ISAC
CENTAR ZA MEĐUNARODNE I BEZBEDNOSNE POSLOVE
INTERNATIONAL AND SECURITY AFFAIRS CENTRE

NIKOLIĆ KOKANOVIĆ OTAŠEVIĆ
Law Office
Serbia • Montenegro

LEGAL ANALYSIS OF THE ARRANGEMENTS BETWEEN SERBIA AND RUSSIA IN THE OIL AND GAS SECTOR

I INTRODUCTION

December 21, 2009

This legal analysis deals with the publicly available documents that regulate relations between Serbia and Russia in the oil and gas sector, not only on an inter-state level, but also in relation to the privatization of Serbia's Naftna industrija Srbije (Petroleum Industry of Serbia, hereafter NIS) and its acquisition by Gazprom Neft, (hereafter, Gazprom Neft and all its related entities will be referred to as "**Gazprom**") in which the Russian Federation is the majority shareholder. Furthermore, we will focus on the documents that establish joint ventures involving Gazprom and the JP „Srbijagas" public enterprise (hereafter, "**Joint Ventures**"), which empower the implementation of the interstate agreement, including the construction of a part of a major gas-pipe system on the territory of Serbia, transiting from the Russian Federation, through the Black Sea, and delivering natural gas to other European countries (hereafter, "**South Stream**"), and the construction of the underground gas storage facilities on the exhausted gas field of "Banatski dvor".

The legal analysis of the above-mentioned acts is important for at least two reasons:

- Such comprehensive arrangements and their far reaching political, economic, social, cultural and legal consequences in the field of energetics, as one of the most important branches of the economy, is unprecedented in Serbia, at least over the last decade.
- Unprecedented, moreover, is the level of benefits and the level of deviation from general provisions of the Republic of Serbia; furthermore, the establishment of special rules and procedures has not been the practice in recent Serbian legislation.

Concretely, this legal analysis takes the following publicly available documents into consideration:

- The Act Confirming the Agreement in the Oil and Gas Sector between the Governments of Serbia and the Russian Federation (hereafter, "**Agreement**"), published in the Official Gazette of the Republic of Serbia – International Agreements, number 83/2008. The Agreement lays

the foundations for the privatization of NIS and the construction project for South Stream and the gas storage facilities in Banatski Dvor.

- The Protocol defining the principal terms of acquisition of the „NIS A.D. Novi Sad“ shares by OAO “Gazprom Neft“, 51 percent of the company’s founding capital, published on the Serbian Government website: http://www.srbija.gov.rs/vesti/dokumenti_sekcija.php?id=81909. This protocol spells out the basic terms under which the NIS Sale Agreement was signed.
- The Agreement on the Sale and Purchase of the NIS A.D. Novi Sad shares (hereafter, “**NIS Sale Agreement**”), and all appendixes, published on the Serbian Government website: http://www.srbija.gov.rs/vesti/dokumenti_sekcija.php?id=119768. The NIS Sale Agreement defines relations between the Republic of Serbia and Gazprom regarding the privatization of NIS. The appendixes include a Social Program for NIS employees; a Program for the Reconstruction and Modernization of the NIS Technological Systems; the NIS Collective Agreement; Concluding Remarks from the Government of Serbia on the NIS Shares Sale Agreement; the NIS Founding Document and Gazprom Corporate Guarantees.
- The Principal Conditions for the Initial Agreement on Cooperation between OAO Gazprom and JP Srbijagas (hereafter, “**Principal Conditions**”), published at the following link: http://www.srbija.gov.rs/vesti/dokumenti_sekcija.php?id=119768. These conditions regulate the fundamental issues in the establishment of the Joint Venture for the construction and exploitation of South Stream through Serbia.
- The Memorandum of Understanding between OOO Gazprom Export and JP Srbijagas, published at http://www.srbija.gov.rs/vesti/dokumenti_sekcija.php?id=119768. The Memorandum regulates the fundamental issues surrounding the establishment of a Joint Venture for the construction of the “Banatski dvor” underground gas storage facilities.
- The Law on the Ratification of the Treaty Establishing the Energy Community between the European Union and the Republic of Albania, the Republic of Bulgaria, Bosnia and Herzegovina, the Republic of Croatia, the Former Yugoslav Republic of Macedonia, the Republic of Montenegro, Romania, the Republic of Serbia and the United Nations Interim Administration Mission in Kosovo, pursuant to United Nations Security Council Resolution 1244 (hereafter, “**Energy Community**”), signed on October 25, 2005 in Athens and published in the Official Gazette of the Republic of Serbia, number 62/2006.

Although the Contract establishing the joint venture for the construction of South Stream through Serbia has since been signed, it is not the subject of this legal analysis as it is not publicly available to the best of our knowledge.

In the text bellow, all the documents listed above will be referred to as the “Arrangements”.

II SUMMARY OF THE LEGAL ANALYSIS

Below is a summary of the legal analysis identifying the key legal shortcomings of the Arrangements regarding their harmonization with the Constitution of the Republic of Serbia, ratified international agreements signed by the Republic of Serbia and Serbian legislation. The analysis also identifies some concerns and reservations that might arise during the implementation of provisions that are an integral part of the Arrangements.

- **Harmonization with the Constitution of the Republic of Serbia.** Some articles of the Agreement can be questioned regarding their harmonization with the Constitution. Specifically, those provisions which put entities from the contracting states (Russia and Serbia) in a more favorable position compared to other entities and provisions which give more favorable tax treatment to NIS and participants and contractors in projects that the Agreement envisions. These provisos can be questioned under the Constitutional articles that guarantee the prohibition of discrimination, fair and equal market access, and general obligation to pay tax based on the economic power of the taxpayer. The Constitutional Court neither accepted some initiatives challenging the constitutionality of the Agreement, nor offered completely convincing arguments in some parts of its court decision handed down in July 2009.

- **Harmonization with international agreements.** The provisions of the Agreement, which put subjects from the contracting states (Russia and Serbia) in a more favorable position compared to other entities, is in contradiction with Agreements on the Mutual Promotion and Protection of Investment signed with Spain, the Netherlands, Germany, Hungary and Switzerland. By signing these Agreements, Serbia undertook an obligation to ensure that treatment to investors from these countries would not be less favorable than the treatment given to its own investors or investors from any other country.

- **Harmonization with legislation.** The Agreement does not contemplate its applicability within the context of some laws, including the Law on Public Purchase and the Law on Privatization; to the contrary, it includes general provisions that take account of some particular rules in relation to the general provisions, while their scope and mutual relation to the provisions of other acts in Serbian law is not clearly defined, which leads directly to legal insecurity. As the Constitutional Court specifies in its decision, the Agreement can not derogate the legislation in force, its effect can only be limited to relations defined within the Agreement. Unfortunately, these relations have not been precisely regulated, thus questioning the harmonization of the Arrangement with the positive legislation of the Republic of Serbia.

- **Harmonization with obligations regarding the establishment of the Energy Community.** By signing the Treaty Establishing the Energy Community, Serbia has assumed responsibility, in cooperation with other contracting parties, to establish an integrated market for natural gas and electricity, and consequently, an obligation to adopt the relevant European Union acts into its legislation. Since Serbia has assumed the obligation to ensure free and fair competition and to prohibit the unfair advantage of any company, it remains to be clarified how the provisions of the Arrangement, which guarantee many benefits to NIS, joint ventures, and

Russian companies that participate in the implementation of these projects envisioned in the Arrangement, can be incorporated into this concept.

- **Rights and Obligations of Joint Ventures and their Founders**. The Agreement states that the right to use all the capacities of the South Stream pipeline and the underground gas storage facilities at Banatski Dvor belongs to the Russian participants, i.e. members-shareholders of the joint ventures. Bearing in mind that these capacities, according to some other provisions of the Agreement, should belong to Joint Ventures, legal ambiguity arises from some contradictions in the Agreement provisions. Although the Contracts on establishing Joint Ventures will define the rights and obligations of the companies involved in detail, the issue cannot be fully solved, since the statutory effects of the Agreement are above all other documents that are part of the Arrangement, thus any open issue in the Agreement can have important effects on all other documents. Legal ambiguity opens the possibility for abuse and legal actions regarding some very important issues.

- **Establishing South Stream Serbia AG Joint Venture in Switzerland.** It remains unclear why the Basic Cooperation Agreement, establishing the joint venture between Gazprom and Srbijagas, has been stipulated in Switzerland, since the company's activities will be implemented on the territory of Serbia. According to statements issued, the Joint Venture will establish a limited liability company in Serbia for the implementation of the project, which raises the question why the joint venture was not directly established in Serbia.

- **The Status of the Social Program and the NIS Collective Contract and the Gazprom Corporate Guarantees.** The legal importance of the Social Program and the NIS Collective Agreement, both enclosed in the NIS Sale Agreement, remains unclear, since the contracting parties agreed that breach of contract, except in a very limited number of cases, cannot have any effects on the contracting parties (Gazprom and the Republic of Serbia). Moreover, the Corporate Guarantees that Gazprom enclosed to the NIS Sale Contract for fulfilling its obligations, are of very limited importance, since they represent merely a repetition of the Gazprom obligations from the Sale Contract. In case Gazprom does not respect contractual obligations, no real security can exist for the Republic of Serbia, as the seller of NIS shares, unless a bank guarantee or other type of risk-adjusted guarantee is provided.

- **Gazprom's power in managing NIS.** The NIS Founding Act envisions a right of veto for the Republic of Serbia regarding some issues, while at the same time gives extensive power to the NIS Board of Directors, which, among other things, has the power to decide on the distribution of profit and the approval of reconstruction programs and modernization of the NIS technological systems. The Board of Directors makes decisions by simple majority, while members of the Board are elected by cumulative voting of the Shareholders' Assembly. This procedure enables Gazprom, as the majority shareholder, to have great influence on the Board of Directors, and consequently on NIS operations.

- **Concerns regarding some terms.** In all the documents that are included in the Arrangement, there is a frequent use of some terms that are not harmonized with Serbian legislation, i. e. participants instead of founders or members/shareholders; fungible guarantee instead of fungible bonds; financing instruments instead of financial instruments; inner auditor and/or auditors' commission instead of internal auditor and board of auditors, etc. Although these doubts should not create substantial problems, incorrect terms might lead to problems in interpreting the provisions, and thus, accentuate legal ambiguity in case of judicial proceedings.

III CONCLUSIONS

Following the legal analysis of the documents that are an integral part of the Arrangement, the subsequent conclusions can be drawn:

- Documents were created without paying due attention to the Constitution. Many issues, regulated above all by the Agreement, remain problematic from a constitutional point of view. Moreover, serious problems and lack of coordination might arise in later phases from the implementation of some generic and insufficiently clear provisions.

- The Agreement is scantly and ambiguously related to other international agreements, thus its harmonization with other accords on the promotion and mutual protection of investments, previously signed by the Republic of Serbia, is questionable.

- The Agreement does not clearly define the applicability of some Serbian laws. Moreover, it defines general provisions which establish some particular rules related to the regular legislation. However, the reach and mutual relations of those provisions with clauses of other Serbian laws has not been clearly defined. This leads to ambiguity. Some provisions of the NIS Sale Agreement are in obvious contradiction with the Law on Privatization and general legal principles, while the NIS Founding Act in some of its parts attempts to derogate provisions of the Law on Foreign Exchange Operations, the Law on Trade Associations, as well as violating some constitutional principles.

- It remains unclear how Serbia will incorporate provisions of the Arrangements, which guarantee many benefits to NIS, Joint Ventures, and Russian companies participating in the projects' implementation, since Serbia has the obligation to secure free and fair competition and to prohibit the unfair advantage of any one company, obligations coming from the Treaty Establishing the Energy Community.

- The mutual rights and obligations of Joint Ventures and their founders are not clearly defined - neither are the status of the Social Program and the NIS Collective Agreement. The Gazprom Corporate Guarantees do not give sufficient security to fulfill the obligations of the NIS Sale

Agreement, while unclearly defined terminology in the documents of the Arrangement strengthens existing concerns.

- In general, there is an attempt to establish a sort of immunity for Gazprom, NIS, Joint Ventures and other entities that participate in the project from any changes in tax legislations, legislations on foreign currency operations, the application of the Social Program and the NIS Collective Agreement. Moreover, this directly leads to a selective application of legal regulations to those companies, which is controversial both from the constitutional point of view and the practical application of the law. From the political point of view, it could lead to the establishment of a state within in the state, which functions according to rules and procedures outside the Serbian legislation.

The above-listed concerns and issues could lead to the following consequences in practice:

- The opening of further legal procedures disputing some provisions within the Arrangement, or some interpretations that might block the implementation of projects defined by the Arrangement, or at least slow down their implementation until the conclusion of judicial proceedings or the reconsideration of the provisions in question.

- A halt or slowdown of planned projects could occur should any interested person open a legal dispute regarding the harmonization of some activities related to the Arrangement with international agreements or domestic legislation. This would go hand-in-hand with the excessively lengthy court proceedings in Serbia and lead to provisional measures which could easily block the projects' implementation.

- The imprecise nature of some provisions in the Arrangements might lead to another type of problem with the Russian partners: the same provisions could be interpreted in different ways, and this could lead to legal disputes with the Russian side, with an unpredictable outcome and duration. This might slow down the implementation and bring further complications, leading to negative consequences for all involved.

In conclusion, greater efforts needed to be invested in strengthening the legal dimension of all the documents that are an integral part of the Arrangement, since its importance is fundamental with far-reaching political, economic and legal consequences. It is to be expected that economic and political interests should be shaped in accordance with the existing legal framework. Unfortunately, in this case it seems that the process was quite the opposite and that the legal aspects of the Arrangement have been marginalized and completely put at the service of economic and political interests, even when there was no ground in jurisprudence and positive legislation.

Nikolić Kokanović Otašević Law Office