

# Enforcing Oil and Gas Contracts Without Courts

## Reputational Constraints on Resource Nationalism in Russia and Azerbaijan

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**Abstract:** Amidst the recent record-breaking spike in oil prices, many resource-rich countries have moved aggressively to increase national control over large, internationally-financed hydrocarbon projects. Commentators have sensationalized these breaches as politically-motivated moves toward resource nationalism and a reflection of a weak rule of law. This commentary, however, oversimplifies a complex phenomenon. Many countries accused of resource nationalism have selectively renegotiated contracts and have stopped far short of full-scale nationalization. Furthermore, other resource-rich countries—often with weaker systems of legal enforcement and similar political incentives to renegotiate—have reacted to the oil boom by respecting long-term contracts and encouraging additional foreign investment. Russia and Azerbaijan can help us understand the forces driving these recent developments in the hydrocarbon industry: while Russia has renegotiated long-term contracts and partially re-nationalized its hydrocarbon industry, Azerbaijan has done the opposite. Comparing these two countries, this article will propose that these differing responses are strategic reactions to the oil boom. Both countries still require access to the technology, capital, and political connections of international oil companies to pursue their interests; thus, the *ex post* reputational costs of contractual breach have helped insulate long-term contracts from expropriation in the absence of a strong rule of law. Thus, like in other business communities that do not have access to impartial court systems to enforce contracts, maintaining a good reputation has emerged as a key factor in ensuring the stability of existing long-term hydrocarbon contracts.<sup>1</sup>

**Keywords:** Azerbaijan, hydrocarbon, rule of law, Russia

**T**he spike in oil prices between 2003 and 2008 has transformed the dynamics of hydrocarbon investment. From South America to Central Asia, resource-rich countries have unilaterally renegotiated contracts and imposed national control over long-

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term hydrocarbon projects. Commentators and analysts have described these partial or full-scale nationalizations in the developing world as a return to a “1970’s style of resource nationalism riding along the crest of high prices”<sup>2</sup> and typical of nations with a weak rule of law.<sup>3</sup> They have been particularly critical of post-Soviet countries, describing recent state-forced renegotiations in Russia and Kazakhstan as short-sighted and politically motivated.

The reality, however, is far more complex. Rapid, full-scale nationalizations, which typified the 1970s, have not been the order of the day. Many of these contractual disputes have resulted in negotiated solutions: resource-rich countries have offered international oil companies (IOCs) reduced shares, and many IOCs have accepted. Finally—and most strangely—other resource-rich, developing countries like Azerbaijan, despite weak rule of law and the potential of capturing skyrocketing revenue streams, have resisted the temptation to override their long-term contractual obligations and capture skyrocketing rents.

This article will seek to understand the stability of hydrocarbon contracts in the former Soviet Union. In the absence of a strong rule of law, can IOCs expect resource-rich countries to respect the bargained-for terms in long-term hydrocarbon contracts if oil prices rise or political circumstances change? In other words, are there factors other than courts that can constrain the “grabbing hand” of the state in the high stakes hydrocarbon contracting game? The answer to these questions will help shed light on the complex relationship between law and investment risk in long-term, cross-border hydrocarbon contracting.

### **Back to the 1970s: No Courts, No Protection**

The dominant paradigm for understanding post-Soviet hydrocarbon contractual renegotiations goes as follows. The recent oil boom has freed resource-rich, post-Soviet countries from dependence on IOCs. Unconstrained by independent judiciaries, these countries are now renege on recent contractual agreements and renationalizing. In trampling on property rights and bargained-for contractual terms, however, host countries trade short-term benefits for long costs: by taking resource rents that fuel corruption, host countries will eventually undermine their own economies in a phenomenon called the “resource curse.”<sup>4</sup> One solution, according to this paradigm, is stronger domestic and international public enforcement and the rule of law; only then will host countries be able to accomplish the Ulyssean task of resisting the short-term siren song of bulging resource rents.<sup>5</sup>

This critique has been particularly strong in relation to post-Soviet countries. Following the renegotiation of the massive Sakhalin II project in Russia’s far east, commentators portrayed this incident as the typical behavior of a country that has a weak rule of law and refuses to uphold its moral obligation to honor long-term commitments. For instance, the *New York Times* writes, “Moscow also needs to be reminded that threatening property rights will eventually dissuade all investments. Even Mr. [Vladimir] Putin’s allies should remember that without a clear rule of law, their own assets might be threatened if political winds shifted.”<sup>6</sup> The *Financial Times* makes a similar point: “It is wrong to tear up the contract now, a decade later. The costs dispute should have been settled as envisaged under the PSA by arbitration, not by expropriation.”<sup>7</sup> The *Economist* comments: “It is natural to be miffed when a deal that seemed shrewd turns out

worse than you thought. It is especially galling if it involves a prized asset. The civilised response—if the other party is disinclined to renegotiate—is to shrug and move on. But with the gigantic energy developments on Sakhalin Island, the Kremlin prefers to bully its partners into surrender.”<sup>8</sup> The *Wall Street Journal* is even more blunt, equating investment in Russia as foolish and misguided as the rigged craps game in *Guys and Dolls*: “[I]nvesting in a nation in which there is no established rule of law is to shoot craps with Big Vladimir of Leningrad.”<sup>9</sup>

In comparing these renegotiations with the nationalizations of the 1970s, scholars have brought back an old model for understanding the dynamics of hydrocarbon investment: the obsolescing bargain model (OBM).<sup>10</sup> Drawn from the experiences of the 1970s, the OBM focuses on the internal political and economic balance of power between the IOC and the government over the course of the contract.<sup>11</sup> In the beginning, the OBM predicts, resource-rich countries need IOC investment; thus, IOCs exploit this powerful position by forcing favorable contractual provisions. However, as IOCs make the large up-front investments to explore and extract hydrocarbon resources, bargaining power shifts to the host country: IOCs cannot credibly pull out of the contract if a dispute arises because they would lose their up-front investment. Furthermore, as production begins, it is politically and economically tempting for the host country to make a show of sovereignty and expropriate the fruits of the IOC’s sunk investment. Thus, the OBM predicts that the host country will increasingly have incentives to force new terms into the contract with time.

Long criticized by scholars as obsolete, the dynamics of the OBM are now viewed as being at play in post-Communist contractual renegotiation.<sup>12</sup> IOCs exploited their powerful position to negotiate favorable long-term contracts to develop resources in the post-Soviet world during the 1990s. Just as IOCs had made the up-front investments to locate and extract hydrocarbons, however, rising oil prices have drastically changed the political and economic context of these long-term hydrocarbon contracts. Post-Soviet states, therefore, have taken this opportunity to renegotiate, reasserting control over their resources in a demonstration of political sovereignty to their populace and increasing their access to rising hydrocarbon revenue streams.

Thus, the OBM predicts that as long as oil prices remain high, contractual relations will be conflictual and post-Soviet countries will continue to squeeze out IOCs, filling state coffers with resource rents and asserting sovereignty over their natural resources. In this picture, IOCs will continue to weaken and, ultimately, “lack resilience to survive on their own in the long term.”<sup>13</sup>

This approach explains the renegotiations. But it does not explain a phenomenon that is admittedly less attention-grabbing: Why, with rising oil prices and weak judiciaries, have many long-term contracts not been renegotiated in the post-Soviet world?

### **Reputational Ordering in the Prisoner’s Dilemma**

The key shortcoming in this dominant approach is that it ignores the role of external, non-legal mechanisms in encouraging cooperation.<sup>14</sup> Game theory demonstrates that reputation can be one such mechanism in ensuring self-interested cooperation.<sup>15</sup> In the classic prisoner’s dilemma game, two players have the option of complying or reneging on an agreement. Although both players would be better off if they cooperated, it is in the interests of both players to defect in a single transaction.

Classic Prisoner's Dilemma	Player 2 (Cooperate)	Player 2 (Defect)
Player 1 (Cooperate)	P1: 3 P2: 3	P1: 0 P2: 5
Player 1 (Defect)	P1: 5 P2: 0	P1: 1 P2: 1

However, over a series of transactions, reputation becomes an important indicator of what the other player is likely to do in the future; reputation, therefore, can alter the expected payoffs in future iterations of the game. To demonstrate this, I will assign a value to reputation. If a player cooperates, he will receive the value  $R(c)$  plus the anticipated payoff. If a player defects, however, he will receive the negative value  $R(d)$ , representing the loss to the state's reputation for noncompliance. For the purposes of this model, I will assume that  $R(d)$  is always the negative of  $R(c)$ .

Reputational Prisoner's Dilemma	Player 2 (Cooperate)	Player 2 (Defect)
Player 1 (Cooperate)	P1: $3 + R(c)$ P2: $3 + R(c)$	P1: $0 + R(c)$ P2: $5 + R(d)$
Player 1 (Defect)	P1: $5 + R(d)$ P2: $0 + R(c)$	P1: $1 + R(d)$ P2: $1 + R(d)$

If we assign  $R(c) = 1$  and  $R(d) = -1$ , we can see that reputation increases the likelihood that the players will cooperate.

Reputational Prisoner's Dilemma	Player 2 (Cooperate)	Player 2 (Defect)
Player 1 (Cooperate)	P1: 4 P2: 4	P1: 1 P2: 4
Player 1 (Defect)	P1: 4 P2: 1	P1: 0 P2: 0

### The Hydrocarbon Investment Dilemma

This article will seek to understand the OBM through the prism of the reputational prisoner's dilemma game. Late in a long-term contract, the OBM predicts that the IOC will want to cooperate (it has little choice after its large sunk investment) and the host country (HC) will want to defect (renegotiate or expropriate to get increased access to hydrocarbon revenue). Thus, I will assign the payoffs accordingly. Because the IOC has already made the investment, it will only achieve a positive payoff if both it and the HC cooperate (I assign this outcome a value of 6 for the IOC). At this point in the game, the HC has more

options. If it cooperates, it will continue to be locked into the terms of the original contract, yielding low payoffs (1 if the IOC cooperates, 0 if the IOC defects). However, if the HC “defects” it can expect a high defection payoff of 10 if the IOC cooperates or 9 if it does not (this is slightly lower because of the costs that IOC defection might have on the HC’s payoff). As the OBM predicts, the dominant outcome in this game will be for the IOC to cooperate and the HC to defect.

Obsolescing Bargain Dilemma	HC (Cooperate)	HC (Defect)
IOC (Cooperate)	IOC: 6 HC: 1	IOC: 0 HC: 10 (defection payoff)
IOC (Defect)	IOC: 0 HC: 0	IOC: 0 HC: 9 (defection payoff)

However, as above, if we add a reputational value into the game, we alter the payoffs because both players receive their payoff plus a reputation value.

Reputational Obsolescing Bargain Dilemma	HC (Cooperate)	HC (Defect)
IOC (Cooperate)	IOC: $6 + R(c)$ HC: $1 + R(c)$	IOC: $0 + R(c)$ HC: $10 + R(d)$
IOC (Defect)	IOC: $0 + R(d)$ HC: $0 + R(c)$	IOC: $0 + R(d)$ HC: $9 + R(d)$

In a universe where cooperation is beneficial and defection is costly,  $R(c)$  will be assigned a number greater than 0. Even if  $R(c)$  is only a fraction of the defection payoff for the HC—for instance 2 (only 20 percent of the defection payoff of 10)—it increases the likelihood that the IOC and the HC will cooperate.

Reputational Obsolescing Bargain Dilemma	HC (Cooperate)	HC (Defect)
IOC (Cooperate)	IOC: 8 HC: 3	IOC: 2 HC: 8
IOC (Defect)	IOC: -2 HC: 2	IOC: -2 HC: 7

If  $R(c)$  is higher than the defection payoff, then we see that the HC is highly unlikely to defect. For instance, if  $R(c)$  is 11 (and  $R(d)$  is -11) in the game above, the dominant outcome in this game is now for both the IOC and the HC to cooperate: it is the only possible outcome in which both the HC and IOC receive positive payoffs. The payoffs below demonstrate that reputation can help overcome the forces of the OBM.

Reputational Obsolescing Bargain Dilemma	HC (Cooperate)	HC (Defect)
IOC (Cooperate)	IOC: 17 HC: 12	IOC: 11 HC: -1
IOC (Defect)	IOC: -11 HC: 11	IOC: -11 HC: -2

### Reputational Factors

Thus, this game theoretic model predicts that, as long as HCs value their reputation ( $R(c)$  is greater than 0), they are more likely to cooperate and comply with an agreement. Furthermore, if the HC values its reputation more highly than the defection payoff, then the HC is likely to ignore the incentives of the OBM and cooperate. A HC is likely to value its reputation highly when it needs future IOC cooperation. It will value its reputation because a bad reputation will lead to costly future exclusion while a good one will lead to beneficial future cooperation.<sup>16</sup>

The value that a HC places on its reputation will fluctuate depending on certain factors. First, global factors will affect this value. Perhaps the best example is the oil price. When the price of oil is low, the HC will need to compete for IOC investment and will seek a good reputation for cooperation to achieve IOC cooperation. When the price of oil is high, however, HCs will require IOC investment less and will likely value their reputation less highly.

Second, country-specific factors affect the extent to which a HC will value future IOC cooperation and, therefore, its reputation. For instance, a HC with large unproven resources will favor cooperation because it will require IOCs to assume the considerable financial risks of exploration. Furthermore, a HC with resources located deep underwater or in the ground in harsh environments will require IOC cooperation in order to secure access to their technology and expertise. Also, a HC that needs significant investment to develop the infrastructure for an undeveloped region will require IOC cooperation because the state (or a nationally-owned oil company) cannot bear the up-front costs of such projects. Finally, a HC will often need to cooperate with IOCs to ensure access to markets in which the HC is located.

A HC's political aspirations will also affect the value it places on its reputation. In particular, if the HC wants to build political alliances, stable contractual relationships with IOCs based in powerful, importing countries can help in this process, facilitating foreign aid as well as political or military support.

### Testing the Theory

Both Azerbaijan and Russia desperately needed foreign investment in the 1990s. To attract this investment, they sought to establish a good reputation as a safe destination for hydrocarbon investment by tying themselves into long-term contracts with large IOCs. These contracts, however, rapidly obsolesced as the price of oil increased and IOCs had made large up-front investments. This article will test whether the reputational approach to the OBM helps to explain Russia and Azerbaijan's reactions to the oil boom. The first section will first analyze country-specific factors in both countries to determine the impact that the oil boom has had on the value that each country placed on its reputation. The second section will then trace whether this value is consistent with Russia and Azerbaijan's behavior toward contracts that have obsolesced.

## The Importance of Reputation in Russia and Azerbaijan

### *Azerbaijan*

Since the oil boom, Azerbaijan has continued to value its reputation highly. In fact, Azerbaijan needs IOCs to ensure both the economic vitality of its hydrocarbon industry and to secure its political alliances with the United States and Europe. First, to ensure continued economic growth, Azerbaijan realizes that it must maintain a good reputation and relationship with IOCs in order to ensure future access to IOC investment. Although Azerbaijan likely still has large untapped hydrocarbon reserves (particularly off-shore in the Caspian Sea), it needs IOC technology and exploration to locate and develop these resources. As one commentator writes: “The trouble is that Azerbaijan’s proven reserves of oil and gas condensate amount to less than 1.5 billion tons and the associated oil gas reserves of 1.5 trillion cubic meters as of this year. Therefore, with Baku’s official estimates of oil output of 60-65 million tons a year and gas production of more than 30 billion cubic meters annually, those reserves will not last Azerbaijan very long: its oil reserves are to be depleted in 25 years and gas reserves exhausted in 50 years.”<sup>17</sup>

In fact, many IOCs that have invested in Azerbaijan have been unsuccessful in finding resources. For instance, ExxonMobil and Lukoil failed to discover commercially viable hydrocarbon reserves at the Zafar-Mashal and Yalama blocks, which will lower future production estimates from Azerbaijan’s offshore area.<sup>18</sup> Azerbaijan signed numerous PSAs for development of various onshore and offshore oil fields during the 1990s, but only the PSA for the development of the Azeri, Chirag, and Guneshli fields (see below) has resulted in significant oil findings.<sup>19</sup> Azerbaijan alone cannot bear the risks and costs of this needed exploration. Thus, Azerbaijan must attract IOC investment to explore and find the remaining resources or risk losing its hydrocarbon revenues, one of the most important parts of its economy.

At the same time, renegotiation would risk valuable political alliances. From the beginning, Azerbaijan saw its hydrocarbon resources as a key political tool. Heydar Aliyev, the Azeri President, reportedly said during the 1990s: “My weapon is oil, and with that we will manage to win the war [in Nagorno-Karabakh].”<sup>20</sup> Aliyev’s vision has been at least partially successful: IOC investments have brought Azerbaijan much closer to Europe and the U.S. politically and diplomatically. Soon after the ACG deal was signed in 1994, the Russians voiced their displeasure by promising high transport costs to European markets, threatening the commercial viability of the project. In response, the AIOC consortium began an organized lobbying project to involve the U.S.: “[b]y early 1995, the U.S. oil companies operating in Azerbaijan had set up a Foreign Oil Companies group in Washington. It met with National Security Council energy expert Sheila Heslin and later with an interagency committee headed by her boss, Samuel R. ‘Sandy’ Berger.”<sup>21</sup>

These efforts soon brought political fruit. First, the U.S. and Europe began to work closely with Azerbaijan and its neighbors in building the Baku-Tbilisi-Ceyhan (BTC) pipeline, providing large public loans and generous aid to help develop this pipeline. As Azerbaijan became a key part of the Europe-U.S. energy security strategy, Azerbaijan also became a key ally of the U.S. in the global war on terror after September 11, 2001. Oil companies and the Bush administration lobbied Congress hard to lift bans on foreign aid to Azerbaijan that were in place since the Azerbaijan-Armenia war; Azerbaijan is now a recipient of significant foreign aid.<sup>22</sup>

Furthermore, Azerbaijan continues to rely heavily on its energy partnership with the West in securing a favorable outcome for Azerbaijan in the ongoing Nagorno-Karabakh conflict. Strong relations with European and U.S. governments can help blunt the power of the Armenian diaspora in lobbying these governments and secure an outcome that will be advantageous to Azerbaijan.<sup>23</sup>

Finally, the European Union—largely inactive in lobbying for commercial interests during the 1990s—has also recently realized the importance of the Azeri region to its energy security. As a result, it has sought to draw Azerbaijan into the Council of Europe. In 2004, Azerbaijan and the EU signed a European Neighborhood Policy Plan. Part of this plan was the creation of a strategic energy partnership between Azerbaijan and the EU.<sup>24</sup> These moves also reflect Azerbaijan's growing role as a transportation hub for the massive oil and gas reserves that currently exist in the Caspian Sea.<sup>25</sup>

Thus, Azerbaijan highly values its reputation; the model would predict, therefore, that Azerbaijan would avoid jeopardizing long-term future cooperation for the short-term gains of renegotiation.

#### *Russia: A Medium Reputational Value*

Since the oil boom, Russia has reduced the value it places on its reputation. In fact, it has seen its position in the hydrocarbon investment game transformed. From a debtor country with a rapidly disintegrating hydrocarbon infrastructure, it has been transformed into a hydrocarbon superpower. This new position has allowed it to incur reputational costs in return for short-term payoffs.<sup>26</sup>

Russia needs fewer reputational incentives to encourage IOC investment. First, because of Russia's large proven resource base, IOCs are willing to invest in Russia even if they regard it as risky because the potential payoffs of working in Russia are so substantial. According to the U.S. Department of Energy, Russia has the world's largest natural gas reserves and the eighth largest oil reserves. Second, Russian-owned Gazprom has emerged as a massive asset for investing and developing Russian resources; thus, the Russian state has less need for future IOC cooperation. Third, Russia no longer needs IOC support to secure international political assistance; on the contrary, Putin's rise to power coupled with soaring resource rents have allowed Russia to assert its independence on the world stage.

Despite Russia's reduced need for IOC involvement, it still requires future IOC investment because it does not have the resources to develop its large but difficult-to-extract hydrocarbon reserves. In fact, studies reveal that since 2005, underinvestment has slowed hydrocarbon output growth, which fell to 2.5 percent in 2005 and 2.2 percent in 2006. Russia's oil boom since 1999 was achieved largely by rehabilitating existing fields and using more efficient production technologies in the core oil regions of western Siberia. Furthermore, until recently, Russia has spent very little in the exploration of new fields, many of which are found in remote arctic regions of eastern Siberia, where exploration and exploitation will be considerably more expensive and technically challenging. A 2008 report suggested that due to "underinvestment, incompetence, corruption, political interference and crude profiteering," Russia's oil production will decline this year for the first time. Finally, reliance on Gazprom can only go so far: Gazprom cannot underwrite the massive future investment that Russia will need. The company has begun to extend its global reach; meanwhile, little progress has been made in developing new fields, such as Yamal and Shtokman.

From a political standpoint, Russia also needs future cooperation with IOCs based in key export markets. In fact, many European countries who import Russian hydrocarbons have reacted nervously to Russian attempts to use its hydrocarbon resources as a political weapon; some have proposed looking for alternative sources of hydrocarbons or closing their markets to Russian oil. To avoid this possibility, Russia has sought to cooperate with French and German IOCs to show it is a reliable partner.<sup>32</sup> If Russia seeks to expand into the U.S. market, cooperation with American IOCs might increase as well.

Thus, although the value that Russia places on its reputation has dropped since the 1990s, Russia cannot ignore its reputation. The model would predict, therefore, that Russia will proceed cautiously but might be willing to risk its reputation for a renegotiation that yields significant defection payoffs.

### **Production Sharing Agreements**

To test the importance of reputation in restraining the forces of the OBM, this article will focus on a controversial long-term investment instrument that both Russia and Azerbaijan used in the 1990s to attract IOC investment: the production sharing agreement (PSA). In a PSA, the HC retains title to the mineral resources and engages the IOC as a “contractor” to explore and produce oil and gas on its behalf. The IOC bears all the risk and costs of exploration and extraction; the HC receives a pre-arranged share of hydrocarbon revenues. In order to reduce the risk of expropriation, PSAs often contain stabilization clauses that insulate the agreement from any changes in domestic law.<sup>33</sup> These stabilization clauses, which can be placed in PSAs lasting thirty years or more, test the fidelity of the HC and aggravate the dynamics of the obsolescing bargain model because they deny the host the country the ability to adjust taxes or royalties as political and economic conditions change.

Emerging from Communism in the 1990s in a low-oil-price environment, the IOCs were in a powerful bargaining position: to secure desperately-needed IOC investment, technology, and risk spreading ability, Russia and Azerbaijan signed long-term PSAs with attractive terms for IOCs. Russia signed three PSAs in the 1990s, all for massive, proven hydrocarbon resources in remote areas. Two PSAs were for the reserves off of Sakhalin Island in the Russian far east, and the other was for the Kharyaga field in the Russian Arctic. Azerbaijan signed more than 20 PSAs during the 1990s, many for unproven offshore reserves in the Caspian Sea; by far the largest PSA, however, was for a proven offshore field to be developed by international consortium led by British Petroleum.

As the price of oil rose and the IOCs made a significant amount of their up-front investment, the terms in these PSAs quickly obsolesced. The next section will trace how reputation constrained Russia and Azerbaijan in exploiting their newly powerful bargaining position. Looking at specific PSAs in these countries, it will demonstrate that many PSAs which had obsolesced were not renegotiated, suggesting that reputational concerns have helped alleviate the problems of the OBM.

### ***Russia***

#### **Sakhalin**

The offshore region of Sakhalin has gigantic hydrocarbon reserves. The difficulties of hydrocarbon extraction in this region, however, made it impossible to develop these reserves during the Soviet period. Soviet engineers and companies could not marshal the resources to operate

in conditions described as “ferocious.”<sup>34</sup> Consequently, after the fall of the Soviet Union, the Russian government turned to IOCs to develop these fields.

### Sakhalin II

The Sakhalin II PSA was signed on June 22, 1994 between the Russian Federation (in partnership with the Sakhalin Oblast administration) and the Sakhalin Energy Investment Company (SEIC). This deal was cemented as part of Vice President Al Gore’s and Prime Minister Viktor Chernomyrdin’s joint Russia-U.S. mission, which was set up to promote economic relationships between the two countries.<sup>35</sup> The SEIC had sought help from home governments and the PSA was the result of intense lobbying and pressure from the U.S., from the presidential level all the way down. After the American IOC Marathon Oil left the SEIC in 2000, Anglo-Dutch IOC Shell (the operator of the project) increased its stake to 55 percent alongside Mitsui’s 25 percent share and Mitsubishi’s 20 percent stake.

Compared with other PSAs, the terms of the Sakhalin II PSA were highly unfavorable to the Russian state. First, one of the typical reasons that a government will provide favorable terms in a PSA is to encourage the IOC to undertake the exploration risk. In the Sakhalin II project, however, the exploration had already been carried out during the Soviet period; the SEIC bore no exploration risk. Second, in most PSAs, once the company has recouped its costs from the initial operations, the state and the company then share the profits in agreed proportions (in a ratio generally favoring the state). In this PSA, however, the Russian state would get nothing until the SEIC recouped its costs and had reached a 17.5 percent rate of return on capital. Thus, the PSA provided the SEIC incentives to invest in the operational phase before moving to the profit stage. Finally, the royalties and taxation fixed by the PSA’s stability clause were also low: the royalty payable to the state was 6 percent (much lower than comparable PSA numbers) and the tax rate (32 percent) was lower than the standard Russian rate at the time of signing (35 percent).<sup>37</sup>

As oil prices began to rise, the contractual terms of the Sakhalin II PSA came under significant pressure. In 2005, the Russian government began to pressure the SEIC to allow Gazprom to join the consortium; the SEIC reluctantly offered Gazprom a minority stake in June, 2005. Two weeks later, however, that deal was derailed when Shell announced that the project costs would double from \$10 million to \$20 million.<sup>38</sup> The Russian government was furious: these cost overruns would delay Russia’s access to a potentially high revenue stream from the oil boom.<sup>39</sup> By this point, the scale of Shell’s investment was massive: at the end of 2006, it represented the largest private foreign energy investment in Russia (reaching more than \$15 billion dollars).<sup>40</sup> With costs spiraling out of control, Shell was in a vulnerable position.

On September 18, 2006, Russia cancelled all environmental permits for the project, effectively halting it.<sup>41</sup> A couple of months later, Oleg Mitvol, deputy head of the Russian environmental watchdog group, threatened to bring a \$15 billion dollar claim against Shell for environmental violations in an arbitration proceeding in Stockholm.<sup>42</sup> On December 21, 2006, the SEIC negotiated with Gazprom to pay \$7.45 billion to SEIC shareholders for a 50 percent plus one share stake in the project.<sup>43</sup> According to Merrill Lynch, this price was higher than many industry observers predicted and was “fair.”<sup>44</sup>

On April 15, 2007, the exact details of the buyout were finally secured. Each partner diluted its stake by 50 percent: Shell’s stake was reduced to 27.5 percent less one share, Mitsui’s stake to 12.5 percent, and Mitsubishi’s stake to 10 percent.<sup>45</sup> Despite Gazprom’s

position as majority shareholder, the SEIC was to continue its operatorship of the Sakhalin II project.<sup>46</sup>

The benefits of renegotiation (Russia's defection payoff) were large. Under the original terms of the PSA, the cost overruns significantly delayed the Russian state's take in the lucrative project because the Russian state would receive nothing until the SEIC had generated a 17.5 percent profit. After renegotiation, however, the Russian government now had access to a steady flow of revenues through its controlling stake in Gazprom. Furthermore, through Gazprom, Russia could now move to expand its monopoly over natural gas export to rapidly-expanding Asian (and west-coast U.S.) markets.<sup>47</sup> As one journalist writes, "[i]f successful, the project will confirm Sakhalin's stature as a major new energy province and transform Russia into a key supplier to Asia. Sakhalin II will also be Russia's first ticket into the game of liquefied natural gas, a hot area of the energy industry these days."<sup>48</sup>

This renegotiation did cause significant reputational costs for Russia. Sakhalin II was the most well-known western investment in Russian hydrocarbons. Renegotiation spawned critical commentary on Russia's suitability for investment across the international media; Russia's image would be tarnished going forward. Internally, the Sakhalin II project lost many of its Western multilateral financiers. For instance, the European Bank for Reconstruction and Development (EBRD) pulled its funding.<sup>49</sup>

The Russian state worked hard to reduce these reputation costs. Apart from giving the SEIC a fair cash price, it offered consortium-leader Shell a partnership with Gazprom in other fields and sought to stress that this move against foreign investors was limited to cases of PSAs with unfair terms. In turn, Shell has not sought to punish Russia for the forced renegotiation. Shell not only remained as operator at Sakhalin II but has issued positive statements about the Russian government. In fact, Shell's CEO, Jeroen Van der Veer, in a ceremony finalizing the Gazprom buyout, thanked Vladimir Putin.<sup>50</sup> Konstantin Simonov, managing director of the National Energy Security Foundation, said: "Shell . . . pocketed a multibillion-dollar compensation, and amid the general outcry against the Kremlin, the victim itself remained surprisingly reserved. Now that Shell is among the key Gazprom partners, it is unlikely to bear any grudge—saying nothing of those German and Italian companies that can access Russian assets and earn hundreds of millions from options alone."<sup>51</sup>

### Sakhalin I

The Sakhalin I PSA was signed in June 1995. The consortium, led by Exxon, signed the deal to develop three gas and condensate fields located at Odoptu More, Chaivo More, and Arkutun-Daginskoye near Sakhalin. Exxon was the operator, with a 30 percent stake; a consortium of Japanese companies (Sodeco) had another 30 percent; local producer Sakhalinmorneftegas had a 23 percent share; and the Russian oil company Rosneft had a 17 percent share.<sup>52</sup> The deal gave Russia 15 percent of the proceeds until the break-even point. Russia would then receive 15 to 70 percent of the profit oil proceeds, depending on the success of the project after the break-even point.<sup>53</sup>

Much like Sakhalin II, the deal had clearly obsolesced after the oil shock: Exxon-Mobil (Exxon merged with Mobil in 1999) had sunk a large sum of money into the project and, in 2004, ExxonMobil reported cost overruns and presented a significantly larger spending program for developing the fields.<sup>54</sup> In 2006, ExxonMobil reported a cost overrun of 30 percent from the projected \$1.645 billion to \$2.064 billion.<sup>55</sup> Russian authorities began to pressure Exxon Mobil, using similar tactics to the ones they

employed to push out Shell in the Sakhalin II project. In 2007, Gazprom Deputy Chairman Alexander Ananenko characterized ExxonMobil's control of the project as "an infringement of Russia's national interest."<sup>56</sup> Despite predictions that ExxonMobil would be forced to reduce its stake, the Russian state has backed away from renegotiation.

Although renegotiation would increase Russia's control over natural gas distribution to Asia, the benefits of renegotiation (Russia's defection payoff) would not prove as much of a "game changer" in access to revenues as in Sakhalin II. First, the scale of the Sakhalin I project was much smaller. Cost overruns at Sakhalin II totaled more than \$10 billion; those at Sakhalin I were less than \$1 billion. Second, the terms of the PSA did not completely deprive the state of access to resource rents during the oil boom. In fact, only a year after the report of cost overruns, the Russian state began receiving steady hydrocarbon revenues from the project in 2005 as production started at the Chaivo field.<sup>57</sup> Third, in 2008, the project reached its break-even point and the Russian state's share increased. Finally, Gazprom's control over Sakhalin II helped solidify its position of future control over LNG exported from Sakhalin I: "While legally the Sakhalin-1 consortium is exempt from Gazprom's export monopoly, practically, it must deal with the state behemoth in pipeline construction and contend with its plans to turn Sakhalin-2 into a regional gas export hub, which would involve Sakhalin-1 supplies."<sup>58</sup>

Meanwhile, in the wake of Sakhalin II, the reputational costs of renegotiating Sakhalin I were particularly high; a contentious renegotiation would further tarnish Russia's reputation as an insecure place to invest. Furthermore, driving ExxonMobil from the Russian market through renegotiation could also imperil Russia's possible long-term plans to export natural gas to the west coast of the U.S. Finally, ExxonMobil's actions suggest that it would be a far less cooperative partner in responding to Russian pressure than Shell. For instance, in 2009, in response to Russian refusals to approve the yearly budget, ExxonMobil played hardball and imposed a work-stoppage to persuade Russia to adopt the budget.<sup>59</sup>

Thus, although ExxonMobil and the Russian state continue to jockey for position, it is likely that the Russian state and ExxonMobil will continue to cooperate in developing the Sakhalin I project. In fact, some experts think that a compromise will be reached in which ExxonMobil will maintain its operatorship in return for selling its gas to Gazprom, thus allowing the state gas agency to retain a monopoly on the export of gas to East Asian markets.<sup>60</sup>

### Kharyaga

The Kharyaga PSA was signed in 1995 and came into effect in 1999, giving France's Total a 50 percent interest, Norway's Hydro a 40 percent share, and the Nenets Oil Company 10 percent in a project located in the Russian Arctic.<sup>61</sup> This field is an important staging post for Russia's plan for developing its hydrocarbon resources in the Arctic. In comparison to the Sakhalin I and II PSAs, this PSA was small—Total projected a full investment of less than \$1 billion over the life of the project. Under the terms of the PSA, the Russian state would receive 50 to 65 percent of the profit after the break-even point and pay a 5 to 11 percent royalty<sup>62</sup>

The project began producing oil in 1999.<sup>63</sup> In 2001, the Putin administration served Total with a \$48.5 million tax bill. Total responded by filing suit against Russia in an international arbitration court in Stockholm. In 2003, the government and Total reached an out-of-court settlement and Total withdrew its suit in exchange for approval of its Kharyaga expenses.<sup>64</sup>

In 2006, the project came under environmental scrutiny and commentators speculated that the PSA would be renegotiated.<sup>65</sup> In March 2007, however, Russia's Environment Ministry announced it would not recommend revoking the consortium's development licenses for environmental infractions. In the end, it presented Total with a fine of just \$1,150 for minor safety violations.<sup>66</sup>

Although the benefits of operating this field would have yielded some additional revenue, Russia would not have pocketed a large defection payoff. First, the additional profits that the Russian state would generate through ownership were small compared with the massive Sakhalin II PSA. Furthermore, despite tax disputes, the PSA was generating a steady income for the Russian state during the oil boom. In fact, Total paid \$107 million in 2006 and \$70 million in profit oil to the Russian state in 2007.<sup>67</sup> Finally, in 2009, the Russian state increased its stake in the project when members of the consortium finally satisfied a provision in the PSA that required that a Russian partner be given a 20 percent stake.<sup>68</sup>

The reputation costs of renegotiating this deal would be high. Renegotiation would send a damaging message to IOCs about the Arctic region, an area where Russia needs IOC cooperation. In fact, experts believe that developing the region will cost approximately \$65 billion—\$5 billion for geological surveys; \$50 billion for exploration and development; and \$10 billion for vital infrastructure, such as railways, export pipelines and port facilities.<sup>69</sup> Furthermore, the Russian state is seeking to build a close relationship with Total, as it seeks to improve relations with the French government, both to ease access to French export markets and strengthen its bilateral relationship.

Thus, in the end, it is likely that the strategic goals of developing this region are constraining the desire of Russian officials to capture a larger share of revenue streams from Kharyaga.

### **Further Cooperation**

Other recent hydrocarbon decisions confirm that Russia requires IOC cooperation in its hydrocarbon industry and therefore must continue to value its reputation. This is particularly the case as Russia seeks to tap its massive natural gas reserves in the Arctic and Barents Sea. In projects like these, the traditional advantages of IOCs come into play, particularly vis a vis Gazprom. First, Gazprom does not have the technological know-how to solely develop Shtokman or Yamal alone. Russia has little choice but to rely on the technological expertise of IOCs in tapping the deeper, harder to reach, but potentially massive Yamal reserves. Furthermore, the Russian state needs to share both the risks and costs of developing these areas. One expert writes: "Gazprom estimates that the huge Bovanenkovo oil and gas condensate field [in Yamal] will require \$100bn to build the infrastructure and come onstream. The total estimate is \$200bn, and you have to bear in mind that planned costs tend to increase as the project progresses."<sup>70</sup>

Consequently, Russia has opened both Yamal and Shtokman to IOCs. Shtokman, located in the Barents Sea, contains a potentially massive amount of natural gas reserves. After initially declaring that they would not need foreign investment, the Russian government came under significant pressure to reverse its decision. Yuri Yevdokimov, the governor of Russia's Murmansk region, told *Rossiiskaya Gazeta* that the project faced major obstacles, including its distance from shore and the challenges posed by drifting ice.<sup>71</sup> Soon after, the Russian state changed its mind. In June, 2007, Gazprom, which owns a 51 percent stake in Shtokman, brought in French-owned Total as a 25 percent equity partner.<sup>72</sup> After con-

sidering ConocoPhillips for its distribution access to the U.S. market, the Russians finally chose Statoil Hydro, with its experience in deep-water Arctic drilling.

The Yamal “Mega-Project” offers a potentially massive amount of hydrocarbon reserves. Experts estimate that Yamal holds about 12 trillion cubic meters of natural gas, or over 25 percent of the total Russian resource base—plus another 50 trillion cubic meters of exploration potential, according to Sergey Shmatko, the Russian Energy Minister.<sup>73</sup> This project also is too big for Russia to develop without IOC help. At a September 2009 meeting, Prime Minister Putin told a group of IOC executives: “The partnership on Yamal should be stable and long-term”, adding that, “We want that you feel yourselves to be part of our team and participants in this process.”<sup>74</sup> Shell has an inside track in these renegotiations because of its cooperation following the Sakhalin II renegotiation.<sup>75</sup>

### Azerbaijan

#### Azeri, Chirag, and Guneshli PSA

In November 1994, an international consortium of oil companies (the Azerbaijan International Operating Company, AIOC) signed a PSA dubbed the “Contract of the Century” with the State Oil Company of the Azeri Republic (SOCAR) to develop the Azeri, Chirag, and Guneshli oil fields (ACG) located offshore in the Caspian Sea. The agreement called for a total \$7.4 billion investment over thirty years in the three offshore oil fields.<sup>76</sup> The fields were estimated to contain 4 billion barrels (511 million tons) and contain high quality crude considered to be among the lightest in the world and, thus, the easiest to refine.<sup>77</sup> This deal immediately gave the government some much-needed hard currency: the contract carried a \$300 million dollar signing bonus.<sup>78</sup>

In the end, British Petroleum (BP) ended up with 40 percent of the ACG deal. The terms of the deal were more favorable to Azerbaijan than those of the Sakhalin II deal were for Russia. The Azeri state received 30 percent of the profits after the break-even point and until the BP-led consortium achieved a 16.75 percent rate of return. After achieving that return, Azerbaijan’s share rose to 55 percent. Only after the consortium had achieved a 22.75 percent rate of return did the state’s share of profit oil go up to 80 percent.<sup>79</sup> Finally, the state ensured that it would retain a direct take of the profits, as SOCAR was part of the consortium.

The more favorable terms were partially a reflection of the fact that SOCAR was a highly competent negotiating adversary. In fact, SOCAR has shown incredible foresight and technical expertise in signing these deals. Even at the lowest point of the oil price slump during the 1990s, SOCAR drove a hard bargain with Houston-based Frontera: “Frontera confronted SOCAR’s insistence that it flatten its production-sharing curve, spreading out the cost recovery period and allowing for early profit oil.”<sup>80</sup> SOCAR has also grown more sophisticated at signing deals: “At SOCAR’s insistence, its participation in each of the 19 PSAs has steadily risen, while its up-front expenses are carried by other consortia members.”<sup>81</sup>

As the price of oil rose, the terms in the ACG PSA began to obsolesce; like Russia, Azerbaijan had clear incentives to increase their take in the rapidly rising hydrocarbon rents that were emerging. First, the BP-led consortium at ACG had already invested heavily in the project. Second, BP reported cost overruns in Azerbaijan. In late 2005, “BP on Dec. 14, 2005, said capital expenditures on projects in Azerbaijan had exceeded forecasts. BP’s Azerbaijan CEO, David Woodward, said [that the] AIOC had been spending more than it had planned

because of a combination of an increase in activity, cost increases and fluctuations in the dollar exchange rate.”<sup>82</sup>

Azerbaijan’s defection payoffs for the ACG PSA were significant; with high oil prices, increased access to resources rents coming from the ACG PSA would yield a large windfall for the state. In fact, the ACG fields were by far the most significant aspect of Azerbaijan’s hydrocarbon output. For instance, in 2008, they accounted for over 80 percent of Azerbaijan’s total oil output in 2008.<sup>83</sup> Increasing state involvement, therefore, would significantly increase Azerbaijan’s take in resource rents.

This windfall, however, was not as large as Sakhalin II. For instance, the terms of the deal did not mean that cost overruns would significantly delay the beginning of revenues to the state. Furthermore, unlike Sakhalin II, there were no significant delays in producing oil that would deprive the Azeri state of its share of the oil boom. For instance, production in 2008 already neared the one million barrels a day, generating a significant revenue stream for Azerbaijan under the terms of the PSA.<sup>84</sup>

Thus, even at the very height of the oil boom, Azerbaijan did not threaten to renegotiate the contract; on the contrary, reports suggested that Azerbaijan was in talks with BP to extend the PSA beyond its original 30-year term.<sup>85</sup> This accords with the reputational model: for the Azeri state, the rents that they were foregoing by failing to renegotiate were outweighed by the *ex post* reputational costs that would come with renegotiation.

Azerbaijan signed more than 20 other PSAs prior to the oil boom. None of these have been renegotiated. On the contrary, IOCs have abandoned more than a third of these PSAs due to disappointing exploration discoveries.<sup>86</sup> Azerbaijan’s top priority now is to attract new hydrocarbon investment into previously-abandoned hydrocarbon fields. The Absheron field is a good example. Chevron and Total signed a PSA to work with SOCAR to develop this field, estimated to contain between 1 and 3 trillion cubic meters of gas. However, the first exploration well failed to yield any commercially viable resources and the companies abandoned the block in 2003.<sup>87</sup> Now, SOCAR estimates that Absheron contains 300 billion cubic meters. After an extensive search, Azerbaijan signed a new PSA in 2009 to develop the Absheron fields with Total as the operator.<sup>88</sup>

### Conclusion

The dominant explanation of resource nationalism is incomplete: the stability of hydrocarbon contracts signed during the 1990s is a product of more than just the internal cost-benefit calculus of the IOC-HC bargaining relationship as the OBM predicts. This article presents compelling evidence that both Russia and Azerbaijan are proceeding strategically, weighing the short-term benefits of renegotiation against the long-term *ex post* reputational costs in a complex bargaining game with IOCs. Steven Dashevsky, co-head of equities at Moscow-based UniCredit Aton, nicely captures this argument: “While this could be dismissed as resource nationalism, it’s actually sovereign nations reestablishing their negotiating positions . . . They’re behaving as any rational economic agent would.”<sup>89</sup>

This finding has important implications for IOCs. In the continuing absence of strong courts to enforce contracts, IOCs should (and many are) adopt private ordering strategies to ensure the stability of their contracts. First, IOCs should avoid contracts that deprive the HC a share of the revenues until late into the life of the contract. Such an approach avoids the problem of spiraling up-front costs that deprive the HC a share of the revenues—a major problem in the Sakhalin II PSA. One strategy for countering this problem is to include a

HC-owned partner in the consortium. ExxonMobil's partnership with Rosneft in Sakhalin I has likely played a significant role in ensuring continued contractual enforcement.

Second, IOCs should push to publicize the terms of their long-term contracts in order to ensure that renegotiations carry high reputational costs for HCs. These publicized terms will help frame the debate for the possibility of future renegotiations and should help constrain the actions of the HC. In fact, contractual disputes in high stakes hydrocarbon contracting are more likely to be decided on the front pages of international newspapers than in courts, as sovereign governments seek to reduce the reputation costs of renegotiation while also increasing their access to the flow of hydrocarbon rents. HCs are trying hard to strengthen their reputation as a safe harbor for IOC investment and have hired public relations firms to advance this image; IOCs should consider similar attempts to control public perceptions of disputes.<sup>90</sup>

Third, IOCs should increase coordination with each other (through mergers or cooperation agreements) so that they can more effectively coordinate and punish HCs that renege on long-term contracts. IOCs should also coordinate with their home governments. For instance, Total's close relationship with the French government has aided its expansion in Russia because Russia sees a close relationship with Total as both a way to improve relations with France and as a way to increase export opportunities in France.

Finally, IOCs should look to invest in HCs that are more likely to value future IOC cooperation. This article has suggested some factors that would increase this likelihood; more work is required to pinpoint other such factors, whether global or country-specific.

In sum, this article should be read as a starting point for a comprehensive and empirical study of the importance of reputation in hydrocarbon contract stability. To more rigorously test the model of reputational private ordering advanced in this article, more country data is needed on hydrocarbon investment contracts. Anecdotal evidence suggests that the reputational considerations are at play in HC-IOC relations across the globe. For instance, even Venezuela, which has gone much further in breaching contracts than Russia, has avoided full-scale nationalization. Rather, cooperation remains the norm. Of the six major oil companies involved in Venezuela, only two exited completely from Venezuela: ConocoPhillips and ExxonMobil.<sup>91</sup> Two others (Total and Statoil) reduced their holdings to allow space for the state-owned Petroleos de Venezuela S.A., and two more (Chevron and BP) maintained their previous stakes. Furthermore, since the fall of the oil price in response to the global financial crisis, Venezuela has once again started to solicit bids from foreign oil companies.<sup>92</sup>

This work will yield interesting insights as we uncover more details about the complex bargaining game between resource-rich HCs and highly sophisticated, capital-rich IOCs. This empirical approach to hydrocarbon investment will help us challenge other assumptions about resource nationalism and help us predict the future of IOC-HC relations. In so doing, researchers can help build a more accurate view of the complex new hydrocarbon investment game of the 21st century.

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