Financing the Russian Oil and Gas Sector

The Effects of International Law Instruments

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The development of any economy takes its momentum from the implementation of investment projects which ensure reproduction on a progressively increasing scale, add new values, create new jobs and spawn new producer and consumer demand. The financial sustainability of such projects, i.e. their ability to attract the required cash resources on acceptable/competitive terms and to make for such returns on these inputs as match the risks involved, is a key factor not only for the efficient implementation of the undertakings concerned but also for their very possibility. This is especially true of investment projects in the fuel and energy sector, considering the latter's unavoidably high capital/output ratio, long lead times and a greater diversity of risks compared with other sectors.

The purpose of this article is to show how multilateral international law instruments, in particular the Energy Charter Treaty (ECT) and various related arrangements, can lower project-financing risks and the costs of raising external capital. The analysis below basically consists of five sections.

Section 1 looks at the evolution of mechanisms employed in the world to finance oil and gas projects as such projects themselves get more challenging—with the deterioration of natural conditions on deposits under development—and as the energy market structures become more complex—with the field of players growing and their inter-relationships becoming ever more intricate. The evolution of the market machinery in question reflects searches for such efficient tools as can counter emergent new risks that spell higher financing and other costs.

The second Section describes the principal stages covered on the way to project financing in the oil and gas industries in Russia. It is only now—more than ten years after the country proclaimed its sovereignty—that possibilities have appeared not only for all manner of hybrid project-financing schemes but also for pure-blooded ones in

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the oil and gas sector, with the organization of funding for the Sakhalin-2 project having set the first example of the latter type of arrangements in Russia.

Section III is a brief overview of Russia's rating history, which mirrors the progress of changes in an overall assessment of investment-project risks in the country. With account taken of the fundamental regularities of project financing—the credit rating of a project cannot ordinarily be higher than the comparable scores of the companies involved in its implementation, which, for their part, cannot be higher than the credit rating of the country in which these companies are pursuing the project concerned—such rankings substantially mark the limits of the appeal held by a specific country for investors, as well as the rock bottom below which the costs of raising external capital for investment needs and the costs of project financing cannot be expected to fall.

The fourth section reviews the underlying rationale of energy market development and the parallel build-up of safety nets available for investors which should ward off the surfacing new risks of investment-project financing.

Finally, Section V is devoted to the Energy Charter process and the ways in which the ECT and related mechanisms help reduce the risks of project financing and the costs of raising external capital in order to implement investment projects in the fuel and energy sector.

1. The Evolution of Financing Arrangements for Oil and Gas Projects

The evolution of the machinery of financing investment projects in the world's oil and gas industries replicates the development pattern of oil and gas markets.[1] Each major phase in market growth, as a rule, is characterized by its own prevalent combination of arrangements used to bankroll oil and gas projects.

Before the 1970s, most oil and gas projects in developing nations were financed out of international petroleum companies' internal cash flows. Such financing arrangements corresponded to those companies' then-dominant role in the international oil business. They carried out investment projects in developing countries through their regional subsidiaries. Funding came either from internal cash flow (profit refinancing) or through corporate financing schemes whereby commercial banks based in the companies' home countries provided them with investment resources against guarantees from such recipients, which in turn used intra-corporate mechanisms to pass the monies on to their subsidiaries in order to back the corresponding projects in developing nations.

New field finds at the time usually occurred in areas blessed with felicitous natural conditions, with resulting low exploration and development costs. The host countries,

[1] The author has expounded his views on principal regularities in the development of oil and gas markets in such works as *World Oil Market: A Return of the Epoch of Low Prices? (Consequences for Russia)* (in Russian), Publishing House of the National Economic Forecasting Institute at the Russian Academy of Sciences, Moscow, 2000; and in a series of articles on the subject published in Oil of Russia, a Russian-language journal, over the period 1999-2002.

as a rule, were developing nations who were Members of the Organization of Petroleum Exporting Countries (OPEC), which accommodated the largest oil and gas reserves being exploited outside the United States and which accounted for most of the increases in the hydrocarbon stocks explored and proved. Even on virgin fields, opening-up costs were relatively minor. The array of concession agreements then concluded between international petroleum companies and host countries provided the former with long-term guarantees of crude supplies and, consequently, warranted only minimal delivery, or "volume", risks. The pricing policy based on the then-dominant transfer prices (i.e. prices at which international petroleum companies' producing branches provided their crude output to the parents in their home countries and which constituted not market prices but so-called reference prices intended solely to assess the tax bases of such companies' regional divisions in the host countries) assured the businesses concerned of low price risks. International petroleum companies, therefore, were in a position to be able to undertake ambitious new projects single-handedly, without having to form consortiums in order to spread out risks or owing to the possible want of resources to finance capital investments.

Most such ventures enjoyed a low debt-to-equity ratio and, for this reason, usually needed no foreign borrowing to fund field exploration and development projects. Should any external capital be required, they easily obtained the desired financial resources against low interest and for a long term, thanks to their high credit ratings that were due, as a rule, to their consistently positive balance sheets. Since it is not such companies themselves but, as already noted above, their producing branches or other divisions that operated in most oil-rich developing countries, those operations were able to obtain the required monies more cheaply against the cover of guarantees from the parents which had no reason to fear that such borrowers would exceed their internal borrowing limits or commercial banks' applicable lending limits and which could move cash to the desired region via intra-corporate channels. This made debt financing even less expensive.

Following the upswing in oil prices during the 1970s, the governments of various countries started going into the petroleum business themselves one after another: in importer nations, in order to allay fears over the reliability of fuel supplies; and in developing host countries, in order to gain tighter control over uses of their sovereign natural resources and to boost national revenue from the latter's exploitation through both direct and indirect equity participation in related businesses. Some of the host countries nationalized the local assets of international petroleum companies. It is such assets that served as the basis for the establishment of national, State-owned petroleum ventures in the majority of OPEC countries. Funding for the surviving regional subsidiaries of international oil businesses continued in the same way as before. In contrast, national oil producers were financed either through the refinancing of profits derived from their projects—most of which had already been assured of positive

discounted cash flows by regional branches of transnational corporations before the nationalization moves—or out of appropriations from the host nations' government budgets. Joint ventures between foreign companies in those developing countries where they continued in existence or made a new appearance and such nations' domestic businesses were launched in a number of cases to take care of new projects.

The desire to provide a cushion against the adverse consequences of rising oil prices for the balances of trade and payment of importing countries initially boiled down to nothing more than attempts at replacing imports (primarily those from OPEC Members) by crude oil domestically produced in importer nations and/or that supplied by non-OPEC exporters. With this aim in mind, importing countries and potential new oil-producer States stepped up oil and gas exploration, among other things, thanks to new players joining the petroleum business as a result of their being tempted by the then-high crude oil prices. This is why, during the 1970s and the first half of the 1980s, the governments of producer countries, international financial organizations, commercial banks and many other market players were willing to pour substantial investments into oil projects and companies, with privately owned ventures eager to do so in the hope of high returns on their inputs amid soaring petroleum prices and State-owned institutions keen to join in in a desire to ensure energy security (then understood as the energy security of nations) and reduce dependence on imports.

The new oil and gas projects started getting additional cash injections from government budgets and out of official loans. A fair share of government appropriations came as funding for national/State-controlled oil companies, putting on ever stronger muscle in developing nations thanks to direct government equity investments in companies pursuing State-supported projects and/or as debt financing and other forms of credit backing relying on the possibilities of government financial institutions for such projects.

Over the second half of the 1980s and the early 1990s, however, almost all of the above financing sources dried up. The main reason for this was the collapse of petroleum prices in 1986 and the resulting sluggish business environment which perceptibly undercut the financial standing of all oil companies. The worsening of natural conditions then available for the development of new pools, as increasingly more difficult-of-access deposits had to be opened up and exploration parties went ever further into the wilderness and had to make ever greater efforts to strike a field (none of which represented any huge financial problem for oil producers while crude prices were running high and left the costs of production, though likewise rising, far behind), dramatically detracted from the appeal of investments in oil projects as prices fell off. Public attention to environmental problems at the time also gained in intensity, this also resulting in tighter nature conservation requirements and further related expenses.

The palpable deterioration of natural conditions in evidence for exploiting deposits and the relocation of some production operations to fields located in extreme conditions

and requiring enormous capital inputs for oil and gas recovery purposes led to individual businesses beginning to shy away from the high overall risks of opening up such pools. There arose the need for consortiums, which had not been previously experienced in the sector, either during the 1970s or before. International oil companies were compelled to review their standard funding criteria and impose more stringent criteria for investment projects meriting equity participation. As prices became uncertain and prone to vacillate much more unpredictably, investors started to prefer projects where risks could be spread out among participants and recoupment periods were shorter compared with what they had been used to. They became more selective in choosing the targets of their financial inputs. For these and other reasons, including politically motivated claims by host countries for larger participatory shares in local businesses and their purchases of equipment and other products and services, transnational corporations began enlisting a wider range of partners, including local ventures, in investment undertakings in the petroleum sector. This resulted in a marked increase in the number and diversity of players in business on the oil and gas market at the time and in more intricately structured and complicated financing schemes owing both to more rigorous country restrictions and to the involvement of participants having a lower creditworthiness.

Beginning in the early 1990s, most countries, including both oil exporters and oil importers, started to limit their participation in and government budget allocations for the oil and gas sector, preferring instead to encourage private investors to shell out money for projects in the field. For one thing, the market development had reached a stage where the build-up of domestic oil supplies for importing States had ceased to be a national priority. In the market-economy zone, the world market itself could, through its own, now sophisticated machinery, meet with any rise in demand for liquid fuel, at acceptable prices and with sufficient guarantees of delivery to any part of the globe. This was, at least in part, a reflection of the fact that energy security in that period—when the oil business had become increasingly interwoven internationally and a focus of globalization—was associated no longer with independence but with the energy interdependence of States. For another thing, there came into view an obvious trend of constraints on direct government involvement in those economic sectors where private business is efficient by itself, and a number of countries were swept by a wave of oil company denationalizations and privatizations. As a result, organizing financing for oil and gas projects turned into a still tougher proposition, presupposing the involvement of sundry government and private investment and financial institutions.

These days, petroleum companies make use of the full array of available financial instruments to fund oil and gas investment projects. The larger of such businesses prefer to fund oil projects, especially medium-scale ones, out of their own resources, as well as, if necessary, by recourse to corporate borrowings. Such borrowings are sometimes

even cheaper for major transnationals with their exceptionally high credit ratings than debt project financing, particularly in transitional economies keynoted by heightened risks and fair to mediocre country credit ratings. However, a great many smaller petroleum companies which have only taken off and gained a foothold on the market over the past few years do not enjoy the advantage of the international pace-setters' high capitalization, budget surpluses, lines of credit out of their own resources and, as a result, high credit ratings. In such cases, the appeal of a project may prove higher than the rating of its specific participant, thus assuring the latter of cheaper project borrowing compared with corporate borrowing.

It is over this period that petroleum companies have started resorting to project financing proper, whereby returns on funds invested in a project are secured, as a rule, by future proceeds from its implementation rather than by the host country's sovereign guarantee or a corporate guarantee from a participating business.[2] However, even big petroleum companies prefer project borrowing when undertaking highly ambitious mega-projects or upon encountering country restrictions—for example, where the risk of potential losses in a country turns out exceedingly high or goes over the limit applicable to that country or when their partners are such businesses as are not in a position to be able to draw the necessary funds on corporate financing terms. The ratio between private shareholding financing and private debt financing in oil and gas production projects stands at between 20 to 40 percent and 60 to 80 percent, respectively. The sources of private shareholding financing are constituted by inputs from other project sponsors, international money markets, investment foundations, certain international financial institutions under the World Bank (the International Finance Corporation and/or regional development banks such as the EBRD in Europe and its opposite numbers in Asia, Africa, etc.)[3] and the national development banks of host nations.

International commercial banks providing loans against future project revenues act as private debt financing sources. Such sources include supplier credits, specialized energy foundations, the International Finance Corporation (in its capacity as a lending institution) and local banks in those countries where the particular projects are pursued, as well as development banks at each level of the triple-tier World Bank system.[4] Companies participating in a project can also enter money markets by floating funded debts and using other derivatives.

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[2] Special aspects of project financing are covered in detail in A. Konoplyanik and S. Lebedev, *Project Financing in the Oil and Gas Industry: Worldwide Practice and Initial Experience in Russia* (in Russian), Oil, Gas and Law, 2000, No. 1, pp. 25–40; and No. 2, pp. 23–42.

[3] In addition to the World Bank (International Bank for Reconstruction and Development (IBRD)) itself, which is a purely lending institution which credits governments against their sovereign guarantees and which, unlike the International Finance Corporation, may not have any equity participation in project companies organized to implement business undertakings supported/credited by the IBRD.

[4] With the IBRD itself representing the global level, regional reconstruction and development banks coming at the regional level, and national reconstruction and development banks forming the national level.

Attempts were made in Russia during the 1990s to set up a national bank for development under the World Bank's wing. They resulted in 1993 in the establishment of a Russian Bank for Reconstruction and Development (RBRD), with this author appointed in 1996 to serve as its Executive Director with responsibilities for the institution's investment business. This happened immediately following the enactment and implementation of the Law "On Production-Sharing Agreements", the group of drafters of which was likewise led by this author. We drew up legislation on production-sharing agreements (PSAs) as the legal basis for project financing. The concept I prepared for RBRD's investment business emphasized its development as a bank to provide project financing for oil and gas projects pursued on a PSA basis. The idea attracted the European Bank for Reconstruction and Development (EBRD) but failed to find support either from the RBRD's Russian shareholders, which had gained a hold over the bank, or from the Russian government, which had failed to retain even the blocking parcel of stock (25 percent + 1 share) and only had a 25 percent equity (and even that ultimately unpaid) and which, for that reason, had no way of controlling the bank's key decisions. With the national financial meltdown following soon after that, the RBRD project finally folded up.[5]

II. PRINCIPAL LANDMARKS ENROUTE TO PROJECT FINANCING IN THE RUSSIAN OIL AND GAS SECTOR

The evolution of arrangements used to fund oil and gas projects in Russia on the way to project financing reflected changes in the patterns of ownership, control and governance in the country's fuel and power sectors during the 1990s.

The very beginning of the decade saw a gradual—but fairly rapid and final—renunciation of government budget financing for the oil industry as it was turned over piecemeal to private interests capable of putting resulting petroleum companies on a pay-your-own-way basis. Those companies were provided virtually free-of-charge with those oil assets—subsoil sites—which they had previously exploited with government funds. The State, as will be shown below, was prepared at the initial stage of privatization in the oil sector to support such companies with government guarantees for their borrowings. The rocky path from plan-based government financing—effectively amounting to open-ended donations—for the oil industry to corporate self-financing on the basis of the corresponding Russian petroleum companies' own resources and loan facilities drawn on a repayable basis for fixed terms for expanded reproduction purposes, made still more difficult by the numerous obstacles which such companies had to negotiate before becoming full-blooded and efficient players on the market, was among the reasons why output in the sector over the 1990s plummeted in a cave-in which was also brought about by such equally weighty factors as declining solvent demand.

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[5] See A. Konoplyanik, *Russian Development Bank: Where to Get the Money for Investments?* (in Russian), Investments in Russia, No. 5, 1999, pp. 3–5.

Project financing in Russia commenced with the launch of joint ventures (JVs). The absolute majority of such businesses were established on the basis of cost-benefit analyses performed for specific projects aiming to open up new and, as a rule, small deposits or to increase oil recovery from fields already under development. Investments—usually coming from Western participants—were to be repaid with net after-tax profits from the projects. Therefore, economically, those JV projects lifting off in 1991 or earlier were designed with account taken of the taxation system then in place in Russia.

That system, including the constitution of taxes, their rates and tax administration procedures, underwent sweeping changes on 1 January 1992, with the imposition of a customs export duty representing the most radical innovation. From the point of view of the State, it was a fair step intended to take away a portion of the hefty earnings made by oil exporters on the differential between the prices on the domestic and external markets (so-called price rent). The new measure, however, also hit "innocents" such as those companies which had planned to pursue their oil projects on the basis of project financing, because the economic principles governing JV economics, which the partners had relied upon when launching the joint enterprises, were now entirely different. For those going concerns in the oil industry which had already absorbed most of the investments needed to develop new fields and had entered the project implementation phases dominated by operating rather than capital costs, the duty came as a heavy, yet not lethal, blow. In contrast, for those newly-undertaken projects whose (Western) investors had relied on the then-existing taxation conditions remaining intact for at least a time exceeding recoupment periods, the new levy proved fatal, making the projects' costs actually prohibitive and those undertakings then loss-makers. However, many of the JVs had by then already completed substantial portions of the investments called for and thus came face to face with the dilemma of writing them off as losses and withdrawing from both those projects and Russia in general or of trying to seek justice and relief by appealing to the generally accepted principle of contractual-term inviolability.

Polar Lights and KomiArcticOil[6] were the first JVs to apply to the Russian government for a solution to the contradictory situation where the government of the host country has the natural sovereign right to establish any taxation system of its choice and to alter it at its own discretion and the impossibility for parties to investment agreements to observe their material terms and conditions owing to the latter's unilateral review by the government as the other party. The JVs were concerned, in other words, about the conflict between the possibility for the Russian government to make one-sided decisions without being held liable for the damage such decisions cause to investors in the public-law system of coordinates and the possibility for it, under

[6] A. Konoplyanik and M. Selimov, *Polar Lights Look Brighter for Conoco*, Russian Petroleum Investor, July 1992, pp. 40–42; *Idem*, *How Gulf Canada and British Gas Received Tariff Exemptions*, Russian Petroleum Investor, July 1992, pp. 45–47, and 71.

investment agreements, to only make decisions by mutual consent with the other parties or be otherwise held financially liable for the detriment inflicted on investors by its unilateral acts. It is precisely as breaches of the principle of investment-agreement stability that foreign investors treated the Government's acts as they pondered the resulting implications for their JVs established with then State-owned oil producers before 1992 under civil law.

Russian legislation at the time included practically no grandfather clauses that would seal agreed implementing conditions for the entire terms of the corresponding projects. Therefore, ensuring the enduring consistency of Russian laws in respect of newly contemplated projects was among the crucial factors prompting the later drafting work on PSA legislation which, among other things, extended the validity of grandfather clauses to the full duration of a project.[7] The maximum that the effective period of a grandfather clause outside PSA legislation can reach today—and then only in individual projects with foreign equity participation—is seven years, a term apparently designed to ensure that the foreign participants will enjoy a return on investment of up to 15 percent.[8]

Nothing of the kind was in evidence at the start of 1992 when this author was serving as the Russian Deputy Minister of Fuel and Energy responsible for external economic relations and direct foreign investments and when we drafted a Russian government Executive Order intended to conserve the agreed conditions for JV investors for the corresponding payback periods. It was an attempt to balance, on the one hand, the interests of the State, which had prompted the imposition of the customs export duty so as to transfer a portion of the price rent to the federal budget, and, on the other hand, the interests of the investors which had come to the Russian economy on the basis of project financing-arrangements in order to share in oil and gas projects. To sum it up, oil and gas JVs amounted to the first (and not quite successful) experience of applying project-financing principles in the Russian oil industry.

Several scenarios were carried out for project financing without Western equity participation. They began with the World Bank's Petroleum Rehabilitation Projects (loan facilities). A total of two such facilities were prepared and realized. Their internal organization relied on project-financing principles, even though they also required sovereign guarantees, considering that the loans were extended to the Russian government. The participants in the World Bank's first Petroleum Rehabilitation Project included three oil-producing associations, namely, Kogalymneftegaz, Varyeganneftegaz and Purneftegaz, which later joined the oil companies LUKoil, SIDANKO, and Rosneft.

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[7] A. Konoplyanik, *Concept for Legalization of Production-Sharing Agreements in Russia: Key Aspects* (in Russian), Oil Economy, Nos. 11–12, 1994, pp. 6–15.

[8] A. Konoplyanik, *Concession Contract: Possible Place and Role in Russian Investment Legislation* (in Russian), in *Oil, Gas, Energy, and Legislation: 2001-2002*, a legal yearbook on the Russian fuel and energy sector, Nestor Economic Publishers, Moscow, 2001, pp. 77–92.

The scope of the facility and the machinery of its availability were not the same as those of credit lines granted against sovereign guarantees against the federal budget which later set aside certain sums to be allocated free-of-charge (as regular government budget financing) among recipient enterprises. The amount extended under the Petroleum Rehabilitation Project was determined on the basis of relevant needs specified "from below"—through joint work by World Bank and EBRD experts and Russian professionals who compared the various parameters of feasibility studies for specific projects proposed by oil- and gas-producing associations in order to determine the volume of required financing based on the possibilities of its being effectively repaid with due regard for the lending banks' appropriate regulations. That was precisely why it proved possible to increase the sum of loan proceeds allocated by the World Bank itself as part of the facility (based on the relevant feasibility studies) from the original US$ 300,000 to US$ 600,000.

With the Russian oil industry substantially privatized, international financial organizations were not prepared to issue loans to restore idle wells—the purpose for which the money was being made available under the Petroleum Rehabilitation Project—on "pure" project-financing terms directly to the corresponding Russian producers, since the latter could only assure creditors of production guarantees within the limits of their own legal competence, i.e. on ex-field conditions. The oil companies themselves were not secure against changes to Russian legislation, which was the reason why some of them had to forgo the undrawn remainder of proceeds made available under the rehabilitation loan after another change in tax laws had made it impossible for these businesses to repay the credits on time. It is only the Russian government, as the sole voting shareholder in the Transneft export pipeline company, that can provide the required guarantees for the shipping of additionally produced crude for export (in order to ensure early returns on the borrowings). This is why the World Bank and the EBRD extended the cash resources issued as part of the rehabilitation loan to the Russian Federation represented by its Government rather than directly to oil producers (which was one of the conditions to make certain that the money would be paid back amid the post-privatization business set-up in the Russian oil and gas sector).

Therefore, State guarantees against loan proceeds were among the linchpin elements of the World Bank's petroleum facilities. The State thus effectively acted as the borrower in place of petroleum companies. That was among the reasons why the World Bank's credit resources were among those least expensive and available for the longest periods: the State assumes many of the risks involved in project preparation and implementation. At the next juncture in the development of the Russian oil sector, as its private segment had gained in weight and grown stronger, we proceeded to fashioning such mechanisms for its financing—with continued government involvement, as petroleum companies were still unable to draw sufficient funds independently from international money markets, while the domestic money market was simply non-existent—as made government guarantees redundant.

The loan structure prepared during the negotiation of a framework credit-facility agreement with the U.S. Eximbank for the Russian oil and gas sector was somewhat different from that employed in co-operation with the World Bank. Whereas the Petroleum Rehabilitation Project was geared to fulfilling a specific production task (recovery of idle wells) for which special market-oriented legal frameworks were created as halfway arrangement between government budget financing and project financing, the framework agreement with Eximbank was from the very beginning intended to give rise to such a legal scheme or model conditions as met the specified range of parameters and which could be used for a number of production projects selected for their consistency with such framework requirements. In other words, the objective of the agreement with Eximbank was to set up a kind of "finance conveyer" to provide funding for the Russian oil industry. Specific projects between Russian producers and U.S. firms—each requiring its own volume of investments depending on the substantiated financial needs of the local company—were as a result undertaken on the basis of model-based individual contracts having a minimum threshold value of US$ 25 million but, in their sum-total at a given time, subject to the US$ 2 billion overall ceiling under the framework agreement with Eximbank. The projects were chosen according to standard procedures to be implemented along the lines of project financing needing no government guarantee.

A Russian production association would file a borrowing request with the Ministry of Fuel and Energy, which would then agree on it with other Ministries and agencies in terms of a large number of aspects. After that, the approved request would be sent to Eximbank together with the would-be borrower's export licence and long-term quota to serve as evidence that the State would not obstruct the latter's commodity and cash flows within the framework of the crediting project. On the basis of those documents, Eximbank would issue guarantees to a so-called guaranteed creditor. In each project, however, Eximbank would only guarantee 85 percent of the facility. A cash-payment creditor was to be found for the remaining 15 percent to ensure that production associations themselves would partially assume the risks as well and thereby have greater motivation to use the financing mechanism for the particular project as efficiently as possible. A long-term supply contract would be executed with oil and gas buyers. Sales proceeds would go to an escrow account with a special deposit bank. The borrowing production association would sign a loan agreement with both the guaranteed creditor and the cash-payment creditor.

One important feature of the agreement with Eximbank was that it provided for tied credits: 85 percent of purchases was to be made up of U.S. equipment to be delivered to the country of destination by American carriers, etc. Those were the terms of the bank, the primary statutory purpose of which is to facilitate the advancement of the national—U.S.—economy. It was only on such conditions that it offered what was—for the time—fairly soft financing and agreed to cover the borrowing country's

political risks. That was why 85 percent of the loan—the money extended by the guaranteed creditor—went to overseas suppliers of equipment and services and only the 15 percent made available by the cash-payment creditor was untied, meaning that the equipment buyer was to that extent relatively free in choosing suppliers.

Following the break-up of the Soviet Union, most manufacturing operations to build oil and gas industry equipment ended up outside Russia. While Russian industry scrambled to fill in the resulting gap and to begin producing its own competitive analogues, it was necessary to replace the forfeited supplies with imports and, among others, tied credits. U.S. equipment is usually more expensive than any other. In price/quality terms (which is the best yardstick for judging competitiveness), however, it is all too often unbeatable, in particular in comparison with that hardware which could continue to be purchased in former Soviet Union countries as part of co-production arrangements dating from Soviet times. The agreement with Eximbank provided Russian oil and gas enterprises with yet another, alternative opportunity to choose other, competitive suppliers and more efficient financing options.

"Pure" project financing for newly-launched, large-scale projects first began to be practiced in Russia in the Sakhalin-2 PSA project (development of the Piltun-Astokhskoye and Lunskoye deposits on the shelf of Sakhalin Island).[9] It is the machinery of PSAs that makes it possible for investors to lower project-financing risks to a minimum. This is precisely why a PSA-based undertaking was the first to benefit from project financing in the Russian oil and gas industry.

Considering the substantial amount of investments required for the project, on the one hand, and its challenging nature and long implementation period, on the other, it was crucial—in order to streamline its economics and improve its "financibility"—for participants to begin generating revenue as soon as possible. Within this aim, the investors proposed that the project be broken into several development phases, the ultimate goal of the opening one being to start producing initial oil as early as July 1999.

Most of the funding (70 per cent) for the first phase of the Sakhalin-2 project, which successfully achieved that end, came from its sponsors—shareholders in the project (or special-purpose company) called Sakhalin Energy Investment Company (which today include Royal Dutch/Shell, Mitsui and Mitsubishi). Over the entire project implementation period, however, the lion's share of the money required (80 percent) is to be made available by the principal creditors—Japan's Eximbank, the United States' Overseas Private Investment Corporation, the EBRD, etc.—as export and import facilities. The Sakhalin-2 project is based on non-recourse financing, whereby the creditors take most of the risks. Since the borrower—Sakhalin Energy Investment Company, a special-purpose company—does not invest any of its own funds in the

[9] For details, see Konoplyanik and Lebedev, *supra*, footnote 2.

project, it does not incur any *del credere* risks. Grounds for resorting to the non-recourse financing option in this case are constituted mostly by the fact that the primary lenders include international financial organizations, as well as the Japanese and U.S. export-import banks and insurance agencies prepared to accept the political risks of the country hosting the project.

If one takes a look at the overall financing scheme for Sakhalin-2, one will see that the net worth contributed by Sakhalin Energy is zero, while subordinated loans extended by its founders—participants in the consortium organized for the purpose—account for 20 percent of the total investments planned for the project and non-subordinated loans provided by the principal creditors make up 80 percent of the required funding. The latter facilities are made available for the purposes of obtaining the principal loans, as proceeds will initially go to clear liabilities to those lenders providing non-subordinated loans. The consortium risks its capital investments before the principal lenders in the event that the revenue generated by the project itself proves insufficient.

It proved possible to arrange funding for the first phase of the Sakhalin-2 project because, among other things, the sponsors did not include any Russian participant, a circumstance that appreciably reduced the credit risks for the financial institutions involved. That project came in many ways as a trailblazer on the Russian market. It is always harder to finance pioneering projects, as the needed experience and expertise have still to be gained and standardized approaches are yet to be hammered out to replace the initial groping in the dark on many issues, since quite a few of the recipes tried and tested in other countries simply do not work in Russia. The want of their own uncommitted funds and low long-term credit ratings at the time would not have realistically made it possible for most Russian companies to adequately share in the project and provide shareholder financing (as corporate borrowings would have been too dear for them). Meanwhile, the role of shareholder financing at the opening phase of the project was fairly large—around 53 percent—meaning that, had Russian companies been involved in the project at that stage, this could have made attracting funds for it much more difficult.

Subsequently, as the capitalization of Russian businesses increased and they won corporate credit ratings that kept rising as time went by, the financing possibilities open to them diversified and came to include, most notably, tied and/or untied credits as part of corporate financing. With continued improvements in the country's economic and legal environment and gains in Russia's national credit rating, some financial institutions found it possible to also provide project financing to consortiums with the equity participation of major Russian companies, not only for PSA-based undertakings but also to enterprises launched under the system of licensed subsoil uses. The plan to develop the Yuzhno-Shapkinsky field in the north of European Russia, jointly pursued by LUKoil and Finland's Fortum, marked the first practical attempt at drawing project

financing for a mineral production scheme undertaken under the license system for subsoil uses.

Therefore, improvements in the sovereign credit rating of Russia itself have proved an important factor for cheaper borrowing on the part of its companies (both as project financing and as corporate financing). Let us take a look at the country's rating history.

III. Russian Risks: The Country's Rating History

Russia's rating history began in October 1996, when it was awarded its initial long-term credit rating (BB-) reflecting the general extent of risks confronted by investors in the country in their crediting of business entities undertaking investment projects. A country's rating thus indicates the minimum level of risks faced by economic agents, with associated corporate hazards, carrying out investment projects, with associated project risks. Consequently, a national credit rating mirrors the level beyond which borrowing costs cannot be expected to sink at the given stage in the country's economic development or, in other words, the minimum level of financial expenses for project implementation.

Following the 1998 financial collapse, it was only on 26 July 2002 that Russia regained the initial BB- rating awarded to it in 1996. In other words, it only overcame the consequences of the 1998 crisis by the middle of 2002. And it was only in December 2002 that the country finally topped the kick-off sovereign long-term credit benchmark, meaning that—from the standpoint of financing for long-term investment projects—its general economic climate became more felicitous than in 1996.

Where does Russia find itself in the overall system of credit rating coordinates? If we take the credit rating matrix, Russia has climbed to the upper rankings—albeit, as yet only their speculative categories.[10] To be able to vie for investments on a par with its competition on world capital markets, Russia has to offer much lower project implementation costs than it can presently manage. Consequently, the combined risks of pursuing investment projects, which determines the national credit standing computed by independent rating agencies, must be lower.

It is important for Russia not only to ensure an inflow of investments in the development/modernization of its fuel and power sector but also to penetrate those new

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[10] The most recent upgrading of Russia's long-term credit rating by Moody's rating agency by two steps to the first (though the lowest yet) investment-grade level Baa3 on 8 October 2003 has stimulated some euphoria in the country about the final and long-expected breakthrough in the evaluation of the Russian investment climate by the international business community as well as raising immediate expectations in the country that the financial costs of project financing might radically decrease in the very nearest future. A more cautious assessment, however, is probably more appropriate, for two reasons. Firstly, for many conservative institutional investors, the sovereign debt moves to investment category only after two rating agencies grant the country in question investment-grade level. Standard & Poor's, another United States-based rating agency, has already expressed that it is not yet ready to grant Russia an investment-grade rating level. Secondly, Moody's has been always more optimistic in evaluating Russian risks than Standard & Poor's. For instance, when in 1999-2000 Standard and Poor's left Russia with a technical default rating SD, Moody's gave it a B- rating, which is five steps higher.

markets opening for it. This means that the country should brace itself for struggles to secure investments in new projects and low related borrowing costs and, hence, for continued rises in its credit rating. Section V of this article will show how the ECT—through the instrumentality of international law—sets the stage for low financial charges and a higher national credit rating, thus enabling Russia to progress from speculative rating categories to the investment-rating big leagues.

IV. Regularities in Energy Market Evolution and Safeguards for Investors

The world economy features an integral international oil market, but the markets of gas, electricity and other energy resources still retain their substantially regional nature.[11] The integral Euro-Asian (Eurasian) gas market is only actually taking shape today, to be followed by the electricity market. It is vital for Russia to diversify its export flows (as its current ones are unduly linked to Western Europe alone) and start supplying energy resources also to the fastest growing market—Asia—and the largest international market—North America.

Russia is today competing on the Western European market with North Sea oil and gas fields—which are the closest to consumers—and African and Middle Eastern suppliers—who enjoy the lowest production costs, thanks to favorable natural conditions, and the most competitive transportation costs, owing to the possibility of delivering crude in large-tonnage tankers. The already stiff rivalry on the petroleum market is going to become even more severe following the commencement of Caspian oil supplies to Europe.

When the Energy Ministers of European Union countries met in Thessaloniki, Greece in February 2003, Turkey and Greece signed an agreement to build a 350-kilometer gas pipeline to link the two countries. Once completed, the pipeline will provide yet another, southeastern, route for gas supplies to Europe—an alternative to northeastern itineraries from Russia and Central Asian countries of the Commonwealth of Independent States, including two pipelines already in place via Ukraine and Belarus and another one, yet on the drawing boards, across the Baltic Sea bed. Gas deliveries to the European market will also grow from Norway, Algeria and Nigeria, including both network gas supplies (among other factors, due to the inevitable construction of a gas pipeline from Nigeria northwards to Europe through Algeria's territory and via the latter's gas piping system) and liquefied gas supplies, and those from Britain and The Netherlands will likewise continue. The opening of the southeastern route for imported gas to reach Europe, therefore, is going to make the already fairly harsh competition among its suppliers only more rigorous.

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[11] A. Konoplyanik, *From Monopoly to Competition: Major Trends in Oil and Gas Market Development* (in Russian), Oil and Capital, No. 3, March 2002, pp. 16–19.

Amid that competition, Russia's position on the European market is far from the most advantageous. Russian fields find themselves, as a rule, in much more difficult natural conditions compared with competitors and at a longer distance from the market. Therefore, the problem of slashing the financial risks involved in organizing funding for oil and gas production and transportation projects is for Russia more urgent than for such countries as are located closer to consumption centers.

Russia is not represented on the booming Asian market these days. Supplies there go from the Middle East, Australia and the United States (Alaska). New projects under way or being launched in Russia's eastern regions (including Eastern Siberia and Sakhalin), however, do target the Asian market. The Caspian fields—a new production area on the world oil and gas map—will be developed with a view to supplying both markets, namely: the Western European one, to be reached by several routes passing both through and in circumvention of Russia (with the "multiple pipelines" concept being an objective need, the satisfaction of which will minimize risks for both suppliers and consumers); and the Asian and Far Eastern one.

Therefore, the emerging Eurasian energy market will encompass not only Europe and Asia proper but also Australasia and Northern Africa (including the Guinean Gulf area). Many of the countries in that emergent consolidated energy space are either Members or Observers in the Energy Charter process.

To put it in a nutshell, Russia is facing today and will continue confronting tomorrow stiffening competition on both long-standing and newly arising energy and capital markets. In order to retain and enhance its presence there, it will have to find ways of augmenting the country's competitive advantages, i.e. to seek, in the first instance, to cut back both technical and financial costs. It is these tasks that the ECT and its tools are designed to fulfil.

As energy markets become increasingly subject to internationalization and globalization, related investment risks escalate, in particular because energy material and product flows begin to cross the territories of ever more countries, the laws of each of which have their specific peculiarities. The role of oil and gas transit from producer countries to the markets of consumer nations grows. Along with extensions in the commercially justified average length of delivery routes for energy resources over time (as the benefits of scientific and technological progress take effect), the number of national borders crossed by export supplies rises (as a result, for example, of disintegration processes taking place on post-Soviet territories in the early 1990s, when the U.S.S.R. broke up into fifteen sovereign nations). The enlarged transportation distances of trans-country energy material and product supplies and the increased number of national borders crossed in the process makes the shipping operations concerned riskier, thus adding to the hazards faced in related export-oriented projects to develop hydrocarbon fields and/or to generate electricity. This inexorably makes

such projects more expensive to finance owing to higher borrowing expenditure—the costs of borrowed resources which usually account for between 70 and 80 percent of total capital investments in a project. Consequently, there arises an objective need for adequate mechanisms for lowering associated risks and for safeguards for investors. Legal instruments are the most efficient in price/quality or cost-effectiveness terms for the purposes of bringing down such risks and increasing investor security.

Market internationalization and globalization are being accompanied by an expansion in the range of protective/encouraging arrangements for investors. Host countries and investors increasingly engaging in trans-border operations have the choice of an ever broader range of international law tools—including both bilateral and multilateral—for minimizing investment risks, in addition to those instruments available under national legalisation.

Within the framework of domestic law, a host country (and this is especially true of transitional economies characterized by volatile economic and legal conditions) ordinarily has two fundamental possibilities in order to protect/stimulate investors, namely:

- to establish enclaves of stability in a generally unsteady economy and legal environment; and/or
- to raise the country's overall investment appeal.

Russia is an economy in transition. Any transitional economy is, by definition, unstable, as it is in the process of system transformation. The Government and legislators (guided, among other things, by good intentions) have been making and updating legislation all the time, thereby lending unsteadiness to the country's legal environment. New laws are issued and existing statutes are amended to fill that void in the legislative regulation of the economy which existed before 1991, but the legal acts and related changes are all too often—and for different reasons—mutually contradictory. It will take years to synchronize and unify them. This is why Russia will yet for a long time to come remain a highly unstable country. The task, therefore, is to set up enclaves of stability in the unsteady economy, at least for large-scale and capital-intensive investment projects in the fuel and energy sector, as a way of increasing the country's attractiveness as an investment option.[12]

As applicable to Russia, the first of the fundamental possibilities mentioned above consists, for example, in the approval of such legislation on PSAs, concessions, free

[12] The influx of investments into projects undertaken in the fuel and energy sector will, through multiplicative effects, generate steady and quality economic growth outside the latter's bounds—in processing industries and in the sphere of consumption. Therefore, investments in the fuel and energy sector do not spell either the Russian economy's increased dependence on commodities nor its conversion into a "banana republic". Instead, they make for economic headway outside the energy sector, as the economic spin-offs from financial inputs in the latter all too often make a greater impact than corresponding direct (for example, tax) effects; see A. Konoplyanik, *Monies Before Goodies: How to Solve the Financial Problems of Russian Oil and Mechanical Engineering Companies Participating in Joint Ventures?* (in Russian), Oil and Gas Vertical, No. 10, 2000, pp. 140–143.

economic zones, etc. as will provide investors in *individual* types of projects with legislative safety nets against those risks connected with the volatility of laws (which can be done, in particular, by extending the validity of grandfather clauses to apply to the entire period of project implementation). The other of the possibilities lies in making corresponding amendments to existing laws on taxes (the Tax Code), investments and subsoil uses with the aim of bettering the investment climate in the country as a whole, i.e. for investors in *every* type of project. Understandably, both aspects of law-making should be seen not as mutually exclusive but as mutually complementing areas of work to be pursued in parallel. In the first of these areas, legislators can expect quicker positive practical results of their efforts in limited priority zones of investment activity, which will spread throughout the economy through consequential and multiplicative effects. In the other area, the favourable impact will/can be achieved later, but on a broader economic front.

International law mechanisms provide significant leverage for expediting positive shifts in national legislation. Initially, as progress is made from local to regional markets and foreign economic relations are not as diversified, the most vigorous efforts are to be made to fashion the system of bilateral international law safeguards to protect investors, including bilateral investment treaties (covenants on the encouragement and protection of investments), agreements on the avoidance of double taxation, etc. As the internationalization of the corresponding market economy registers further advances, efforts to contrive multilateral international law tools to make investors feel more secure become more and more important. The tools concerned comprise agreements laying down the same "rules of the game" within a group of countries brought together by existing and/or future common flows of goods and/or investments. Therefore, the wider the geography of international co-operation, the higher the level of economic interdependence among countries, and the more closely and profoundly the markets of adjoining nations are integrated, the greater is the role assumed by multilateral international law instruments for protecting/encouraging commercial (commodity markets) and investment (capital markets) activity.

The World Trade Organization, successor to the General Agreement on Tariffs and Trade (GATT), is the best known among the diverse multilateral international law mechanisms available today for the regulation of commercial and/or investment activity. The WTO includes 144 Member nations, with 32 countries acting in Observer capacity. The GATT/WTO rules provide for most-favoured-nation (MFN) treatment to be accorded by Members to their peers in their trade in goods and services. President Vladimir Putin in 2002 proclaimed Russia's accession to the WTO as one of three national legislative priorities—along with the reforming of natural monopolies and land reform[13] (although it appears now that, for a number of reasons, Russia's admission to the WTO in 2003 is not going to materialize and is being delayed at least until 2005).

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[13] See A. Konoplyanik, *Rocky Path to the ECT: Energy Market Evolution, Energy Charter Treaty, and Legislative Priorities for President Vladimir Putin* (in Russian), Oil of Russia, No. 11, 2002, pp. 48–51.

However, there exists a multilateral instrument for international law regulation which is applicable not only to flows of goods but also to the movement of capital and which, therefore, has an even greater operating coverage than the WTO. That instrument is the Energy Charter Treaty and its related documents.[14] The ECT encompasses both trade (including transit) and investments, although in the narrower circle of industries formings its subject-matter (which is limited to just the energy sector, albeit in a broad interpretation) and in fewer countries (51 States plus the European Communities as a regional economic integration organization). The ECT provides for the contracting nations' investors to be granted national treatment or MFN treatment, whichever is more favourable. Notwithstanding the high dependence of Russia's economic development on the condition of its fuel and energy industries, the ECT is much less known in both Russia and elsewhere in the world than the GATT/WTO, despite their having much in common. The trade section of the ECT, for example, makes the GATT/WTO disciplines directly applicable to GATT/WTO Members while also making GATT/WTO non-Members subject to the same rules by reference. Investment matters in the GATT/WTO are regulated by the Agreement on Trade-Related Investment Measures in the same manner as under the ECT.

Therefore, there is an inextricable connection between the ECT and the GATT/WTO from the point of view of the principles preached by each of these multilateral international trade agreements. Moreover, the ECT effectively offers/constitutes a ready-to-use legal basis for reforming Russian natural monopolies in the field along the lines supported (assuming continuity in its policies) by the Russian government.

V. THE ECT AS AN INSTRUMENT FOR LOWERING PROJECT-FINANCING RISKS AND THE COSTS OF RAISING EXTERNAL CAPITAL

Let us recall, even if in brief, the Energy Charter history. Everything began in 1990 on the EU's initiative. The Berlin Wall came down, fifteen sovereign nations sprang up where the Soviet Union had stood and there surfaced new risks connected with the dismantling of that system of relations, which had existed during Soviet times both within the U.S.S.R. and between the latter and other countries. It was essential to make up for the contacts lost, especially in conditions where Europe was increasingly dependent on outside energy supplies. Therefore, it was imperative to minimize those risks on a mutually advantageous footing by finding that adhesive which would make the interests of East and West into a blend. That binder could be found in Europe's interest in Russian (and other former Soviet Union) energy resources and the interest of the latter's producers in Western investments for relevant extraction and manufacturing operations.

[14] Various issues related to the ECT are analyzed in their inter-relationships in Thomas Wälde (English-language editor) and A. Konoplyanik (Russian-language editor), *Energy Charter Treaty: An East-West Gateway for Investments and Trade*, Mezhdunarodniye Otnosheniya Publishers, Moscow, 2002.

Things initially progressed very quickly. On 25 June 1990, Ruud Lubbers, then the Dutch Prime Minister, unveiled his initiative for a European energy community. 17 December 1991 saw the signing of the corresponding political declaration—the European Energy Charter. Three years later, on 17 December 1994, signatures were affixed to the legally binding ECT and the Protocol on Energy Efficiency and Related Environmental Aspects. But then the process slowed down. In June 1996, Russia initiated routines for ECT ratification but has not completed them to this day. The attitude of its authorities to formal ECT endorsement is well described by the following formula supported *de facto* by the State *Duma* legislature: "Ratifying is a must, but not today."

Nevertheless, in April 1998, the ECT came fully into force to become part and parcel of international law. As at 1 November 2003, it had been signed by 52 parties (51 countries plus the EU) and ratified by 47 of the signatories (46 countries plus the EU), the five exceptions being Russia, Belarus, Iceland, Australia and Norway. By virtue of Article 45 of the ECT, Russia (just as Belarus) applies the ECT provisionally. The package of Energy Charter documents consists of the political declaration and several independent and legally binding international agreements, some of which remain the subject of ongoing negotiations.

The Russian State *Duma* has made the return to the issue of ratifying the ECT conditional on the outcome of talks on the Transit Protocol,[15] which aims to forge generally recognized legal principles for flows of energy materials and products in transit—those crossing at least two national borders—and to furnish such transit conditions as are satisfactory to different countries. The ECT Protocol on Transit was conceived as a legally binding document "in order to complement, supplement, extend or amplify" those provisions of Article 7 of the ECT ("Transit") and related Articles regarding the interpretation of which the Contracting States developed disagreements or could see differently in the future. Considering the expanding geography of fuel and energy supplies and the continuing formation of an integral Eurasian energy market, it is clear that the adoption of common rules for the regulation of flows of energy materials and products in transit through the territories of countries in that shaping energy space should considerably reduce the risks of investment projects related to the production and trans-border transportation of energy resources.

How does the ECT work from the standpoint of supporting project-financing arrangements for business undertakings in Russia? The practical purpose of the Treaty is to lower project-financing risks through the system of international law instruments. The logic of steps towards this end is simple: the ECT, as part of international legislation, diminishes risks and, hence, financial expenditure, i.e. the costs of raising external capital and obtaining debt financing.

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[15] The Protocol, in accordance with Article 1(13) of the ECT, is one of the agreements executed "in order to complement, supplement, extend or amplify the provisions of this Treaty".

The price of a product sold can be divided into the following three components: costs, taxes and profits. The costs, for their part, fall into technical costs and financial costs. At different stages in the development of the world's markets, they can either rise or fall. Today, at least in Russia, natural conditions on new fields being opened up tend to deteriorate, and the technical costs of bringing them on stream tend to grow, while financial costs, far from declining, are also apt to go up, owing to the risks flowing from the transitional nature of the Russian economy.

In contrast, where international law instruments offer protection, risks wane and financial/borrowing costs slide, while the country's competitiveness/investment appeal on the world capital market increases. After some time (i.e. an unavoidable time lag), Russia will witness a gain in net investments flowing into the country which will consist of two components, namely: an increase in the influx of cash proper, including both domestic investments (a result of their cross-flows from sector to sector) and/or direct foreign financial inputs; and a decrease in the capital drain. This will eventually lead to an upturn in investments, in particular fixed capital expenditure. Capital investments are known to embody those scientific and technical advances (innovations), which result in cost cuts.

The result is the additive effect of reducing financial and technical costs, which fuels the growth of taxable profits (subject to the reasonable organization of the taxation system) from investment projects, their higher internal rates of return and greater competitiveness of Russia or another ECT Member country and the latter's larger role on capital markets. The increased competitiveness on capital markets, for its part, leads to lower costs and more competitive output, as well as to the commercial viability of producers on an ever greater share of commodity markets. It can be said, therefore, that the ECT, in the final analysis, creates multiplicative legal effects in terms of lowering risks and bettering economic results such as cost cuts and income and profit gains. This means that future returns on a project, which should pay back the investments called for, become more predictable and larger.

This is precisely why the ECT is among the more efficient tools for the expanded use of project financing in the Russian energy sector. This factor is among the practical reasons why Russia should be interested in the Treaty being ratified by its Parliament as soon as possible.