142, “Russia’s Trial of the Century.”

explore Sakhalin Island's gigantic oil and gas reserves.¹⁴⁹ The Kremlin used Sakhalin Two to serve notice to IOCs that the period of weak

Figure 3: Sakhalin's New Equity Interest



Source: Royal Dutch Shell governance was over.

Contrary to public perception, Russia neither threatened expropriation, nor actually nationalized Sakhalin's acreage, but used negotiation and threats of environmental fines or the revocation of precious environmental licenses to "legally" achieve its will.

Sakhalin Two, much like its sister, Sakhalin One, was created by a consortium of international IOCs to locate and produce oil and gas from Russia's Far East, Sakhalin Island and its immediate offshore. Sakhalin, an island in the Kuril chain north of Japan, nearly 10,000 kilometers east of Moscow, was the subject of two of the three PSAs signed in the post-Communist economic and political restructuring. The subject of intense IOC interest in the early 1990s, Sakhalin was involved in one of the very first PSAs signed after the fall of communism.

And as can be seen in Figure 3, with its enormous production potential for natural gas and oil, Sakhalin Two is one of the largest energy projects in the world. Sakhalin Two has garnered significant attention worldwide because the project was slated to become the world's largest integrated oil and gas field with the capacity to meet eight percent of global demand for LNG.¹⁵⁰

149. In July 2005, Shell estimated that recoverable reserves at 17.3 trillion cubic feet of natural gas and 1 billion barrels of liquids. See *Country Analysis Brief: Russia*, Energy Information Administration, available at http://www.eia.doe.gov/emeu/cabs/Persian_Gulf/Background.html.

150. Ibid.

Environmental Concerns: A Red Herring?

Almost from its inception, the Sakhalin Two project came under criticism for possible adverse impacts on the region's delicate ecosystem. The most controversial environmental concern was the purported threat to the Western Gray Whale, an endangered species with a surviving population estimated at approximately 100 specimens.¹⁵¹ There were also concerns about the alleged threat to local salmon populations and the purported negative impact on local host communities.¹⁵²

Sakhalin Two is significant, not because it signals a newfound Kremlin concern with environmentalism, or because Russia has gone "green." As will be discussed subsequently, Russia did not initiate an expropriation, or even threaten it: Russia utilized legal and contractual rights to pressure the consortium through environmental audits.

Although the Sakhalin Two PSA tied the state's hands legally and contractually, and shielded Sakhalin Two from subsequent laws, Russia exercised the only means that it had to influence the venture, through its environmental licensing procedure. Russia stayed within its legal limits when it used regulations as the "stick" to further governmental centralization. Officially, Russia merely relied upon its inherent authority to enforce environmental regulations and to review operating procedures.

Sakhalin Energy's Chief Executive, Ian Craig, alluded publicly to some of the environmental problems at the project, with:

"I'll be the first to admit that we haven't got it right the first time everywhere...but there are huge challenges. We're trying to introduce international best practice with Russian contractors, although they've been working to Russian standards – they're not used to performing in this way."¹⁵³

State involvement put international environmental campaigners in a quandary, as to how best to protest and bring pressure to bear on the Sakhalin operators, without lending support to a government purported to be responsible

151. See "Western Gray Whale Project," the World Conservation Union, available at <http://www.iucn.org/themes/marine/sakhalin/index.htm>.

152. Bankwatch group, a network of environmental groups in 11 countries, alleges that Sakhalin 1 and 2 has led to an influx of 5,000 mostly male construction workers that has increased prostitution, alcoholism and drug addiction as well as the rate of HIV infections. Available at < <http://www.bankwatch.org/>>

153. See Peter Davis, "Sakhalin 2 Project-Russia's New Found Environmental Fears," Ethical Corporation, November 6, 2006, available at <http://www.ethicalcorp.com/content.asp?ContentID=4635&rss=41.xml>.

for enormous environmental degradation and alleged human rights transgressions as in Chechnya.¹⁵⁴

As an operator, Shell continued to provide higher and higher cost overrun estimates before it finally announced that the cost overruns were likely to double to \$22 billion.¹⁵⁵ The original PSA would have delayed the date at which the government would see returns from the project since it was structured for Shell to recover all of its costs before sharing profits.¹⁵⁶

The Kremlin responded with a campaign for Gazprom to secure an interest in the project. The tool: Russia's environmental agency. During the summer of 2006, the environmental authorities threatened to withdraw Sakhalin Two's operating license and force the operators to pay multibillion-dollar fines for allegations of damaging the local ecosystem.¹⁵⁷ Gazprom initially offered Shell a share of its Zapolarnoye field in an equity swap for 25 percent of Sakhalin Two; implicit in this offer was the removal of Shell's environmental worries. However, when Shell announced increased cost overruns, Gazprom felt emboldened, and removed its Zapolarnoye offer, and demanded a much larger equity share.¹⁵⁸ To forestall an enormous fine of perhaps up to \$30 billion, Shell allowed Gazprom to take a majority equity share. Shell's Chief Executive, Jeroen van der Veer, agreed to reduce Shell's equity holding by half, i.e., to 27 and a half percent.¹⁵⁹

A resolution was finally announced by the Kremlin on December 22, 2006. Gazprom paid approximately \$7.45 billion to gain a stake of 50 percent plus one share in the Sakhalin Investment Company, while the three founding members had their equity holdings halved. Shell dropped from 55 percent to 27 and a half percent, Mitsui to 12 and a half percent and Mitsubishi to 10 percent (see Figure 3, for the current equity makeup). The newly-formed consortium announced in a joint

154. Ibid.

155. Ibid.

156. See James Watson, "Foreign Investment in Russia: The Case of the Oil Industry," *Europe-Asia Studies* 48, no. 3. (May 1996): 429-455.

157. Some of the allegations – in addition to the ones about the violations at the Western Grey Whale Breeding Grounds – were that subcontractors violated water regulations in laying pipes, and that Shell extracted more oil than it was allowed to under the license agreements. See Terry Macalister and Tom Parfitt, "For Months, Kremlin Piled on the Pressure Until Shell Could Take No More," *The Guardian*, December 12, 2006.

158. See Simon Bowers, "Sakhalin Issues 'Settled' as Russia Takes 50% Stake," *The Guardian*, December 22, 2006.

159. Ibid.

statement that this new merger would open possibilities for expanded cooperation.¹⁶⁰

However, it appeared that Gazprom's entry into Sakhalin Two put the other IOCs, including Total and TNK-BP, a BP subsidiary, on notice that their permits for projects in Eastern and Northern Siberia were vulnerable to possible environmental challenges.¹⁶¹ President Putin stated, mere minutes after the Sakhalin Two deal was concluded, "As far as I've been informed, the fundamental [environmental] issues can be considered resolved."¹⁶² Moreover, Russia's environmental authorities, near that time, informed Exxon that it may not accept a revised cost estimate for the US firm's giant Sakhalin One project.¹⁶³

Conclusion and Prospects for Future GCC-Russian Energy Cooperation

Events on the Horizon

While the Russian strategies to regain control of its energy sector may superficially appear to diverge from the GCC model, there are some important similarities. Although Russia never experienced colonialism as the GCC states had, the period of privatization after the fall of the Soviet Union had many of the same effects on the Russian national psyche as colonialism did on Arab consciousness. Yet in Russia's case, its experimentation with rapid privatization, and the wholesale entry of foreign IOCs into its oil and gas fields, was likely more acute, i.e. more disruptive, whereas in the GCC, the colonial experience could be considered more chronic, i.e. long lasting.

Nonetheless, Russia instituted a policy to reverse what it saw as its humiliating "energy treaty of Versailles" and implemented the means it had at its disposal, such as threats of fines and threatened withdrawal of environmental operating licenses, much like the GCC states utilized the collective apparatus of OPEC to leverage renegotiations of the concession agreements. And while the restructuring process in Russia is still ongoing, it appears that the country, like the GCC states, wants the IOCs to stay and invest in its oil and gas fields (particularly gas), but under the watchful eye of Gazprom or Rosneft.

In the GCC, prior to the OPEC revolution, the IOCs fought against any change in the status quo, but eventually accepted it and sought to derive as advantageous a

160. See "Gazprom Completes Sakhalin-2 Takeover," *The International Herald Tribune*, April 18, 2007.

161. Ibid.

162. See Supra note 159, "Sakhalin Issues 'settled' as Russia Takes 50% Stake."

163. See Supra note 127, "Sakhalin Oil and Gas Projects: What is behind Russia's Coercive Behavior?"

position as possible. The IOCs in Russia seem to be following the same pattern by initially resisting Kremlin control but ultimately accepting a more muscular Kremlin role. With the limited global oil and gas production opportunities, it appears the IOCs have little choice but to accept the new situation.

Russian and GCC cooperation – ranging from multilateral organizations such as the GECF to bilateral investment opportunities for Russian companies to invest in the Gulf and vice versa – shows all indications of increasing in the future.¹⁶⁴ The West tends to be quite wary about the forming of a more assertive GECF. However, the real impact of an invigorated GECF may not be in the sheer domination of natural gas exportation, principally because the natural gas market is not “fungible” enough for natural gas to fulfill that role. Rather the impact may be in decreased investment opportunities for Western IOCs as bilateral joint ventures (intra-GECF) start to take precedence, and NOCs gain confidence in their technical skills for natural gas production.

While it appears that Gazprom has a more active stance in downstream asset acquisition, seeking to enter into the EU and US, Saudi Arabia’s Aramco has an insular stance. Gazprom’s strategy adheres more closely to Qatar Petroleum’s and Kuwait Petroleum’s strategy of seeking increased revenue further down the value chain. If Russia continues with its current strategy, the stage is already set for increased Russia-GCC cooperation.

164. In 2007, Jordan asked Russia to build a refinery, while in Iraq, Lukoil is in the beginning stages of resurrection of its Saddam era contracts in the West Qurna region. See Carola Hoyos, “Lukoil Hopes for Progress in the Iraq Project,” *Financial Times*, January 30, 2006.

