Mitigating Regulatory Risks for U.S. and EU Investments in Russian Oil and Gas Industry

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Introduction

Russia's abundance of natural resources makes the Russian oil and gas sectors highly attractive to foreign investors. According to some estimates, the share of foreign capital in the Russian extractive industry was 13.07 percent in 2014, 26.03 percent in the manufacturing industry, and 3.07 percent in the industries supporting the production and distribution of electricity, water, and gas.[1] However, high levels of administrative bureaucracy, complex and often contradicting regulations, corruption, and the lack of an independent judiciary are still damaging for the investment climate in Russia. In addition, Western sanctions against Russia introduced in response to Russia's annexation of Crimea in 2014 as

[1] Dmitry Bulin, "Inostranny capital terpit v Rossii ubytki, no ne uhodit," [Foreign capital is suffering losses in Russia, but does not go away, *translation of the author*] *BBC, Russian Service*, October 17, 2015, accessed March 17, 2017, http://www.bbc.com/russian/business/2015/10/151026_multinationals_in_russia.

well as Moscow's current policy in Ukraine have led to a tremendous outflow of investments, with foreign direct investments dropping from over $53 billion in 2013 to just under $10 billion in 2015.[2]

Industry regulations shape investment conditions, creating a framework for a foreign company's operation in a host country. Therefore, changes of rules can have a significant impact on businesses, leaving the foreign company vulnerable to uncertainties. Regulatory risk refers to possible detrimental effects of changes in regulations and laws on the business environment: the potential for regulations to constrain or hinder a company's operation in a certain industry decreases the attractiveness of that industry for future investments.

The following research paper analyzes the regulatory risks that EU and U.S. companies face when investing in Russian oil and gas projects. The analysis provides an overview of potential sources for regulatory risks, taking into account important attributes of the oil and gas sectors as well as Russian domestic politics. Finally, the paper aims to suggest important risk mitigation strategies for companies considering investing in the Russian oil and gas sectors, outlining potential opportunities for cooperation and providing examples of successful and failed projects.

What are regulatory risks?

Regulatory risks in general

Regulations are formal legal rules set by governments to coordinate business practices across industries, outline guidelines for private operations in certain sectors, and ensure compliance with government standards. Regulations can both negatively and positively influence businesses by facilitating or restricting the operation of domestic and international companies. Awareness of regulations is particularly important for foreign investors and foreign companies, as formal rules define the legal framework for their engagement in each country.

Countries can have different regulatory models. The United Kingdom, for instance, has a regulatory system that is independent from the government, while some developing countries have governments that shape regulations over the entire market or within certain sectors.[3] However, any regulatory regime must provide the government, institutions, and companies with transparent rules that clearly identify the objectives behind all regulations. A country must also have clear rules so that companies can avoid violating them, as well as an independent judiciary system that can resolve regulatory disputes.[4]

Although regulations are sometimes associated with restrictions placed on foreign investments, they do not always aim to protect domestic producers from the negative impacts of international competition. On the contrary, governments often use regulations to incentivize investors

[2] "Russia Foreign Investment," Santander Trade Portal (November 2016), accessed December 15, 2016, https://en.portal.santandertrade.com/establish-overseas/russia/foreign-investment.

[3] Jon Stern and Stuart Holder, "Regulatory governance: criteria for assessing the performance of regulatory systems. An application to infrastructure industries in the developing countries of Asia," *Utilities Policy* 8 (1999): 33, 36.

[4] Ibid. 43.

in order to increase the flow of foreign direct investment and provide certain economic sectors with additional capital. For example, special regulations can facilitate investor's access to credit, ease taxation, protect investor's interests by creating more transparent procedures for transactions, and speed up the process of registration for foreign companies.[5] Regulations can often help the government compensate for economic imbalance by providing a mechanism that accounts for budget deficits and stimulates the economy in given areas.[6]

However, a government can also introduce regulations that would restrict or even forbid foreign investment or engagement of foreign companies in certain domestic economic sectors. For example, the government can actively protect domestic companies by increasing taxes on foreign companies, introducing sanctions against foreign investors, or restricting visa and labor regulations for foreign employees. Government's regulatory measures can target different industries selectively to ensure favorable conditions for the most important domestic industries or companies.[7] Consequently, a foreign company operating in a host country could face regulatory risks that might lead to considerable financial losses and legal issues or even force the company to stop conducting business in said country. The role of regulations is disputable: on the one hand, regulations can stimulate economic and social development, on the other, regulations can cause more harm due to a lack of information about all actors and their needs.[8]

While measuring regulatory risks is difficult, some indices provide useful criteria for assessment. For example, the Global Opportunity Index (GOI) assesses the environment for foreign investors worldwide along several dimensions, including the quality of a country's regulations and the extent to which its government adheres to the rule of law. The index especially measures regulatory barriers based on the extent and burden of regulation, corruption, transparency, and levels of control on capital.[9] Foreign companies can use the GOI when developing a strategy for operation in a certain country. In addition, assessment of regulatory risks requires analysis of a country's legal structure, as the effectiveness of law enforcement mechanisms protecting the rights of foreign investors influences the quality of regulations. However, taking into account special characteristics of a given industry should also be part of an adequate regulatory risk analysis.

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[5] Dorina Koci, "Business Regulations: Constrain or Safeguard Business Activity? (The Importance of Regulatory Impact Assessment)" *European Scientific Journal* 9 (2013): 312-13.

[6] Colin Kirkpatrick, "Assessing the Impact of Regulatory Reform in Developing Countries," *Public Administration and Development* 34 (2014): 162.

[7] Ian Bremmer, "Regulatory Risk," in *Fat Tail. The Power of Political Knowledge in an Uncertain World,* Ian Bremmer and Preston Keat. (New York: Oxford University Press, 2010), 146.

[8] Johan Den Hertog, "Review of Economic Theories of Regulation," *Tjalling C. Koopmans Research Institute, Discussion Paper Series* 10-18 (2010): 2, accessed December 15, 2016, http://www.uu.nl/sites/default/files/rebo_use_dp_2010_10-18.pdf.

[9] Heather Wickramarachi and Keith Savard, "Global Opportunity Index. Attracting Foreign Investment," *Milken Institute* (2015): 7, accessed December 15, 2016, http://www.globalopportunityindex.org/pdf/2015-Global-Opportunity-Index.pdf.

Typical regulatory risks in the oil and gas industry

The oil and gas industry is prone to regulatory risks associated with a government's interference, regulation of energy production due to volatile prices, and environmental regulations. As the oil and gas sectors usually account for a significant part of a country's gross domestic product (GDP) and are strategically important for national interests, governments often regard foreign involvement in these sectors as a sensitive issue. Some governments, especially those in authoritarian and protectionist states, tend to interfere with companies in the oil and gas industry in order to gain control over domestic natural resources, build a base for societal wealth, and legitimize their regimes. A government in a host country can constrain foreign influence on its fossil fuel sector by restricting foreign investors' shares in the oil and gas industry, increasing taxes on foreign companies, or forcing foreign companies to offer ventures in which domestic companies are majority stakeholders. Such measures are important tools for a government aiming to maintain control over the country's resources and to balance the domestic budget by increasing revenues without hurting domestic companies.

Oil production can be subject to additional regulations that reflect changes of market situation. Oil prices are volatile and can fluctuate dramatically due to changes in supply, demand, and adverse market expectations. Therefore, oil-exporting countries, such as Organization of the Petroleum Exporting Countries (OPEC) member states, can agree on oil production quotas and limit the oil supply to control oil prices. Restricting oil production is also a regulatory measure that can significantly impact the operations of both foreign and domestic oil companies.

Additionally, the production of oil and gas is subject to environmental regulations. The adaptation of a new domestic or international regulatory framework that aims at reducing emission can also pose a regulatory risk for oil and gas companies.[10] Responding to the challenges of environmental regulations requires a company to invest in new technology and develop new production methods, potentially increasing the company's costs.

Regulatory regime in the Russian oil and gas industry

Regulatory reforms in Russia's oil and gas industry

Regulations play an important role in the Russian oil and gas sectors, significantly shaping framework conditions under which foreign companies operate. The Russian government has always emphasized the important place that foreign investment holds within the Russian economy. The Kremlin has made efforts to improve the investment climate by clearly strengthening protection for minority investors between 2009 and 2016.[11] However, with the growing strength of the Russian state,

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[10] Mary Beth Gallagher, "Please Vote In Support of Resolution to Reduce GHG Emissions in Products and Operations, ExxonMobil," *Tri-State Coalition* (2015): 1-2, accessed December 15, 2016, https://www.ceres.org/investor-network/resolutions/exxon-ghg-goals-2015/@@download/attachment.

[11] "Doing Business 2017. Equal Opportunity for All," *World Bank* (2017): 5, accessed December 15, 2016, http://www.doingbusiness.org/~/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB17-Report.pdf; "Doing Business 2010. Reforming through Difficult Times," *IFC, World Bank, Palgrave MacMillan* (2009): 147, accessed December 15, 2016,

the Kremlin wants to enhance control over sectors crucial to the Russian national security and economy. The extraction industry is one of such sectors, with mineral extraction taxes (MET) accounting for 46 percent of the Russian budget in 2014.[12]

A federal law introduced in 2008 defined 42 strategic sectors in the Russian industry and restricted foreign investments in these areas.[13] The Russian government listed the fossil fuels industry among the strategic economic sectors, limiting the participation of foreign investors and foreign companies in businesses related to oil and gas. Restrictions apply to oil deposits with more than seventy million tons of oil and more than fifty billion cubic meters of gas. A foreign private investor needs approval from the Government Commission for Control of Foreign Investment in the Russian Federation when acquiring more than fifty percent of a company in a strategic sector. If a foreign government or an international organization controls a foreign company that is willing to acquire more than a 25 percent stake in a Russian company of strategic importance, the company also requires the Kremlin's approval. Finally, foreign investors must inform the Russian government of their intention to obtain more than five percent of any Russian company that is engaged in developing a strategic natural resource reserve.[14]

As a result of strong state influence, the Russian oil and gas sectors are susceptible to nationalization risk that is related to regulatory risk, as nationalization also defines rules and shapes the business environment in the industry. At the beginning of the 2000s, state influence on the Russian oil and gas sectors significantly increased, with the state obtaining control over 57 percent of oil production and approximately 75 percent of gas production.[15] For example, the state holds a 51 percent stake in Rosneft, a key oil exploration company in Russia. In the gas sector, the state owns slightly more than a fifty percent stake in Gazprom, Russia's gas monopoly and the biggest natural gas producer in the world. The biggest oil transporting company, Transneft, is entirely owned by the state. A possible nationalization could pose an additional regulatory risk for private companies, decreasing companies' enthusiasm to invest in future projects.

The Russian oil and gas industry is likely to see regulatory changes over the next several years due to the Kremlin's large budget deficit resulting from Western sanctions and falling oil prices. The oil and gas sectors underwent structural tax reform in 2015, which resulted in an increase of MET being planned in the future to raise revenues.[16] If economic pressure grows, Moscow might allow

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http://www.doingbusiness.org/~/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB10-FullReport.pdf.

[12] Zachary Waller, "Tax Changes in Russian Oil and Gas," *Enerpo Journal*, April 20, 2016, accessed December 15, 2016, https://enerpojournal.com/2016/04/20/tax-changes-in-russian-oil-and-gas/.

[13] "Federal Law No. 57-FZ of April 29, 2008," accessed December 15, 2016, http://www.rdbforum.com/uploads/files/Federal_Law_57.pdf.

[14] Ibid.

[15] Tatiana Mitrova, "Shifting Political Economy of Russian Oil and Gas," *CSIS Energy and Security Program* (2016): 19, 21, accessed December 15, 2016, https://csis-prod.s3.amazonaws.com/s3fs-public/publication/160323_Mitrova_RussianOilGas_Web_0.pdf.

[16] Yuri Bobylev, "Tax Maneuver in Russia's Oil Sector," *Russian Economic Developments* 8 (2015): 47, accessed December 15, 2016, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2659489.

foreign investors to acquire parts of Russian oil and gas companies, as the Kremlin has already begun discussing the possibility of partial privatization of oil companies.[17]

Restrictions due to Western economic sanctions against Russia

Apart from domestic regulatory barriers, foreign investors in Russia face restrictions from current economic Western sanctions against Russia. EU sanctions apply to a part of the Russian energy industry, including the oil sector. Due to the EU's high dependence on Russian gas, with approximately forty percent of gas coming to the EU from Russia, the EU exempted the gas sector from sanctions. Any cooperation with Russian oil and gas companies that had begun before the introduction of sanctions also remains allowed.[18] In contrast to the EU, the United States does not differentiate between different energy sectors, forbidding U.S. companies from engaging in the Russian oil and gas sectors.

The violation of sanctions' regulations can become very expensive for companies. U.S. companies that are non-compliant with Western sanctions against Russia can face a penalty of up to $250,000 or an amount twice as high as the illicit transaction. A purposeful violation may be penalized by up to a one million dollar fine and imprisonment for twenty years.[19] EU member states have different penalties, set forth in their national legislation. For example, in Germany, anyone can be punished with a prison sentence from three months to five years or a fine of up to €500,000.[20]

Reasons for investment in the Russian oil and gas industry

Opportunities for investors in Russia

Despite obvious regulatory risks that a foreign company can face operating in the Russian oil and gas sectors, being aware of opportunities is important for an investment decision. The Kremlin has put a lot of effort into improving Russia's business climate. According to the World Bank, the country has facilitated foreign investment and the operation of foreign companies, improving Russia's position in the ranking on the ease of doing business from 112th place out of 190 in 2013 to 40th in 2017.[21] Having introduced over thirty reforms aimed at improving the business climate over the last

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[17] "Siluanov predlozhil nachat' privatizaciyu s Rosnefti," [Silutanov has proposed to start privatization with Rosneft, *translation of the author*] *Vedomosti*, January 16, 2016, accessed December 15, 2016, https://www.vedomosti.ru/business/news/2016/01/16/624250-siluanov.

[18] Marcin Szczepański, "Economic impact on the EU of sanctions over Ukraine conflict," *European Parliamentary Research Service* (2015): 3, accessed December 15, 2016, http://www.europarl.europa.eu/RegData/etudes/BRIE/2015/569020/EPRS_BRI(2015)569020_EN.pdf.

[19] "Ukraine/Russia related Sanctions Program," *Department of the Treasury, Office of Foreign Assets Control* (2016): 7, accessed December 15, 2016, https://www.treasury.gov/resource-center/sanctions/Programs/Documents/ukraine.pdf.

[20] "Foreign Trade and Payments Act (Außenwirtschaftsgesetz - AWG), of 6 June 2013," Section 18, Par. 1, p. 23; Section 19, Par. 6, p. 28, accessed December 15, 2016, https://www.bmwi.de/BMWi/Redaktion/PDF/A/awg-englisch,property=pdf,bereich=bmwi2012,sprache=de,rwb=true.pdf.

[21] "Doing Business 2013 Smarter Regulations for Small and Medium-Size Enterprises," *World Bank* (2013): 3, accessed December 15, 2016, http://www.doingbusiness.org/~/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB13-full-report.pdf; "Doing Business 2017," 5.

thirteen years, Russia is one of the countries that have implemented the most reforms in Europe and Central Asia.[22] Russia significantly facilitated start of a new business easier by reducing the number and time of procedures, costs, and required minimum capital. The country also enhanced a company's access to credit, and increased investor protection.[23]

The Western sanctions might be removed in the near future, opening new opportunities for foreign companies for cooperation in the oil and gas sectors. A change in Washington's attitude towards Russia and increasing public and political pressure against Russian sanctions in the EU can undermine the future maintenance of Western sanctions. Even in the worst-case scenario, with Western sanctions remaining or expanding and demand for gas on the Asian market decreasing, Russia's oil and gas industry will be sustainable and thus attractive for potential investments.[24]

European Union's increasing demand for the Russian gas

Foreign investors can rely on energy cooperation between Russian and the EU, as the European and Russian energy industries are deeply interconnected. While the European market is one of the most important markets for Gazprom's gas exports, Russia will remain one of the most important gas suppliers for the European Union due to a lack of viable alternative gas resources. EU domestic gas production decreased by nine percent in 2015, with gas fields in the Netherlands and Norway depleting, whereas imports from Russia went up.[25] The share of the Russian gas in EU gas imports is likely to increase due to declining European gas production and the construction of a second pipeline across the Baltic Sea, Nord Stream 2 that will double the capacity of Russian gas exports to Europe via the existing Nord Stream pipeline.

Importing gas from Russia is still the most cost-effective option for the EU, as export costs of Russian gas are lower compared to Russia's major competitor, liquefied natural gas from the United States.[26] Despite the plans to decrease EU dependence on Russian gas and diversify the EU's energy supply, finding reliable alternatives will take decades and require large investments in building infrastructure. Large environmental groups on both sides of the Atlantic oppose the export of U.S. shale gas to Europe, which could further undermine the ability of U.S. gas companies to compete with

[22] "Doing Business 2017," 9.
[23] "Doing Business 2013," 190; "Doing Business 2017," 234.
[24] Mitrova, "Shifting Political," 38.
[25] "Quarterly Report Energy on European Gas Markets," *Market Observatory for Energy, DG Energy* 9 (2016): 2, accessed December 15, 2016, https://ec.europa.eu/energy/sites/ener/files/documents/quarterly_report_on_european_gas_markets_q4_2015-q1_2016.pdf.
[26] While export costs of Gazprom are $3.50 per million British thermal unit (MMBtu), the costs of LNG are $4.00 per MMBtu, in James Henderson, "Gazprom – Is 2016 the Year for a Change of Pricing Strategy in Europe?" *Oxford Energy Comment* (2016): 4, 7, accessed December 15, 2016, https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/01/Gazprom-Is-2016-the-Year-for-a-Change-of-Pricing-Strategy-in-Europe.pdf.

Gazprom in Europe.[27] Development of renewable energy requires a political will and heavy investments that could amount to hundreds of billion dollars.

Opportunities for partnership in the Arctic

The resource-rich Arctic is an attractive region for investors and provides Western companies with an opportunity for cooperation with Russian oil and gas companies. Due to its geography, Russia has staked a claim over half of the Arctic shelf, which has a considerable amount of oil resources attractive to both international and domestic investors. According to the U.S. Geological Survey, the Arctic contains thirty percent of the world's undiscovered gas resources and thirteen percent of its undiscovered oil.[28] With the decline of domestic energy production, the EU will rely on oil imports and would likely be interested in exploring the Arctic. Oil fields in the Arctic would also be significant for the United States, as the country still relies on oil imports. Despite exploration of new shale oil and gas resources, the United States still imported 306,000 barrels of oil and petroleum products in 2016.[29]

Moscow relies on partnership with Western countries in the Arctic, as Russia needs modern technology to productively explore the country's abundant oil reserves in the Arctic region. Prior to the sanctions introduced in 2014, Russia imported half of the equipment and eighty percent of the software necessary for oil production from the West. While 68 percent of these imports are now subject to sanctions, Russian domestic production lacks the quality to compensate for the restrictions.[30] Sanctions suspended joint Arctic oil drilling projects of many U.S. and EU oil companies like ExxonMobil, Shell, Total, and Russian state-owned oil companies. However, the future of sanctions is not clear, while the Arctic will remain an attractive goal for investors, as oil and gas will still account for more than half of global energy demand by 2040.[31]

The EU and the United States are interested in maintaining cooperation with Russia in the Arctic to be able to compete with Asian investors in the Arctic and secure their influence in the region. As a result of Western sanctions, Russia has turned to its Asian partners to seek help for oil exploration in the Arctic, signing agreements to cooperate on resources extraction with China, India, and

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[27] "No fracking way: how the EU-US trade agreement risks expanding fracking," *Issue Brief* (2014): 3-4, accessed December 15, 2016, https://www.foeeurope.org/sites/default/files/publications/foee_ttip-isds-fracking-060314.pdf; "Environmental Groups Petition Against Natural Gas Exports," *LNG World News*, August 14, 2015, accessed December 15, 2016, http://www.lngworldnews.com/environmental-groups-petition-against-natural-gas-exports/.

[28] "Arctic oil and natural gas resources," US Energy Information Administration, January 20, 2012, accessed December 15, 2016, http://www.eia.gov/todayinenergy/detail.php?id=4650.

[29] "U. S. Imports of Crude Oil and Petroleum Products," U.S. Energy Information Administration, November 30, 2016, accessed December 15, 2016, https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=MTTIMUS1&f=M.

[30] Andres Mäe, "Impact of sanctions on the Russian oil sector," *Estonian Foreign Policy Institute* (2016): 2, accessed December 15, 2016, http://www.evi.ee/wp-content/uploads/2016/02/EVI-mottepaber29_märts16.pdf.

[31] James Griffin and Alvino-Mario Fantini, "2016 World Oil Outlook," *OPEC* (2016): 3, accessed December 15, 2016, http://www.opec.org/opec_web/static_files_project/media/downloads/publications/WOO%202016.pdf.

Singapore. China is especially interested in this engagement, as the country is the biggest oil-importer in the world.[32]

Risk mitigation strategies

Foreign companies acting in Russia need to be aware of possible negative changes in regulations and laws in the oil and gas sectors and should develop strategies for dealing with regulatory risk. By applying such a strategy, companies can reduce their chance of becoming targets of restrictive regulations. The following section explores some of useful approaches.

Understanding general risks for foreign investments in Russia

Regulations are powerful instruments in the hands of the highly centralized Russian state allowing the Kremlin to extend its influence over the private sector and control industries crucial to the Russian strategic interests. As oil and gas sectors play an important role for the Russian economy and foreign policy, worsening relations between Western governments and the Kremlin could result in severe business restrictions and negative changes in Russia's regulations for foreign investors. The complexity of rules and Moscow's use of regulations as a tool for enforcing Russia's interests are one of the sources of potential regulatory risk for foreign investors.

In order to understand potential risks for foreign companies, investors have to be aware of differences in Russian and Western understanding of regulations.[33] Although Russia has established formal institutions and regulations, informal practices from the Soviet Union still dominate the political, economic, and business environment in Russia. These informal practices in Russia are necessary for the effective functioning of the Russian economy as they compensate for shortages resulting from poor infrastructure and cumbersome economic architecture.[34]

Moreover, economic and political elites in Russia have strong ties, resulting in selective law enforcement and the application of rules and laws to exert pressure on individuals or companies.[35] A high level of bureaucracy and the complexity of Russian regulations impedes a foreign company's compliance with formal rules, creating an opportunity for corruption and selective application of punishments for regulatory violations. Moreover, the Russian judiciary lacks independence, further discouraging foreign investments.[36]

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[32] Tom Morgan, "China Now World's Largest Oil Importer; Effect on Global Market," *Forbes*, June 8, 2015, accessed December 15, 2016, http://www.forbes.com/sites/drillinginfo/2015/06/08/china-now-worlds-largest-oil-importer-effect-on-global-market/#4809d52268d6.

[33] Sander Goes, "Foreigners in the Russian petroleum sector: the cases of Sakhalin-II and TNK-BPP" (PhD diss., University of Tromso, 2013): 36, accessed December 15, 2016, http://munin.uit.no/bitstream/handle/10037/5348/thesis.pdf?sequence.

[34] Alena Ledeneva, *How Russia really works: The Informal Practices that Shaped Post-Soviet Politics and Business* (Ithaca, New York: Cornell University Press, 2006): 178.

[35] Goes, "Foreigners," 43.

[36] Russia achieved very low scores— three out of ten—for rule of law in the Global Opportunity Index in 2015, in Wickramarachi and Savard, "Global Opportunity Index," 13. The Freedom House score of the rule of law in Russia is even lower, with the country receiving only two points out of 16 in 2016, in "Russia," Freedom House, accessed

Finally, ongoing political tensions between the West and Moscow, Western economic sanctions against Russia, and Russian counter-sanctions are another significant source of insecurity and regulatory risk for foreign investors in Russia. Sanctions are restrictive regulations significantly shaping the environment in which foreign companies operate in Russia. Uncertainty about the future of sanctions and a real possibility of their expansion due to the escalation of the conflict in Ukraine exposes foreign investors to additional regulatory risk, as sanctions can terminate foreign companies' operation in Russia.

Assessing future regulatory trends

One of the most important risk mitigation strategies for foreign investors in the Russian oil and gas sectors should be monitoring the development of future regulatory trends that will affect the operation of foreign oil and gas companies in Russia. As the sanctions significantly affect opportunity for investments in the Russian oil and gas sectors, foreign investors should follow the events in the Ukrainian crisis and monitor the dynamics between the EU, Russia, and the United States to anticipate changes or increases to sanctions against Russia in the future.

A thaw in U.S.-Russian relations could lead to a shift in the U.S. policy and potentially the cancellation of U.S. sanctions against Russia. The U.S. sanctions are currently "under consideration" in the White House,[37] with the new administration in the White House advocating for a rapprochement with Russia and clearly indicating a change in U.S. policy towards Russia. With former Exxon CEO Rex Tillerson as the new Secretary of State, Trump's cabinet also has an influential member with strong ties to Putin.

The sanctions are highly unpopular in numerous EU countries, as more countries prefer having a strong economic relationship with Russia to being tough with Russia on foreign policy disputes.[38] Unlike the U.S. sanctions, the EU sanctions need to be unanimously extended every six months. According to the EU Commission President Tusk, Trump's election might negatively impact the unity of the EU over the sanctions.[39] Given the growing opposition against sanctions in many EU member states, the maintenance of EU sanctions over the next two years is questionable.

December 15, 2016, https://freedomhouse.org/report/freedom-world/2016/russia. Additionally, Russia shows a very high level of corruption in different areas, ranking 119th among 175 countries in the corruption index according to Trading Economics, in "Russia Business Confidence," Trading Economics, accessed December 15, 2016, http://www.tradingeconomics.com/russia/business-confidence.

[37] Aidan Quigley, "Conway: Russian sanctions 'under consideration' in Trump-Putin call," *Politico*, January 27, 2017, accessed March 17, 2017, http://www.politico.com/story/2017/01/russia-sanctions-trump-putin-234262.

[38] Bruce Stokes, Richard Wike, and Jacob Poushter, "Europeans See the World Divided. 2. Europeans question global engagement," *Pew Research Center*, June 13, 2016, accessed December 15, 2016, http://www.pewglobal.org/2016/06/13/europeans-question-global-engagement/.

[39] "EU Leader Expects Bloc to Extend Sanctions on Russia in 2017," *The New York Times*, December 1, 2016, accessed December 15, 2016, http://www.nytimes.com/aponline/2016/12/01/world/europe/ap-eu-eu-russia-tusk.html.

Partnership with a state-owned company

Another strategy to mitigate regulatory risk in the Russian oil and gas sectors is to do business directly with the government or by proxy through a state-controlled company. However, this strategy may not be successful if a company fails to understand interests of the Kremlin and other actors in the oil and gas sectors.

In one example, ExxonMobil started doing business in Russia in the early 1990s with the Sakhalin-1 offshore development project in Russia's remote Far East. Partnering with the state-controlled company Rosneft, in 2011, both companies agreed on a strategic cooperation in oil and gas exploration. The agreement resulted in ten joint ventures for projects on resource exploration in the Russian Arctic, the Black Sea, and western Siberia.[40]

ExxonMobil's success in Russia is attributed to its straightforward approach to dealing with the Russian authorities,[41] their recognition of the Kremlin's strategic interests in developing the Arctic oil fields and projects in the United States, and to treating Rosneft as an equal business partner. Conducting business with a government-controlled company or entering deals that are strategic to the Kremlin in and of itself exposes Russia's foreign partners to regulatory risk from their own governments. However, U.S. sanctions against Russia following its annexation of Crimea in 2014 forced ExxonMobil to put the strategic cooperation with Rosneft on hold and to delay several joint ventures, including strategic projects in the Arctic, with a "maximum before-tax exposure to loss from these joint ventures as of December 31, 2015," estimated at $1 billion.[42]

In contrast, the oil company British Petroleum (BP) experienced severe tensions operating in the Russian energy industry resulting from a poor understanding of the risk attitude of its Russian partner, neglecting the fact that Russian management culture is highly intolerant to insecurity and is therefore very short-term oriented. BP invested in a joint venture, TNK-BP, with three private Russian companies and investment groups Alfa-Access-Renova (AAR) in 2003. The initial conflict between the partners resulted from different strategic goals, with BP pushing TNK-BP to invest in long-term projects and the Russian partners aiming for short-term goals. With tensions within the British-Russian company mounting, the Russian side used its ties to government agencies to apply regulatory pressure on BP. As a result, BP was exposed to inspections and was twice accused of tax evasion, while the state hindered BP Western employees from receiving Russian work-permits, thereby forcing them to leave the country.[43]

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[40] "Russia," ExxonMobil, accessed December 15, 2016, http://corporate.exxonmobil.com/en/company/worldwide-operations/locations/russia/about/overview.

[41] Lucian Kim, "In ExxonMobil's Rex Tillerson, Moscow Sees Trusted, Highly Regarded Figure," *NPR*, December 12, 2016, accessed December 15, 2016, http://www.npr.org/sections/parallels/2016/12/12/505272577/in-exxonmobils-rex-tillerson-moscow-sees-trusted-highly-regarded-figure.

[42] Kim, "In ExxonMobil."

[43] Alexander Osipovich, "TNK-BP saga raises questions about BP's handling of political risk. Russian roulette," *Risk.net*, March 19, 2013, accessed December 15, 2016, http://www.risk.net/energy-risk/feature/2253578/tnkbp-saga-raises-questions-about-bps-handling-of-political-risk.

Despite having an elaborate risk management strategy and obtaining information from different resources, BP failed to adequately assess the risk environment in the Russian oil and gas industry, thereby showing little understanding of their partners' ambitions and the political connections that enabled them to impose regulatory restrictions on BP and the company's employees.

Understanding power structures before investing in Russian oil and gas companies

As the Russian oil and gas industry is largely under state control, obtaining a better understanding of Russia's political environment and the power structures in the industry is essential for companies to avoid regulatory pressure. A Greenpeace report from 2013 outlines tensions between the main political actors in the Russian oil and gas industry that have been influencing the development of the regulatory structure in the energy sectors.[44] The analysis demonstrates that the major dividing line runs between the Deputy Prime Minister of Russia, Arkady Dvorkovich, and Rosneft's Chief Executive Officer, Igor Sechin. Whereas Sechin's influence on regulatory politics is based on close connections to President Putin, Dvorkovich oversees the energy industry as the Deputy Prime Minister and is empowered to change the regulatory regime of the industry. For example, Dvorkovich advocated for providing companies apart from Rosneft and Gazprom with a license to drill in the Arctic. Another important political division of the Russian oil and gas sectors is rooted in tensions between the heads of Rosneft and Gazprom.[45]

Poor understanding of power structures contributed to the failure of the TNK-BP venture. In its attempt to manage political and regulatory risks arising from the tensions with its Russian partners, BP sought help from the state. Assuming that Sechin would help BP due to his personal connections to Putin, BP offered part of its stake in the joint venture to Rosneft, thereby violating regulations that did not allow the company to sell its assets without the agreement of the Russian partners. However, BP's Russian partners turned out to have more influence on the Russian regulatory agencies and sued the British company for violating the regulations, resulting in significant costs for BP.[46]

Royal Dutch Shell, the main stakeholder in Sakhalin Energy, which extracted oil on the Russian island of Sakhalin in 2005 demonstrated another failure to properly understand the power hierarchy in the Russian oil and gas industry. Shell became engaged in a conflict with the Russian government over delays in the oil extraction related to Sakhalin-2 project and Shell's application for additional subsidies from the Russian government. Instead of approving Shell's request for an extension of the project, the environmental protection agency accused Sakhalin Energy of violating environmental regulations, opening a legal confrontation between the government and Shell. The government used environmental accusations as a bargaining chip in order to renegotiate the conditions of Shell's

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[44] Anna Galkina, "Russian Roulette: International oil company risk in the Russian Arctic," *Greenpeace* (2013): 5, 23, accessed December 15, 2016, http://www.greenpeace.org.uk/sites/files/gpuk/Investor_report_Arctic_risks_2013.pdf.

[45] Pavel Baev, "Rosneft, Gazprom and the Government: the Decision-Making Triangle on Russia's Energy Policy," *Russie. Nei. Visions* 75 (2014): 16, accessed December 15, 2016, https://www.ifri.org/sites/default/files/atoms/files/ifrirnv75pbaevenergyengmarch2014.pdf.

[46] Osipovich, "TNK-BP saga."

operation in Russia and force the company into paying for the delays. Although other Western oil companies in Russia also violate environmental regulations, the regulatory inspections singled out Shell, which clearly indicates hidden political goals to pressure Shell.[47] In contrast, environmental compliance checks of Sakhalin-1, the oil and gas project of ExxonMobil and Rosneft, did not find any problems, and the Russian government announced that there were no threats to ExxonMobil's operations.[48]

Failing to understand the underlying power game of the Russian government, as well as the significance of informal rules and bargaining, Shell decided to draw media attention to the case in order to gain public support. However, competing with the interests of the Russian government in the domestic oil and gas sectors was a fruitless strategy that brought the company to the verge of suspending all projects and leaving the country. The conflict was mitigated thanks to the diplomatic efforts of the Dutch government. Nevertheless, the Russian government won, as Shell eventually sold half of its assets to the state-owned Gazprom in 2006.[49]

Shell's case demonstrate the importance of understanding the real intentions of the Russian government and mechanisms of informal rules. Seeking attention of the media, the company applied a strategy that might have been successful in the context of European or other Western countries. In contrast, in the context of Russian politics, openly opposing the government's interests put Shell under increased regulatory pressure.

Conclusion

As the paper has demonstrated, regulations significantly shape business environment companies and investors. Changes of regulations in a host country can put a foreign company under pressure, severely restricting the company's operation. Therefore, a strategy for mitigating regulatory risks should be an integral part of a company's operation planning. Companies should take account of special features of a given industry as well as cultural and political characteristics of a host country to be able to develop an adequate strategy for dealing with specific regulatory risks.

For EU and U.S. companies involved with the Russian oil and gas industry the regulatory risks come from two distinct sources: Russian regulatory practices towards Western investors and the regulatory policies towards Russia in EU and U.S. investors' home countries. The Russian government often uses regulatory pressure against foreign Western companies as a political instrument to promote domestic economic and geopolitical interests of the Kremlin and various state-owned companies. As the oil and gas sectors in Russia are largely under state control, the Russian government uses regulatory barriers to enforce foreign companies' compliance with the rules of the game. Good relations with the Russian government as well as understanding and monitoring the Kremlin's domestic and geopolitical priorities are therefore essential for successful foreign investments in the Russian oil and gas market.

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[47] Goes, "Foreigners," 64, 161-62.

[48] "UPDATE 1-Russia's Rosneft CEO says Exxon's Sakhalin-1 operations safe," *Reuters*, July 10, 2015, accessed December 15, 2016, http://www.reuters.com/article/russia-rosneft-exxon-idUSL5N0YW1UU20150610.

[49] Goes, "Foreigners," 58-59.

Companies should also monitor relations between Western countries and Russia to adequately assess future developments regarding sanctions against Russia. Changes in the U.S. administration as well as increasing public support for economic relations with Russia in the EU might lead to the easement or cancellation of sanctions in the near future. Lifting of the sanctions would be important for foreign investors in the Russian oil and gas sectors, providing them with the opportunity to resume their engagement in projects such as Arctic oil and gas exploration.

Despite existing regulatory risks, the Russian oil and gas sectors still offer a great potential for cooperation between the Russian and Western companies. The Kremlin and governments of Western countries share interests in guaranteeing energy security and maintaining cooperation that will keep the Russian energy sector attractive to future investors.