Understanding Post-Soviet Resource Nationalism and Contractual Renegotiation: The Demand for Foreign Capital and Contractual Stability

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Since 2003, as the price of oil has increased, many hydrocarbon-rich countries have unilaterally renegotiated massive hydrocarbon contracts, imposing new terms that have increased the state’s take of spiraling hydrocarbon profits. This paper will argue that commentators have misunderstood the forces underlying these contractual renegotiations. In particular, commentators have only focused on the upside of unilateral renegotiation: the increased state take of the large hydrocarbon profits. In so doing, they fail to realize that unilateral renegotiation carries an increasingly large cost in today’s global marketplace: renegotiation incurs reputational costs, which will decrease the renegotiating country’s future access to global capital.

Thus, as the price of oil continued to climb, resource-rich countries’ were forced to weigh the reputational costs of renegotiation versus the benefits of capturing more of the windfall. This Article will reveal how this cost-benefit analysis has shaped behavior in three countries: Russia, Kazakhstan, and Azerbaijan. In Russia and Kazakhstan, the benefits of renegotiation were outweighed by the reputational costs of renegotiating; thus, key long-term contracts were renegotiated. However, these two countries sought to minimize these reputational costs by selectively renegotiating only the most egregious contracts. In Azerbaijan, the reputational costs of renegotiating were too large to bear (due to a large future demand for foreign capital) and, therefore, none of its long-term contracts have been renegotiated.

I. Introduction

Since 2003, many hydrocarbon-rich countries have renegotiated existing contracts, imposing new terms that have increased the state’s take of spiraling hydrocarbon profits. In Latin America, Bolivia, Ecuador, and Venezuela have enacted laws increasing state involvement in their hydrocarbon industries. In Africa, Algeria, Libya, and Nigeria have begun to renegotiate contracts and impose new burdens on foreign oil companies. Finally, in the former Soviet Union, Russia, Kazakhstan, Uzbekistan, and Kyrgyzstan have all tightened liberal investment laws and forced foreign investors to renegotiate.

Although there is general consensus that this behavior can be traced to the oil shock, two general schools of thought have emerged to explain these renegotiations. Some scholars see these renegotiations as a chiefly the product of political ideology: they see these actions as the beginning of a period of intense resource nationalism in which nationalistic countries will use their control of hydrocarbon resources as political weapons to reestablish dominance. Others suggest that these renegotiations are a response to the rapidly changing economics of the hydrocarbon industry.

Analyzing Russia, Kazakhstan, and Azerbaijan, this Article will provide evidence that these renegotiations were (and are being) driven more strongly by economic rather than ideological goals. Indeed, in these countries, where hydrocarbons are such an important part of the federal budget, these renegotiations seem to reflect a policy of expanding present and future state take in the profits of the hydrocarbon industry.

**Ideology: Lack of respect for the rule of law**

Many commentators have argued that these renegotiations are part of a trend toward resource nationalism by countries deeply hostile to property rights and a rule of law. These commentators see these contractual renegotiations as ideologically motivated, short-term actions against foreign oil companies that will ultimately damage the long-term interests of the state. These arguments also hint that these renegotiations are just the beginning and will limit the supply of hydrocarbons by stunting the growth of the global hydrocarbon industry. The following is typical of this approach:

In a process that exhibits signs of a contagious disease, the populist rhetoric of nationalism that contributed to the December 2006 re-election of President Hugo Chavez in Venezuela, has brought similar leaning governments to power in Bolivia and Ecuador. Soaring commodity prices have fuelled aggressive Resource Nationalism policies in a range of African and Central Asian states as energy-producing nations move to secure a greater share of the money and power from their resources, irrespective of the costs and risks of exploration carried by others typically in well documented and carefully negotiated agreements.

This critique has been particularly strong in relation to Russian contractual renegotiation. For instance, the NY Times has said “Moscow also needs to be reminded that threatening property rights will eventually dissuade all investments. Even Mr. Putin's allies should remember that without a clear rule of law, their own assets might be threatened if political winds shifted.” Financial Times: “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.” Economist: “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.”

However, there is evidence that these renegotiations have little to do with a lack of respect for the rule of law. In fact, in the last seven years, democracies with a strong commitment to the rule of law have changed the terms of their hydrocarbon investment

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3 The resource curse has also been cited as a key element in these renegotiations. For a legalist argument in this vein, see Kevin T. Jacobs, Matthew G. Paulson, *The Convergence of Renewed Nationalization, Rising Commodities, and “Americanization” in International Arbitration and the Need for More Rigorous Legal and Procedural Defenses* 43 Tex. Int'l L.J. 359 (2008).


laws. For instance, Canada has increased its maximum royalty tax and will force previously signed contracts to pay this elevated rate.\textsuperscript{9} At the same time, countries with incredibly weak rule of law – like Azerbaijan and Colombia - have not renegotiated contracts.

Furthermore, the presumption that the renegotiation suggests hostility to the rule of law is overly rigid.\textsuperscript{10} Contract law in countries with strong rule of law does not absolutely protect contracts. For instance, in American contract law, courts have not taken a flexible approach to contractual stability and property rights, allowing renegotiations or breaches of contracts in the event of changed circumstances, frustration, and public policy reasons. To take just one example, in the United States, energy contracts are subject to a “just and reasonable” test in which terms are measured against the public interest.\textsuperscript{11} Such flexibility also exists in international law. The United Nations Convention on Contracts for the International Sale of Goods excuses a party that fails to perform due to an “impediment” beyond its control, if the parties could not have reasonably been expected to have taken the impediment into account when the contract was concluded or to have avoided its consequences.\textsuperscript{12}

Thus, the argument that these renegotiations are driven by a powerful hostility to the rule of law by developing countries ignores both flexibility in long-developed American and international contract law and the fact that countries with strong rule of law systems are renegotiating contracts. There is something deeper driving this process of renegotiation.

**Economics: The obsolescing bargain mechanism**

A more convincing explanation for this global trend is one that portrays these renegotiations as an economic strategy to capture more of the rapidly increasing profits from long-term hydrocarbon contracts signed with foreign oil companies (FOCs). Most scholars have explained these changes using a model developed during the 1960s and 1970s: the obsolescing bargain model (OBM).\textsuperscript{13}

OBM theory describes the economic and political forces that transform the initial relationship between foreign investors and host governments in the energy industry. Viewing the FOC-host country contractual relationship as an ongoing two-player game, the OBM describes the changes to the internal cost-benefit bargaining relationship between states and FOCs over the time horizon of the contract.

In the beginning, the host government is initially receptive to foreign investment in the natural resource sector. Indeed, the government in the developing country has neither the capital, technology, nor risk-spreading ability to extract resources from the

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\textsuperscript{10} (285, Making Foreign Investment Safe).

\textsuperscript{11} If U.S. electric power agreements are not considered to be “reasonable” and “just”, the Federal Energy Regulatory Commission has the authority to reorder contracts between parties under Section 206 of the Federal Power Act.

\textsuperscript{12} Article 79.

ground. The FOCs, on the other hand, are perfectly suited for this type of work, since they can diversify their risk across the world and also have considerable capital. At this point, the FOCs are in a powerful position and can bargain for attractive terms. As a result, developing countries sign attractive agreements to induce the FOC to assume the risk of investing.

However, as more of the FOC’s money and expertise are invested in the project over time, the cost-benefit calculus begins to change. As the author of the OBM put it: “almost from the moment that the signatures have dried on the document, powerful forces go to work that quickly render the agreements obsolete in the eyes of the government.”

In fact, as more of the foreign investor’s money and expertise are sunk into the project, the main internal cost of expropriation – the loss of future FOC foreign investment in the project - decreases.

The benefits to the host country of expropriation or unilateral renegotiation also increase as the project progresses. Indeed, once the project has been realized and hydrocarbons are flowing, the tantalizing profits of resource production provide the state with a powerful incentive to expropriate (either outright or through contractual changes) and capture a larger share of the resource rents. At the same time, elites might want to capture a larger share of economic rents to ensure their maintenance of political power (through corruption and patronage). Thus, as the internal cost-benefit analysis changes over the investment, the risk of renegotiation increases.

Scholars have implicitly and explicitly begun to describe the recent renegotiations in these terms. William Tompson has recently argued in a number of different places that the dynamics of the obsolescing bargain are once again explaining the actions of the Russian and Kazakh state in the hydrocarbon industry. “It is not difficult to see elements of the obsolescing bargain at work in Russia today.” For the Kazakh experience, he points to the expropriations of the 1960s as a good precedent for what is happening in Kazakhstan: “In many ways, recent developments in Kazakhstan echo the history of the oil industry in other parts of the world.” He terms institutions like law and international groups as “weak”, writing that “when institutions are still relatively weak and in a state of flux, sharp jumps in the value of assets can make it harder to stabilize/secure property.”

Other scholars see these dynamics at work in Venezuela and other Latin American expropriations. In describing the Venezuelan expropriation, Manzano and Monaldi argue that “the governments took advantage of the stronger negotiating position provided by high oil prices and favorable geopolitical conditions to expropriate revenues and

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15 Another potential cost is the loss of efficiency that occurs when the state takes over running the project. However, the state could alleviate this inefficiency by accessing limited foreign capital or expertise on the market on better terms.
16 This is what has been called the resource curse.
18 Caspian Oil in Global Context, http://eprints.bbk.ac.uk/361/1/Caspian_oil_in_global_context.pdf
At first glance, the actions of the Russian and Kazakh states toward foreign hydrocarbon investment do seem to conform with the traditional OBM. Both Russia and Kazakhstan were initially very weak during the 1990s. Economically, the collapse of global oil prices and their decrepit domestic hydrocarbon industries left their budgets severely depleted: with no tax collection apparatus, hydrocarbon export taxes and rents would be critical to avoid a state collapse.

Negotiating from a position of weakness, these states signed long term contracts with foreign investors that were very favorable to the foreign investor. Many of them guaranteed the FOC a specific rate of return before the state would recover any rent. Furthermore, they also contained stability clauses, which essentially forbid the host government from changing the rules of the game for the duration of the contract (could be fifty years or more).

The tripling of the price of oil between 2003 and 2006, however, led to large-scale obsolescence. The state now was in a powerful bargaining position: many of the FOCs had invested a great deal of capital in developing hydrocarbon fields and the real profits were only beginning to be created. Politically, the leadership saw these extra oil rents as a powerful way to further entrench their political position. As a result, these governments have begun to renegotiate contracts and have grown more hostile to foreign investment.

However, this approach is incomplete. First, it does not explain why, despite their advantageous bargaining position and the large-scale obsolescence of contracts, hydrocarbon-rich countries like Azerbaijan have failed to renegotiate existing hydrocarbon contracts. According to the obsolescing bargain theory, Azerbaijan should be taking advantage of its newfound position of strength in the struggle between states and foreign investors for natural resource rents. Indeed, the internal costs of renegotiation are far outweighed by the internal benefits of capturing a larger stake of the hydrocarbon rents.

Second, it does not explain why Russia and Kazakhstan are selectively renegotiating long-term contracts. In fact, despite the media frenzy, Kazakhstan and Russia have only selectively renegotiated the major hydrocarbon contracts since the oil shock. This selective renegotiation also defies the logic of the obsolescing bargain, which would suggest that these two countries would seek to exploit their advantageous bargaining position by renegotiating all contracts with FOC projects since all long-term contracts have obsolesced.

The Role of Global Capital: Obsolescing Bargain Plus Model

This Article will argue that an economic model that better explains behavior in these three countries is an “obsolescing bargain plus” model in which the state-FOC contractual relationship is affected by more than just the internal terms of the existing deal, but also a key external factor: the future need of the state for access to foreign capital. Indeed, since the 1970s, the increasing role of foreign capital in economic growth has added a key external cost for states that engage in unilateral state renegotiation: it will
send a strong signal to the global community about the country’s risk profile that will hinder the state's ability to attract foreign capital in the future.

This more complete model helps us answer key questions. First, it suggests why Azerbaijan has not renegotiated its long-term hydrocarbon contracts. In Azerbaijan, the reputational costs outweigh the benefits of renegotiation; indeed, Azerbaijan needs future foreign investment more than it does short-term windfall profits it could gain from renegotiating. Second, it reveals why Russia and Kazakhstan have selectively renegotiated. In these two countries, the benefits of contractual renegotiations outweigh the reputational costs; both of these countries is building a substantial nationally-owned oil industry to extract hydrocarbon resources. However, the external costs of renegotiating have constrained their actions, and these countries have been cautious in renegotiating contracts in order to capture the windfall while also hoping to preserve future access to foreign capital (by not sending too strong of a negative legal signal and appearing to be a risky place to invest).21

Overview

To make this argument, this Article will be divided into three additional parts. Part II will describe the theory of the obsolescing bargain plus model. Part III will analyze the investment climate during 1990s when these long-term contracts were signed. The combination of a low oil price and the desperate need for foreign capital to redevelop their hydrocarbon industries meant that Russia, Kazakhstan, and Azerbaijan signed long-term contracts with highly attractive terms for the FOCs.

Part IV will then show how these countries reacted to the post-2000 oil shock. Russia and Kazakhstan, where large excess reserves of hydrocarbon meant a large future flow of domestic capital, contractual renegotiation was more attractive (and economically possible). However, in Azerbaijan, dwindling hydrocarbon resources meant a continued demand for foreign capital; this continued demand helped ensure that renegotiations did not happen.

II. Theory: The Obsolescing Bargain Plus Model

The obsolescing bargain plus model was developed during the late 1980s and 1990s by international business scholars who believed the traditional OBM was an incomplete explanation of FOC-state contractual relations. At the core of their criticism was the contention that new developments in the global market - termed “interdependence” or “globalization” - have allowed foreign investors to retain their initial bargaining advantage across the investment time horizon.

The key factor that they pointed to was the growing role of foreign capital in the economic development of developing countries. As Michael Minor described it, in the new global economy, “the need for new inflows to stimulate domestic resource mobilization, increase export-oriented industries, and improve their balance-of-payments

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21 In this way, many of the recent renegotiations are more aptly understood as a government windfall tax on long-term contracts signed during the 1990s.
situation is obvious.” The importance of foreign capital was strengthened by the fall of communism in the late 1990s, as capitalist development became the dominant economic system throughout the developing world.

This new role of foreign capital in promoting contractual sanctity led theorists to see FOC-state relations as increasingly cooperative rather than conflictual (Dunning, 1993a; Stopford, 1994; Luo, 2001). Although this assessment might have been excessively optimistic – it relied on the assumption that developing countries would always seek foreign capital – it suggested a fundamental theoretical transformation in the theoretical understanding of the forces affecting foreign investment and FOC-state contracts.

In 2005, a commentator suggested the current status of the OBM in international business (IB) scholarship: “the now widely held view amongst IB scholars is that the obsolescing bargain theory has outlived its use.” As a theory only focused on the internal cost-benefit calculus of the contract, this argument was correct. Indeed, this growing need for foreign capital has added a significant external cost to renegotiation. Indeed, the role of global capital made investing a repeat game, in which one renegotiation would bring repeated external costs to the state since it would face repeated barriers to access to foreign capital. In a world where developing states have to compete for capital, the more a state gained a reputation for riskiness or changing the rules of the game midstream, the less likely it was to gain scarce foreign capital.

To model this new factor shaping FOC-state contractual renegotiation, globalization scholars formed a two-tiered theoretical model. The tier two relationship represents the traditional internal bargaining relationship between the developing state and the FOC – the one described by the classic OBM. The tier one relationship represents the developing state’s relationship with foreign capital; a strong tier one requirement for foreign capital requires sending strong signals about the desirability of investing in the host country – attractive contractual terms are one way to send these signals.

The key insight of this two-tiered model is that the tier one relationship helps determine the stability of the tier two relationship. Indeed, if the developing country desperately needs foreign capital, then tier two relationships are much more stable (no matter how bad the terms of the individual deal obsolesced) since the state stands to gain more from future foreign investment (and maintaining their reputation for adhering to the rule of law) than from violating an existing contract. However, if the state has enough domestic capital (and no longer felt that it needed foreign capital), then the traditional terms of the deal at the tier two bargaining level are much more likely to drive the cost-benefit calculus that lies at the center of contractual sanctity.

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23 Minor (1994)
24 Eden et al.
25 Ravi Ramamurti.
Tier one affects on tier two contracts: The push and pull of tier one demand for foreign capital

Two mechanisms affect the tier one relationship. First, and most importantly, poor countries require significant foreign capital to develop their economies. In order to “pull” in this foreign capital, the government provides attractive contractual terms as incentives. Since the 1980s, as capitalism has spread around the world, there has been an explosion of competition amongst developing countries for foreign capital. This competition to “pull” in foreign capital has put even more pressure on countries to provide incentives to attract foreign investment. One of the key contractual mechanisms that foreign countries used to pull in foreign investors was a stability clause. Often used within a production sharing agreement (PSA), this clause stated that the state could not legally change the terms of the agreement; in many cases, it was in effect for up to forty years.

Second, assuming there is demand for foreign capital, wealthy countries themselves have been engaged in an aggressive “push” to further facilitate the flow of capital into developing countries. Often by promising multilateral or bilateral public investment (in the form of low interest loans or foreign aid), developed capitalist countries have further pushed developing countries to include attractive contractual terms in their long term contracts. This has also greatly aided foreign investors: one scholar pointed to the “powerful international actors, institutions, and agreements that have systematically strengthened the bargaining power of MNCs and weakened that of host countries.” (Ramamurti, 28)

This kind of government intervention on behalf of commercial interests increased in the 1990s. Prior to the 1990s, it was feared that such obvious intervention during the Cold War period would abet communist propaganda and encourage communist revolutions around the world.26 “Although the U. S. government had rarely hesitated to intervene in the late nineteenth and early twentieth centuries, between World War II and the 1990s it did fairly little to defend its investors.”27 However, with communism vanquished and liberal, free market ideas sweeping the world, the coast seemed clear for the triumphant western countries to more actively secure the interests of their home FOCs abroad.

Part III: Application: Russia, Kazakhstan, and Azerbaijan during the 1990s

Russia

26 Kenneth Rodman, Sanctity versus Sovereignty. He points to the fact that the Hickenlooper Amendment was only used twice.
27 Wells, Making Foreign Investment Safe, p. 6.
During the 1990s, the Russian state was very weak. It had inherited all of the Soviet Union’s external debt, its economy was in crisis, and it was attempting to fundamentally overhaul its economic system. The hydrocarbon sector was no exception, languishing with outdated equipment and lacking capital to extract additional hydrocarbons. Politically, the Russian government was divided in dealing with these problems. President Yeltsin and his administration advocated rapid pro-market reform while the Russian Parliament was dominated by parties advocating much slower economic reform. This debate was particularly pitched in the sensitive Russian hydrocarbon industry. Thus, the “pull” from the Russian state for foreign capital was divided, led by the President’s administration but obstructed by continued resistance in the legislative branch. The presidential administration was able to force through some contracts that were favorable to the FOCs; however, due to legislative opposition, they were grounded on a weak legal foundation.

At the same time, the Western industrialized countries aggressively sought to “push” the opening of the massive Russian hydrocarbon market. They did this by boosting the position of pro-market reformers in President Yeltsin’s administration. In particular, they used multilateral loans to help prop up the debt-ridden Russian state, thus helping to forestall political collapse and propagating the survival of the Yeltsin, pro-reform administration.28

At the bilateral level, the United States sought to build a strong relationship with Russia. At the Vancouver Summit in 1993, Presidents Clinton and Yeltsin decided to establish a joint commission on energy and space.29 This commission - headed by Vice President Gore and Russian Prime Minister Chernomyrdin - would become a crucial apparatus for Russian-US cooperation, particularly in the field of lobbying Russia to sign contracts with western FOCs. In fact, the US Department of Energy was highly involved in the commission, a key goal of which was to promote “the development of production-sharing agreements as an interim measure to facilitate U.S. involvement in oil and gas development.”30

Deals signed during the period

The combined push on and pull of a determined presidential administration yielded three production sharing agreements (PSAs).31 These PSAs were highly attractive to FOCs, existing outside the Russian domestic legal framework (largely because the legislature refused to pass the implementing legislation for a PSA) and containing long-term stability clauses. For the Russian presidential administration, signing these deals would signal their openness to foreign investment, providing the presidential administration with an external benefit in terms of increased future access to foreign loans. All three deals were in the Russian Far East, which was in desperate need of investment. The Khariaga PSA was signed in 1995 with the French company Total as the operator. The Sakhalin I PSA was signed in 1995 with Exxon Mobil as the operator. The

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29 Fueling Reform, p. 159.
30 Fueling Reform: Energy Technologies for the Former East Bloc, p. 159.
31 Interview with Ambassador Richard Morningstar, member of the Gore-Chernomyrdin commission.
most notable – and largest - foreign investment in the Russian hydrocarbon market, however, was the Sakhalin II deal.

I. Sakhalin II

Sakhalin II was the most significant of these PSAs. Called an “elephant” by Shell’s CEO, it was challenging, remote, but also potentially highly lucrative hydrocarbon field. The offshore deposits were in relatively shallow water but in a climate where the water freezes for over for half the year: “Working conditions are ferocious. Even in March, heavy snow came down on workers struggling to build a 100-megawatt power plant near Nogliki that will be used to power Sakhalin Energy's offshore drilling platforms. Out on the Sea of Okhotsk, ice floes drift much of the year, so the company is building heavily reinforced platforms designed to withstand ice collisions and even earthquakes: Sakhalin sits astride an active seismic zone.”

As a result, offshore development of Sakhalin during the Soviet period was minor. On the eve of the fall of the Soviet Union in 1990, the Soviet Ministry of Oil and Gas was approached by US-based Marathon Petroleum and McDermott International Investment, as well as the Japanese Mitsui and Co. about the prospects for development of explored gas reserves off the coast of Sakhalin Island.

After the fall of the Soviet Union, the Russian authorities sought foreign capital to develop this field. A feasibility study was carried out and a preliminary agreement was signed between Marathon, McDermott, and Mitsui and the Russian government. After years of lobbying, 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). The SEIC at the time of signing was majority American owned: 30% by Marathon Oil (US), 20% by McDermott (US), 20% by Mitsui (Japan), 20% by Shell (Holland), 10% by Mitsubishi Corp (Japan). Suggesting its symbolic power, this deal was cemented as part of Vice President Al Gore and Prime Minister Viktor Chernomyrdin’s joint Russia-US mission, which was set up to secure economic relationships between Russia and the west.

This PSA had been the result of intense lobbying and pressure from the United States from the presidential level all the way down. For instance, large bonuses were promised to Chernomyrdin and his staff in return for signing the deal. Furthermore, significant multilateral loans were given to help with financing. The European Bank of Reconstruction and Development (EBRD) provided a US$ 116 million senior loan. Co-financing was also provided by the American Export Credit Agencies, including Overseas Investment Corporation (OPIC), an agency of the US Government, and the Export-Import Bank of Japan (JEXIM), a Japanese governmental financial institution. OPIC provided $116 million dollar loan. Finally, the American side promised additional developmental funding: “The Sakhalin projects have been a key agenda item

32 Sakhalin Island: Journey to Extreme Oil.  

33 Fact sheet: Gore-Chernomyrdin commission - U.S. Vice President Albert Gore, Jr.; Russia Prime Minister Viktor Chernomyrdin


http://findarticles.com/p/articles/mi_m1584/is_n52_v5/ai_16709518/pg_2.

for the Gore-Chernomyrdin Commission, an American Business Centre has been established in Yuzhno-Sakhalinsk and USAID is helping to fund strong links between the Government of the State of Alaska and the Sakhalin Administration.”

This combination of bonuses, intense lobbying, and IFI capitalization helped generate a highly favorable contractual terms for the SEIC. Compared with other PSAs globally, the terms of the Sakhalin-II PSA were highly unfavorable to the Russian state. First, as mentioned above, one of the typical reasons that a government will sign a PSA is to encourage the company to undertake the exploration risk. In the Sakhalin II project, however, the exploration had already been carried out by the Soviet authorities (collaborating with the Japanese) during the Soviet period.35

Second, this PSA was signed before the Duma had passed a PSA law. The shakiness of the foundations of the deal were revealed in the fact that the actual beginning of the project was conditioned on the enabling legislation for the PSA. “Currently, however, there are literally dozens of clauses in the contract that violate either existing Russian laws or draft legislation that is expected to be passed in the near future.”36 The Russian Auditing office would later suggest in 1999 “The Sakhalin-1 and Sakhalin-2 Production-Sharing Agreements were entered into outside the frameworks of the legal legislative controls of the Russian Federation.”37

Furthermore, 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 significantly favoring the state). In this PSA, however, the SEIC recoups its costs and then is guaranteed a 17.5% rate of return on capital before the state gets anything. Thus, the company has all the incentives to invest in the operational phase (since this cost will be recouped by cost oil) before they move to their profit stage. Finally, the royalties and taxation that are fixed in the PSA are also low. Finally, the royalty payable to the state is 6% (much lower than comparable PSA numbers) and the tax rate (32%) is lower than the standard Russian rate at the time of signing (35%). As we will see, the strength of these terms would be tested by the oil shock.

Part II: Kazakhstan

Kazakhstan’s economy was in tatters in the early 1990s. Its hydrocarbon industry was undercapitalized and had been decapitated after the split with Russia. It had no access to western markets that did not lead through Russia: all of its pipelines went through Russia, which was hostile to an independent Kazakh oil industry. Foreign capital would be critical in establishing a profitable Kazakh hydrocarbon industry; thus, there was a strong and united pull on foreign capital in Kazakhstan.

At the same time, there was also a strong push by the Western governments, and particularly the United States, in promoting their hydrocarbon interests in Kazakhstan. The Kazakh government welcomed this push, hoping that a strong relationship with western countries would help bring the multilateral banking support and political support

36 Keun-Wook Paik, Gas and Oil in Northeast Asia, pp. 216-217.
that would help further jumpstart their hydrocarbon industry. This combination was a success: “By 1997, Kazakhstan had attracted the second largest amount of per capita foreign direct investment (FDI) of all post-communist states (after Hungary).”\textsuperscript{38} Most of this FDI went into Kazakhstan’s hydrocarbon industry.

\textbf{Tengiz}

The first major deal signed between a FOC and Kazakhstan was for the massive Tengiz oilfield. The field was remote and difficult to develop. “Soviet geologists had discovered the Kazakh prize in 1979 in a remote, windblown steppe on the northeast shore of the Caspian. . . . But Tengiz’s sea of oil lay unusually deep, as much as three miles below a salt dome that itself was 900 yards thick. Soviet engineers spent more than $1 billion drilling dozens of wells before concluding that foreign technology was needed.”\textsuperscript{39}

The foundations of this deal had been laid during the final days of the Soviet Union. President George H. Bush was very interested in the deal, pushing Gorbachev to accept, reportedly saying: “Look, you want American investment. Yet you’ve been negotiating with Chevron a long time. Nothing is happening. There is no better way to attract investment than to sign one big contract. Chevron is one of our biggest companies. That would be a sign to other companies that you can do business here.”\textsuperscript{40}

The newly independent Kazakhstan under President Nazarbaev re-engaged in talks. President Nazarbaev was about to make his first post-Soviet visit to Washington to meet with the outgoing President George H. W. Bush and not signing a deal would “be entering the White House empty-handed.”\textsuperscript{41} A major deal with the American oilman president would go a great distance in helping to ensure that the United States had a stake in Kazakhstan’s continued independence.

Under intense political pressure, Nazarbaev finally signed the deal, creating a joint venture between the Kazakh government and Chevron.\textsuperscript{42} Chevron pledged to invest $20 billion in Tengiz over 40 years. But Chevron was cautious about investing too much money up front: a great deal of things needed to be solved before the joint venture could go ahead, most importantly a transport outlet for Tengiz oil. As a result, the contract sharply limited any initial cash outlays. For example, not until Tengiz production reached 250,000 barrels a day would the company have to pay a $420 million installment on the purchase price. The provision in effect allowed Chevron to hang on to a substantial portion of its obligated payment until a pipeline had been built to sell Tengiz oil in Western markets.

By the middle of the 1990s, it soon became clear that the deal would not be successful without a non-Russian controlled export pipeline. Indeed, the Russians were periodically blocking Kazakh (and, therefore, Chevron) access to their pipelines to Europe. After intense lobbying, the United States aggressively pushed the development of a pipeline for Tengiz oil, one which would eventually be called the Caspian Pipeline

\textsuperscript{38} Oil, Transition, and Security in Central Asia, P. 31
\textsuperscript{39} http://www.washingtonpost.com/wp-srv/inatl/europe/caspian100698.htm
\textsuperscript{40} (Oil and Glory, 115).
\textsuperscript{41} Oil and Glory, p. 139.
\textsuperscript{42} http://www.washingtonpost.com/wp-srv/inatl/europe/caspian100698.htm
Consortium. Much of the political risk was shored up by multilateral development banks, including the EBRD, OPIC.\textsuperscript{43} This tier one push had helped to ensure the survival of the Chevron deal.

*Kashagan*

Another major western-led investment was also signed during this period. In 1994, a consortium of Western companies won the rights to explore the Kashagan offshore fields. Kashagan is a large, complex, expensive, and technically challenging field. Based in the Caspian Sea, it is shallow and ice prone and requires artificial islands or Draught barges to drill. The sea level can fluctuate dramatically and unpredictably, which causes logistical difficulties for service and supply companies.

After positive seismic readings (but before any experimental drilling) from the Caspian Sea block, this Western consortium signed a PSA for the Kashagan oil field on November 18, 1997. Reflecting Kazakhstan’s continued desire to engage with the United States, this PSA was finalized in Washington as part of broader discussions between the United States and Kazakhstan regarding nuclear cooperation.\textsuperscript{44} Both Gore and the Energy Secretary Pena stressed that Kazakhstan cooperate in pumping much of this gas through a non-Russian controlled pipeline.\textsuperscript{45}

The PSA was operated by the Italian oil major ENI, which like fellow shareholders ExxonMobil, Shell and Total has a stake of 18.5%.\textsuperscript{46} The terms of the PSA were similar to the Sakhalin PSA. There were no royalties imposed on the deal at all. The consortium can recover up to 80% of its costs. The consortium is guaranteed 90% of the profit oil until the consortium receives a 17.5% rate of return.\textsuperscript{47} These terms were as favorable to the consortium as the ones in the Sakhalin PSA; the oil shock would put considerable pressure on this contract.

*Azerbaijan*

Like Russia and Kazakhstan, Azerbaijan emerged into the post-socialist world weak. Economically, Azerbaijan was in near collapse. GDP plummeted 62 percent between 1991 and 1995 in Azerbaijan.\textsuperscript{48} Real wages plunged 80 percent between 1991 and 1997. Oil production was in 1996 was 22 percent below 1991 levels.\textsuperscript{49} The economy was in free fall and its main industry – hydrocarbons – was in desperate need of foreign funding.

At the same time, Azerbaijan hoped to entice in foreign investment in order to secure its independence from Russia and ensure its build alliances with Western countries. Indeed, the oil industry was seen by the government as a powerful tool for

\textsuperscript{43} The Oil and the Glory, p. 282.
\textsuperscript{44} http://online.wsj.com/article/SB879978057601775500.html?mod=googlewsj
\textsuperscript{45} http://www.fas.org/news/kazakh/97111811_wpo.html
\textsuperscript{46} http://www.economist.com/displayStory.cfm?story_id=9573066
\textsuperscript{48} Alec Rasizade, Azerbaijan and the Oil Trade: Prospects and Pitfalls, 4 Brown J. World Aff. 280 1997,
\textsuperscript{49} P. 185, Oil, Transition, and Security.
securing its state budget and government stability. At the same time, foreign capital in the oil industry was seen as a powerful foreign policy tool: “Baku has calculated that its best chance of engaging foreign interests to counter Russian domination and support Azerbaijani independence and stability is by bringing major foreign investments into the petroleum industry.” (135, The New Caucasus). Heydar Aliyev, the President, reportedly said: “My weapon is oil, and with that we will manage to win the war.”

Similar to Kazakhstan, foreign investment in Azerbaijan would secure both the state budget and key international support for the fledgling Azeri state.

Despite the strong pull on capital, there was little push by the western governments to influence attractive terms in long term contracts. Azerbaijan was fighting a bloody war with Russian-supported Armenia over Nagorno-Karabakh, leading to international isolation. This isolation meant little Western governmental push for contracts in Azerbaijan. Azerbaijan only began to attract IMF involvement in 1995, and these investments were small. “In Azerbaijan efforts to implement a thoroughgoing economic reform programme began only in 1995.” (123, The New Caucasus)

This isolation was particularly true in the United States. The American Congress – after intense lobbying from the Armenians - passed the Freedom Support Act in 1992, barring any government-to-government assistance to Azerbaijan, except for nonproliferation and disarmament activities. This position was slowly softened as Azerbaijan’s important position in the Caspian energy game be clear.

Deals

Despite its isolation, the Azerbaijani government aggressively sought to pull in investment from Western FOCs. 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 offshore Azeri, Chirag, and Guneshli oil fields (ACG) located in Azerbaijan’s sector of the Caspian. Although the deal was finally hashed out at Amoco’s office in Houston, Texas, this bargaining had taken place with little inter-governmental cooperation. The agreement called for a total $7.4 billion investment over 30 years in three offshore oil fields. This deal immediately gave the government much-needed hard currency: the contract carried a $300 million dollar signing bonus as well as a five million dollar personal gift to Aliyev.

In the end, American companies ended up with 40% of the ACG deal. The terms of the deal were more favorable to Azerbaijan than those of the Kashagan or Sakhalin II deals. In the terms of this PSA, the Azerbaijan state received 30% of the profit oil until the BP-led consortium has achieved 16.75% rate of return. After that, the state's share goes up to 55%. Only after the consortium had achieved a 22.75% rate of return - a high level of profits - did the state's share of profit oil go up to 80% (much more normal). [ACG PSA, article XI, clause 11.6] Finally, the state ensured that it would retain a direct take of the profits, as SOCAR was part of the consortium.

50 190, The Oil and the Glory.
51 P. 185, Oil, Transition, and Security.
The relative favorableness of the terms for the Azeri state (in comparison to the Sakhalin II and Kashagan PSAs) were partly a reflection of the fact that the Western oil companies were not aided by a powerful Western push (thus, there were no external benefits to better terms). They are also a reflection of the fact that SOCAR was a highly competent negotiating adversary. In fact, SOCAR – the newly created state-owned company - has showed incredible foresight and technical expertise in signing these deals. Even at the height of the oil price slump in negotiating 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.”

Part IV: 2000s: The Oil Shock

In the early 2000s, the price of hydrocarbons (and particularly oil) began to spiral upwards. The oil shock drastically changed the tier two relationship. As the price of oil spiraled upwards, the internal terms of all of these long term deals obsolesced drastically. More importantly, it also began to transform the tier one relationship. Indeed, the oil shock generated massive rents in the hydrocarbon industry, lessening the “pull” for foreign capital in some countries’ hydrocarbon sector. Indeed, these present and future rents were so high that countries have significantly reduced their demand for foreign capital in their hydrocarbon industries. At the same time, the increasing profits in the hydrocarbon industry have made foreign capital easier to acquire as increased profits have made foreign capital more risk tolerant and, therefore, reduced demand for an open and liberal legal system. This changing tier one calculus would play a large role in determining the outcome of the long term contracts signed during the 1990s.

Russia

As oil prices began to move upwards, the “pull” on foreign capital in Russia – coming largely from the Presidential administration – precipitously decreased. The newly filled budget coffers allowed Russia to recapitalize and rejuvenate its own nationally owned hydrocarbon industry. At the same time, the tier one push that the IMF and the United States had pressed during the 1990s began to break down in the new millennium. The once powerful position of the IMF in Russia was diminished: the problems of 1998 poisoned the relationship between Russia and the IMF. The Russian Finance Minister was clear about Russia’s growing self-sufficiency: “We will not need IMF credits. Russia has enough of its own financial instruments which will be used to fulfill the budget.”

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53 (64, Hoffman).
54 First, Western countries’ tier one monopoly on foreign capital which allowed them to “push” legal reform began to erode during the 2000s. In particular, Western multilateral institutions like the IMF began to lose legitimacy as they faced increasing criticism for worsening problems in developing countries. At the same time, the rise of China and other non-Western economies (Middle East) began to provide an alternative source of tier one foreign capital for developing countries; the supply of foreign capital has grown more diverse. This has given developing countries (like Kazakhstan and Russia) more room to maneuver. Finally, the balance of payments crises in many developing countries (like Russia and Kazakhstan) improved remarkably at the end of the 1990s; this meant that the demand for public loans to prop up the state were less pressing.
55 Russia’s Uncertain Economic Future, p. 462
Deals

The decreasing need for foreign capital in the Russian hydrocarbon sector (one of the key justifications for the Sakhalin deal in the first place) changed the cost-benefit calculus of deals that were signed during the 1990s. However, as we will see, the Russian state proceeded very cautiously in responding to these changes.

Sakhalin-II came under significant pressure. Indeed, as the price of oil and other commodities rose, control of the project became an increasingly lucrative prize for the Russian government: by the end of 2006, it represented the largest private foreign energy investment in Russia (reaching more than $15 billion dollars). Now that much of the difficult and expensive work had been done, the possibilities of operating a large oil and liquefied natural gas (LNG) field so close to the Asian (and West coast US) markets was potentially highly profitable to the Russian state. “If 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.” In particular, state-owned Gazprom wanted to ensure that it would have the monopoly of LNG export to these expanding East Asian economies going forward.

To make matters worse, the Shell-run project had been forced to declare massive cost overruns in the billions of dollars. Under the terms of the PSA, these cost overruns significantly delayed the Russian state’s take in the lucrative project. The benefits of renegotiation would not only increase government take of the profit, but would also mean that the government would begin to see hydrocarbon revenues much sooner.

Taken together with Russia’s decreasing need for foreign capital to develop its domestic hydrocarbon sector, the cost-benefit calculus of renegotiating began to look highly attractive for the Russian state. The Russian state had a couple of options. First, they could nationalize the project together, following the example of many hydrocarbon rich countries of the 1970s. Second, they could force a renegotiation, preserving minority foreign investment but ensuring that they would capture some of the rent and have control of the project going forward.

They chose the latter, suggesting a desire to reduce reputation costs while also ensuring a piece of the profits. On September 18, 2006, all environmental permits were cancelled for the project, effectively halting the project. A couple of months later, Oleg Mitvol, deputy head of the Russian environmental watchdog, threatened to bring a $15 billion dollar claim against Shell for environmental violations in an arbitration proceeding in Stockholm. On December 21, 2006 with 80% of the second phase

57 Commentators were particularly drawn to the potential that Sakhalin might emerge as one of the first major exporters of LNG to both the Asian markets (Japan and China) as well as the west coast of the US.
complete, the SEIC negotiated with Gazprom to pay $7.45 billion for a 50% plus one share stake in the project. On April 15, 2007 the buyout was finally secured. Each partner diluted their stakes by 50%: Shell’s stake was reduced to 27.5% less one share, Mitsui’s stake to 12.5%, and Mitsubishi’s stake to 10%.62

The benefits of this renegotiation to the Russian state were large. The Russian government’s stake rose from 0% to 19% during the initial recovery period. Furthermore, it now had control over a major project supplying LNG to the rapidly growing East Asian markets. Billions of dollars in future earnings for the state were likely to follow.

Tier one costs did follow. Internally, the Sakhalin-II project lost many of its Western multilateral financiers. For instance, the EBRD pulled its funding.63 Furthermore, the U.S. Import-Export Bank as well as the UK Export Credit Guarantee Department have also decided no longer to fund the project. Finally, external costs were also high as Russia’s reputation as a place for safe returns in the hydrocarbon sector was tarnished. However, the Russian state did its best to reduce external costs, offering Shell a partnership with Gazprom in other fields and seeking to stress that this move against foreign investors was limited to cases of PSAs with unfair terms.

Other Russian actions in their hydrocarbon industry also suggest a cautious approach to renegotiation. For instance, Sakhalin I is still operated by the US oil major ExxonMobil. For Sakhalin I, the deal has clearly obsolesced: ExxonMobil has sunk most of its investment into the project and high commodity prices as well as Gazprom’s desire to control all outgoing LNG were putting serious economic and political pressure on the deal. Despite some threatening moves, recent moves by Gazprom to threaten the deal also look likely to be the subject of a compromise.64 Indeed, most analysts think it is likely that Gazprom will not force out ExxonMobil and 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 monopoly to retain a monopoly on the export of gas to East Asian markets.65 This commentary is strengthened by the fact that the cost benefit calculus was not as bad as Sakhalin largely because windfall profits were being captured by the state: Russian owned Rosneft is a part of the deal (see Keun-Wook Paik, Gas and Oil in Northeast Asia, pp. 211-214).

Other moves also confirm that Russia still needs foreign capital in its hydrocarbon industry. After initially declaring that they would not need foreign investment in the massive Shtokman natural gas fields, the Russian state changed its mind and signed a deal with the French oil company, Total; ideology gave way to the need for foreign capital. Total’s role is necessarily limited: it only holds a 25% stake in an operating company that will finance the exploration and build the infrastructure for extracting and

http://news.bbc.co.uk/2/hi/business/6254475.stm
http://www.redorbit.com/news/business/1304130/exxonmobil_drills_record_extendedreach_well_at_sakhalin1/
transporting gas. However, Total’s expertise will be critical to the development of this field. The example of Shtokman is likely to repeat itself in the future: as Russia seeks to extract hydrocarbon resources in increasingly difficult areas, it will be forced to rely on foreign capital. Thus, it appears that Russia’s renegotiation in Sakhalin II was constrained and that hysterical accounts of a return to politically charged nationalism are false or, at least, premature.

Kazakhstan

Like Russia, the oil shock reduced Kazakhstan’s pull on foreign capital during the 2000s. In fact, the oil shock spurred a rapid turnaround in the Kazakh oil and gas industry. One example of the turnaround is that, in 1997, oil and gas accounted for just 19 percent of industrial production. By 2000, it accounted for almost half (42%) of Kazakh industrial production. Furthermore, between 1999 and 2000 production almost doubled: from 631,000 bpd to 1,106,000 bpd. This turnaround was the result of the unexpectedly massive findings at Kashagan, the largest oil field outside of the Middle East. Following a large currency devaluation in 1999 and an upturn in proven oil reserves and in oil prices, Kazakhstan entered a boom period in the early twenty-first century.

At the same time, Kazakhstan’s geopolitical situation was far more secure: the Kazakh state no longer required Western support to counter Russian ambitions. Suddenly, Kazakhstan began to realize that it no longer needed to offer highly attractive legal enticements to keep its hydrocarbon industry running; on the contrary, they were able to tap into their domestic capital base to generate those revenues.

At the same time, the concerted tier one push by Western countries (particularly the U.S.) weakened in the 2000s. Kazakhstan had less need for the United States and Western-dominated international financial institutions. This newfound economic power meant that IMF emergency loans were no longer needed. In May 2000, “the National Bank of Kazakhstan made an early repurchase of all outstanding balances owed to the IMF drawn between 1993 and 1998.” This full repayment was seven years ahead of schedule. In 2003, the IMF closed its offices in Kazakhstan.

Effect on deals

The cost-benefit calculus of the Kashagan deal shifted greatly. Not only was the price of oil increasing rapidly, the size of the field defied all expectations. Upon discovery, Kashagan became the largest oil field outside of the Middle East. “Kashagan, in the north Caspian sea, is the biggest oilfield to have been discovered since the 1960s, with reserves of up to 9bn barrels of oil equivalent.” Suddenly, Kashagan promised to be a vital contributor to the Kazakh state budget: “Kazakhstan’s prospects to become a

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66 See email cite:
67 P. 184, oil, transition, and security.
68 Pomfret, p. 155.
70 (Unfulfilled, 170).
world-class oil exporter depend largely on Kashagan. The country’s total output in 2006 was approximately 65 million tons. Kashagan could double that output.”\(^{72}\) In fact, Jonathan Waghorn, an oil industry analyst with Goldman, Sachs in London, wrote that “It will provide a stable stream of cash for the next 30 or 40 years, so it is certainly a good thing for companies that are able to absorb such a project into their portfolios.”\(^{73}\)

As oil prices increased, it became increasingly difficult for the Kazakh state to extract the massive profits through taxes and royalties at Kashagan (there continued to be no state involvement in this project). Despite its importance, Kazakh officials, like the Russians, proceeded slowly and cautiously to increase their take while seeking to minimize reputational costs.

In 2004, when BG sought to exit the Kashagan project, the Kazakhs aggressively sought to ensure that Kazmunaigas (KMG) would acquire BG’s stake in the Kashagan field, using a law (see above) that had just recently been passed for this very occasion. The other members of the consortium wanted to buy the shares themselves. Indeed, BG’s exit was seen as a way of making the deal more workable: “This project is unique in having so many majors with equal shares. It makes decision-making very difficult. And we still need to bring the number of partners down.”\(^{74}\)

However, the Kazakhs persisted. The members of the consortium – faced with a new law providing Kazakhstan preemption rights – compromised with the Kazakhs: they would be allowed to purchase half of BG’s share (8.33%). The rest would be distributed amongst the consortium members. BG’s shareholders were faced with a fait accompli: “Eventually, on June 11, BG was forced to post a note to its shareholders on its website announcing that the Kazakh government ‘has indicated that it believes it has a preemptive right’ to acquire the BG stake on the same terms ‘and has expressed its desire to do so.’”\(^{75}\)

This would not prove to be the end of government intervention in the Kashagan project. As more delays and cost increases were announced, the government created a special working group in August 2005 to explore the terms and conditions of the 1997 PSA, especially with regard to the customs and tax payments, “taking into account the present, medium, and long-term interests of Kazakhstan.”\(^{76}\)

Kazakhstan then employed similar tactics to the Russians in taking over Sakhalin II. Citing environmental problems, Kazakhstan requested over $10 billion in compensation from the multinational consortium and the government prohibited further work on the field for environment until the parties come to an agreement. The negotiations over solving this problem took place at the highest level. The Prime Minister of Italy, Romano Prodi, traveled to meet with Nazarbaev to ensure the interests of the Italian run consortium.

An agreement was finally reached on Jan 13, 2008: “The consortium – which includes ExxonMobil of the US, Royal Dutch Shell and Total of France – agreed to pay Kazakhstan $2.5bn-$4.5bn in compensation for the project’s late start. It will also sell shares to KazMunaigas, so the Kazakhstan national oil company’s stake can be doubled.


to 16.8 per cent, equalling the holdings of the largest western members of the consortium. KMG will take a bigger role in running the project.”77

So, through KMG, the Kazakh government had succeeded in securing the rest of the BG stake that they initially wanted. In so doing, Kazakhstan guarantees itself an increased take over the life of the project: under the terms, Kazakhstan’s national energy company, KMG, will gain extra income of up to $20 billion over the life of the project. 78 “We have agreed that Kazakhstan will purchase on a proportional basis from all existing shareholders in the project an extra stake, and as a result the country’s share in the project will be 16.81 percent,” Energy Minister Sauat Mynbayev said in comments broadcast by Khabar TV.

Reputational costs and fear of reduced access to foreign capital have restrained Kazakh behavior in other areas as well. For instance, Tengiz has also come under significant pressure. In fact, in response to rising oil prices, “the government insisted on an accounting method that would have brought in more for the state but was not, the consortium contended, part of the 1993 contract.”79 In response, the Chevron-ExxonMobil consortium suspended all operations in protest. This gambit worked: the Kazakh leadership backed down. Since then, the Kazakh government has been forced to follow a lower level strategy: collecting smaller one time fines. For instance, after negotiations, a “subsequent compromise deal is said to have netted the government an additional income of $810m over three years.”80 In 2007, a Kazakh court has forced Chevron to pay $37 million in damages for environmental damage.81 Thus, despite considerable obsolescence, future access to foreign capital has helped restrain Kazakh actions.

**Azerbaijan**

**2000s**

In contrast to both Kazakhstan and Russia, the tier one relationship between Azerbaijan and Western capital has grown closer in the 2000s. This is the result of two factors. First and foremost, Azerbaijan continued to need to pull in foreign capital in order to secure its economic and political situation. In particular, Azerbaijan greatly needed foreign capital to explore and find new hydrocarbon reserves in the Caspian; its proven reserves were dwindling and the recovering state could not afford to bear the risks of exploration. Furthermore, Azerbaijan’s economy did not recover as quickly as the

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Kazakh economy (and its hydrocarbon sector did not offer the same future revenue); as a result, Western aid was still needed. Finally, Azerbaijan continued to greatly need Western support to assure its continued sovereignty.

Second, the “push” of Western capital has increased dramatically in Azerbaijan since 2000. Azerbaijan has emerged as critical American energy ally. Indeed, the United States government worked closely with Azerbaijan in building the Baku-Tbilisi-Ceyhan (BTC) pipeline, providing large public loans and generous aid to help develop this pipeline.

The success of the BTC pipeline and America’s increasing engagement in the post-9/11 world has strengthened Azerbaijan’s position as a reliable and favored ally of the West. As a result, multilateral loans have increased dramatically in Azerbaijan since 2000. In fact, in contrast to both Kazakhstan and Russia, the IMF has remained active in Azerbaijan. In 2001: “Government reforms supported by the IMF under its three-year Poverty Reduction and Growth Facility (PRGF), approved in July 2001, included Oil Fund budget and asset management rules.”

Furthermore, this strategic alliance has meant that American foreign aid to Azerbaijan has skyrocketed since 2000. Indeed, after September 11, 2001, Azerbaijan became a key ally of the US in the global war on terror. Its position as a key player in the great game that was taking place between Russia, China, and the West was further strengthened. Oil companies and the Bush administration lobbied Congress hard to get Section 907 of the Freedom Support Act lifted in the Congress. It was effectively lifted in 2002. Since then, President Bush has annually waived section 907 of the Freedom Support Act giving US aid to Azerbaijan.

Deals

The strengthening tier one interrelationship between foreign capital and the Azeri hydrocarbon industry has greatly helped to insulate the ACG deal (and others) from renegotiation. Indeed, like Kazakhstan and Russia, Azerbaijan clearly had incentives to increase their take in the rapidly rising hydrocarbon rents that were emerging. The ACG deal had clearly obsolesced. First, the BP-led consortium at ACG had already made the heavy investment into the project. Second, there were even reports of cost overruns in Azerbaijan. “BP on Dec. 14, 2005, said capital expenditures on projects in Azerbaijan had exceeded forecasts. BP's Azerbaijan CEO, David Woodward, said 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.”

However, Azerbaijan has failed to renegotiate, since renegotiations would risk jeopardizing future access to foreign capital that is critical to the maintenance of the Azeri economy. Put another way, the increased take they could get from renegotiating their existing hydrocarbon PSAs would be outweighed by the economic costs of weakening their strong tier one relationship with foreign capital.

First, if they renegotiate, Azerbaijan stands to lose much of the future multilateral bank support that has contributed recently to the development of the Azeri economy.

82 http://www.eurasianet.org/caspian.oil.windfalls/full%5Freport.pdf
84 http://www.entrepreneur.com/tradejournals/article/148014677.html
Such support is critical for Azerbaijan, since its non-oil economy is in far worse condition than Kazakhstan’s or Russia’s. Second, 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. In fact, negotiations about the Nagorno-Karabakh dispute are likely to continue within both the Council of Europe and the United Nations. Strong relations with European and American governments can help blunt the power of the Armenian diaspora in lobbying these governments and in securing an outcome that will be advantageous to Azerbaijan.

Third, since Azerbaijan was not under significant tier one, governmental pressure to sign the deals during the 1990s, the terms of the PSAs were not as unfavorable for the country as in Russia or Kazakhstan. Thus, there is not as much of an incentive to recoup the windfall from these deals as in Russia or Kazakhstan.

Finally, and most importantly, the Azeris do not have the same long-term, hydrocarbon-based cash flow that the Russians and the Kazakhs do. Its proven oil and gas reserves are less than those of Kazakhstan or Russia. In fact, the potential yield of Azerbaijani hydrocarbon reserves has proven to be disappointing. Recently, 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. As one commentator has said: “Azerbaijan is unlikely to see a substantial rise in its reserves because the south-western Caspian is a mature oil province and recent exploration has been disappointing.” (58, Richard M. Auty, Energy, Wealth, and Governance in the Caucasus and Central Asia).

Furthermore, Azerbaijan has signed over 21 PSAs for development of various onshore and offshore oil fields, but only the contract for the development of the ACG fields, run by the AIOC, has resulted in significant oil findings. In fact, commentators argue that Azerbaijan is only likely to have a brief oil boom. “in the absence of further discoveries or of improved extractive efficiency production will rise swiftly to peak at 1.3 million bpd during 2009-2013, before falling to modest levels by 2020.” (59, Richard M. Auty, Energy, Wealth, and Governance in the Caucasus and Central Asia) “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 c.m. 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 c.m. 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.” “Natural gas production in Azerbaijan is comparatively limited and falls short of meeting domestic needs, with the gap between domestic supply covered by imports from Russia.” The country cannot bear the whole risk of the needed exploration that would boost these numbers. Thus, Azerbaijan is in desperate need of

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85 P. 190, Oil, transition, and Security.
86 Pomfret, p. 158
87 http://www.eoearth.org/article/Energy_profile_of_Azerbaijan
89 http://en.ng.ru/energy/2008-01-16/1_stall.html?mthree=1
additional private foreign investment to ensure that it remains one of the world’s leaders in the production of hydrocarbons.

Thus, the huge returns that the BP led AIOC were not captured through renegotiation because they were effectively seen as an investment in an ongoing tier one relationship that was generating considerable current benefits and promises future benefits as well. In this way, Azerbaijan’s belief in the importance of maintaining good relations with foreign capital has helped bolster the position of the western oil majors that had invested in the Azeri hydrocarbon sector.

**Conclusion**

This Article suggests that recent legal changes sweeping the hydrocarbon sector in Russia, Kazakhstan, and Azerbaijan are neither aggressive attacks on the foreign property rights nor a result of the traditional obsolescencing bargain model. Instead, this Article has revealed how these renegotiations have been constrained. This finding suggests that the two-tiered, externalized model of FOC-state relations - developed during the 1980s and 1990s - is the correct way of understanding these renegotiations. Thus, one of the key lessons for FOCs is that hydrocarbon investment is safer in countries that have a long term need for foreign investment in their hydrocarbon industries.

Applying this analysis going forward, it seems likely that, given a continued high price of oil, Russia and Kazakhstan will continue to put pressure on contracts signed during the 1990s. However, although possible, future large-scale renegotiations are unlikely as the continued role and demand for foreign capital and expertise will mean that neither can afford to close their hydrocarbon markets to foreign capital. As for Azerbaijan, assuming its demand for foreign capital remains high (which is highly likely), is unlikely to follow Russia and Kazakhstan and will abide by previous contractual terms.

Finally, these findings suggest that, while there is certainly an ideological component to the recent legal instability, the economic cost-benefit analysis (in particular, access to foreign capital) is playing a larger role in legal changes to hydrocarbon regulation than it did in the 1970s. Understood as primarily an economic reaction, recent legal changes are best understood as a way for the state to capture a share of the windfall profit provided by the rising oil prices while also preserving access to foreign capital. In this way, this Article accords with the words of one scholar, "Expropriations were not the result of abnormal decision-making processes by the host governments but were a function of calculated economic and political decisions."92

Anecdotal information from other countries seems to confirm that they too are constrained by the important role of foreign capital in economic development.93 For instance, even Venezuela, which has been heavily criticized for taking extreme legal measures, has avoided full-scale nationalization and essentially imposed a particularly harsh form of windfall tax by forcing the state-owned PDVSA to take part in major

91
92 Roderick Duncan, Cost and Consequences of Expropriation by Host Governments
93 Finally, Colombia – which has a similar need for foreign capital to develop its stalling hydrocarbon sector – has also failed to renegotiate.
projects. Of the six major oil companies involved in the projects, only two exited completely from Venezuela: (ConocoPhillips and ExxonMobil).\textsuperscript{94} Two others reduced their holdings to allow space for the enlarged PDVSA share (Total and Statoil) and two maintained their previous stakes (Chevron, BP).

To build on this analysis and provide more support for its contention that the obsolescing bargain plus model is the most appropriate way to understand these renegotiations, more empirical research needs to be done. This work should seek to test the relationship between demand for foreign capital and the stability of hydrocarbon law. To test the relationship between these two factors it is important to specify the factors that determine a country's relative demand for foreign capital.

Three factors are likely to play a role in a country’s relative tier one need for foreign capital in the hydrocarbon industry: 1) quantity of untapped proven hydrocarbon reserves; 2) difficulty/cost in extracting hydrocarbon reserves; and 3) relative healthiness of the hydrocarbon sector, including age of equipment, capital contributions. Therefore, we can hypothesize that, as with the three countries in the Article, countries with 1) large proven hydrocarbon reserves 2) which are easy to extract that also 3) have strong economic growth are more likely seek to renegotiate contracts when the price of oil increases. Those without those attributes will be less likely to renegotiate.

In sum, this Article should be understood as a starting point for a more rational understanding of the forces affecting the stability of hydrocarbon law in the high oil price environment of the early 21\textsuperscript{st} century. Free of misleading historical examples and theoretical approaches, we can better understand the future of the legal frameworks that play such a large role in determining energy prices and policy.

\textsuperscript{94} EIA, Venezuela Country Analysis Brief, October 2007, available at: \url{www.eia.doe.gov}. 