The James A. Baker III
Institute for Public Policy
of Rice University

The Energy Dimension in Russian Global Strategy

From Rigs to Riches:
Oilmen vs. Financiers in the Russian Oil Sector

Dr. Nina Poussenkova

Senior Researcher, Institute of World Economy and International Relations, Russian Academy of Science

Prepared in conjunction with an energy study sponsored by
The Petroleum Energy Center of Japan
And
The James A. Baker III Institute for Public Policy
Rice University - October 2004

THESE PAPERS WERE WRITTEN BY A RESEARCHER (OR RESEARCHERS) WHO PARTICIPATED IN A BAKER INSTITUTE RESEARCH PROJECT. WHEREVER FEASIBLE, THESE PAPERS ARE REVIEWED BY OUTSIDE EXPERTS BEFORE THEY ARE RELEASED. HOWEVER, THE RESEARCH AND VIEWS EXPRESSED IN THESE PAPERS ARE THOSE OF THE INDIVIDUAL RESEARCHER(S), AND DO NOT NECESSARILY REPRESENT THE VIEWS OF THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY.

This study was made possible through the generous support of

The Petroleum Energy Center of Japan

Renaissance Capital

Baker Botts L.L.P.

Lehman Brothers

Baker Institute Energy Forum

Anadarko Petroleum
The Honorable Hushang Ansary and Mrs. Ansary
Apache Corporation
Aramco Services
Baker Botts LLP
Baker Hughes
BP
ChevronTexaco
ConocoPhillips
ExxonMobil
Halliburton
Kuwait Petroleum
Marathon Oil Corporation
Mission Resources
Noble Corporation
Petroleum Energy Center of Japan
Qatar Petroleum
Schlumberger
Shell
Shell Exploration & Production Co.
Simmons & Company International
Total E&P USA, Inc.
Wallace S. Wilson

Russia's Rockefellers

There's good money in empire building.
But, there's more in empire wrecking...
-M. Mitchell, Gone with the Wind

The Russian petroleum privatization race began 12 years ago. The "go" signal was given by the Presidential Decree # 1403 of November 17, 1992. The first runners were oil "generals"-heads of oil production associations (PAs) within the Ministry of the Oil Industry. They were highly qualified professionals, neither rich nor sophisticated by today's Russian and international standards, with a strong communist party background. The Soviet directors were experienced in coping with state and party officials who regarded the industry as a cash cow, kept it on a short leash, and placed exorbitant demands on the all-important generators of petrodollars.

Before 1992, there were 32 oil PAs and 29 refineries in Russia. After the Soviet Union collapsed, they were united in Rosneftegas, a voluntary association of oil PAs that evolved from the Ministry of the Oil Industry. Decree # 1403 transformed state-owned entities into joint-stock companies (JSCs). Their capital was split into 25% preferred shares and 75% ordinary shares; 51% of the ordinary shares (i.e. 38% of the total share capital) were to be retained in federal ownership for three years. The remaining shares were distributed among personnel and managers and sold in voucher auctions. At that time, foreign participation in Russian oil corporations was limited to 15%. Decree # 1403 established several new entities including three vertically-integrated companies (VICs) that united the whole production cycle, from oil well to gasoline-filling station-LUKOIL, YUKOS and Surgutneftegas; the state entity Rosneft; and Transneft and Transnefteproduct (crude oil and petroleum products transporters, respectively). The new state oil company Rosneft was directed to perform a number of additional functions. It was to assist with the organization of other JSCs; to guarantee supplies of oil and petroleum products to consumers; to represent the interests of the state on the Boards of Directors of JSCs; and to facilitate investment and financial activities.

This industry structure turned out to be only a temporary phenomenon. When the non-payment crisis hit Russia in 1993-94, upstream and downstream companies found themselves in a different financial situation. The E&P sector suffered the most, while petroleum product distributors, with close access to cash-paying consumers, fared somewhat better. To strengthen the position of crude producers, the government decided to combine all segments and functions in the oil industry under the umbrella of additional VICs. The state participated in the process by contributing voting shares it owned in various upstream and downstream companies to the authorized capital of the newly created VICs, thereby facilitating vertical control over subsidiaries.

Over the next couple of years, other oil producers and refineries split from Rosneft. Some of them joined LUKOIL and YUKOS, and others formed new VICs, such as Slavneft, SIDANCO, TNK, KomiTEK, Sibneft. There were some accusations at that time that Sibneft was established to help fund Boris Yeltsin's 1996 election campaign (see Exhibit 1). Initially, VICs functioned as holdings with shares in separate production, refining and distribution companies. The process of their integration was accelerated by the presidential decree of April 1, 1995. This decree allowed consolidation of subsidiaries into vertically-integrated entities through share swaps. The same decree determined the final structure and new functions of Rosneft, including the right to sell the federal government's share of oil under production-sharing agreements (PSA), as well as trust management of shares held in federal property of companies not included in other VICs.

Subsequently, the Russian Government's stakes in most vertically-integrated companies were placed under trust management with banks in the "loans-for-shares" program held in the late 1995. Under this program, lenders extended credits to the Government in return for the right to manage these shares. Proceeds from these transactions were used to cover wage and pension arrears, thus helping Boris Yeltsin sustain popular support and remain in office. When the loans were not repaid at maturity, the stakes were typically sold off to redeem them.

Many analysts criticized the scheme. "The loans-for-shares auctions resembled prearranged football matches, where players pretend to play, spectators seem to watch, the referee blows his whistle from time to time, but it does not affect the end result in any way,"[1] noted one observer. It was definitely an insider game. For example, Rosneft's application bid to participate in the auction for 40.12% of Surgutneftegas held on November 3, 1995 was not even accepted under the pretext that its bank guarantees were filled in incorrectly. The

[1] Oil and Capital, # 5, 1997, p. 14.

Surgutneftegas pension fund established by the company's management won by pledging to pay the tax debt of Surgutneftegas Oil Company to the government in the amount of $216 million and to provide an $84 million loan to the state.

In addition, investment contests to sell shares were traditionally burdened by special conditions to eliminate the possibility of outside participation. For example, Surgutneftegas, in its usual style, denominated in rubles all monetary terms for placement of shares when the 40.12% stake was to be resold in 1997, probably in order to symbolically demonstrate its domestic focus. Moreover, only Russian entities were admitted to the auction. The winner's investment obligations envisaged financing for Surgutneftegas production programs (1.1 trillion rubles for 3 years), as well as funding for programs of local social and economic development (100 billion rubles for one year). The last condition made it clear that a company that is completely dependent on Surgut would win.[2] The market was not disappointed in its expectations: Surgutfondinvest got the stake.

In general, the state sold its shares in oil companies at what appeared -even at that time- exorbitantly low prices. Thus, on December 8, 1995, Group MENATEP acquired control over 78% of YUKOS for $509 million: it provided a $159 million loan to the state for 45% of its shares and paid $150 million for a further 33% stake offered at an investment tender. The bank also pledged to invest $200 million in the company over the next 3 years. However, the all-time record was established at the investment contest in 1999 when the government made the most expensive corporate gift in history: it ceded to Alfa-Group and Renova 49% of TNK for a mere $90 million, the equivalent of roughly one cent per barrel for TNK reserves.[3]

Since the government established unfair and non-transparent rules of the game, privatization battles were outrageously dirty and occasionally bloody. Journalists had a field day covering the guerilla war that the indomitable Victor Paliy, general director of Nizhnevartovskneftegas, waged against the new owners of TNK, or the scandal of the Slavneft privatization when two groups of managers besieged the office of the state company, or the sudden demise of Ivan Litskevich, director of the Omsk refinery, on the eve of Sibneft's establishment. While Vladimir Putin is at present ostensibly trying to enforce law

[2] Oil and Capital, # 2, 1997, p. 49.

[3] Oil and Gas Vertical, # 2, 2000, p. 25.

and order in the oil sector and to strengthen the influence of the state by investigating the legality of oligarchs' fortunes, it seems only fair similarly to purge the government from corrupt officials who sold off Russian petroleum assets for a pittance.

In the past few years, the consolidation in the oil industry has continued both through further privatization auctions and mergers and acquisitions. As a result, smaller or weaker companies were acquired by their more powerful rivals. By 2004, there were only 6 vertically-integrated companies left, as well as Tatneft and Bashneft (see Exhibit 2).

Over these turbulent years of privatization, the corps of the Soviet directors, for whom oil was a way of life rather than simply a tangible asset, was largely replaced by a new petroleum elite made up of successful entrepreneurs who had no experience with oil in past careers. Out of those who left the oil industry starting gate in 1992 (Vagit Alekperov/LUKOIL, Vladimir Bogdanov/Surgutneftegas, Sergei Bogdanchikov/ Sakhalinmorneftegas, Sergei Muravlenko/Yuganskneftegas, Victor Paliy/ Nizhnevartovskneftegas, Anatoliy Fomin/Megionneftegas, Victor Gorodilov/ Noyabrskneftegas, Victor Ageev/Purneftegas, Boris Volkov/Chernogorneft, etc.), only the first three crossed the interim finish line in 2004.

As a result of this displacement of professional oilmen at the helm of oil companies, two different schools of thought emerged for how to implement a petroleum business. The "commercial-minded" versus "production-minded" visions now compete in Russia for the model of success. In both, the objective of profit generation is dominant but is met in different ways. The most notable representatives of the first category are YUKOS and Sibneft, and of the second, LUKOIL and Surgutneftegas.

"Commercial yuppies" of the first group strive to generate maximum profit in the minimum span of time and focus on the market value of their companies. They aim for the greatest efficiency in field development with the lowest costs by using the most advanced Western technologies and operating fewer, but highly productive wells. They regard their reserves as market capitalization drivers and increase production capacities through aggressive acquisitions. These companies dynamically raise output, reduce costs, improve management efficiency and pay tribute to Western standards.

For their part, “production gurus” of the second group focus on longer-term oil projects, higher oil recovery ratios, denser well patterns and strict control over reservoirs. Financial analysts frequently say that the production-oriented companies still resemble socialist industrial ministries in terms of their structure, management style and attitude to shareholders, rather than public corporations working in accordance with Western standards. However, they completely reject the old Soviet approach, which forced PAs to fulfill stringent production plans, come hell or high water. It is known that the strict production planning approach resulted in the damage of many promising reservoirs through indiscriminate water flooding in the socialist past.

Shares of companies headed by financial whiz kids that were growing increasingly westernized appreciated rapidly, and they became darlings of the investment community, courted by Western bankers and investment houses. At one point, they outperformed their production-focused counterparts, including with greater increases of oil output. However, now they find themselves in a crisis (largely with political overtones), while LUKOIL and Surgutneftegas have consolidated their positions.

In Russia, outstanding individuals have always played a crucial role in business and economy–indeed, such leaders as Vagit Alekperov, Vladimir Bogdanov and Mikhail Khodorkovskiy literally shaped the contemporary oil industry of Russia. Manageability in the sector is largely based upon personal connections. Obviously, the answer to the question of who will win or lose in the petroleum game does not lie in economic, production and financial spheres alone: it is necessary to take into account political, social, cultural and psychological factors as well. The key issue is what business models and personalities do better in Russia, especially given the new rules of the game established by the state.

In this respect, the study of two complete antipodes-Surgutneftegas and YUKOS-is of particular relevance. When we say Surgutneftegas, we really mean Vladimir Bogdanov, and YUKOS in its current form is the creation of Mikhail Khodorkovskiy. They are both mavericks: remarkable people with polar views that radically differ from conventional thinking in Russia’s oil community.

Vladimir Bogdanov, a low-key self-made Siberian, is not well known abroad or even beyond the oil community in Russia. He is exceptionally private, has never been involved in major scandals, rarely gives interviews and stays mainly in Surgut, which earns him the nickname of "Surgut Hermit." Foreign investors often perceive him as an old-style executive with xenophobic views and criticize him for a conservative and authoritarian style of management, insufficient reforms and lack of transparency in the company. Further, the company is viewed as failing to deliver optimum value to shareholders with meager dividends, primitive accounting and under-utilized cash reserves. The stock market considers Surgutneftegas to be somewhat of a "dinosaur" because it seemingly does not care about increasing its capitalization.[4] On the other hand, many experts admit that Bogdanov leads the best managed oil company in Russia from an operations standpoint.

Mikhail Khodorkovskiy, a high-profile former Komsomol boss, is considered a brilliant master of the public relations game and lobbyist, who inspired and led many oil sector initiatives and reforms. In contrast to Bogdanov, who is a mining engineer by background and who personifies the best traditions of the Russian oil industry, the "outsider" Khodorkovskiy was not burdened by industrial taboos and began to break stereotypes and introduce radical changes. Currently, discussions about Khodorkovskiy mainly focus on his political ambitions and the criminal charges against him based on notorious "loans-for-shares" auctions and domestic offshores.[5] His reputation as Russia's current leading oligarch now sits in disgrace while his professional achievements are largely discounted. This despite the fact that his accomplishments were quite formidable: he turned YUKOS around twice, pioneered important strategic, management and corporate governance innovations in the country, and made a valuable contribution not only to oil production growth in Russia, but also to its scientific and intellectual potential.

Perhaps, the key difference between the two tycoons is that Vladimir Bogdanov literally "minded his own business" by improving operations of Surgutneftegas and taking care of its workers and the local community. He was a success. By contrast, Mikhail Khodorkovskiy represents a case study of business trying to influence authorities in order to improve the situation beyond the immediate scope of his company. In the process, Khodorkovskiy has destroyed himself and brought YUKOS to the brink of ruin.

---

[4] Gazeta, 16.04.03.

[5] In Russian context, "domestic offshores" are territories to which the federal government granted the right in the mid-1990s to provide special tax benefits to companies that signed agreements with the regional authorities on implementing investment projects in the regions. In the early 2004, the last three "offshore" zones (Morvodia, Kalmykiya and Chukotka) were deprived of such privileges.

The Realist: Vladimir Bogdanov/Surgutneftegas

> *He knows how to bide his time and change with changing ways…*
>
> *The world can forgive practically anything except people who mind their own business.*
>
> *-M. Mitchell, Gone with the Wind*

This Sweet Word "Independence"

Friends and foes alike admit that Surgutneftegas is a unique phenomenon in Russia. Its sustained and solid success over the last 20 years (an unprecedented length of time in contemporary Russia) raises a natural question about what makes the company tick-and, clearly, the answer largely lies in the leadership of Vladimir Bogdanov. *Forbes* acknowledged that "as a competent and honest industrial tycoon, Bogdanov stands out in Russia."[6] He was appointed general director of Surgutneftegas PA in 1984, at the age of 32, becoming the industry's youngest oil baron. Surgutneftegas (or SNG as it is spelled in the logo) is a typical one-man Russian company, and Vladimir Bogdanov knows everything about his firm down to minute, technical details. He created a highly professional management team but retains the final say on important matters. However, similar to most one-man companies, Surgutneftegas' dependence on the qualities of one individual might also be its vulnerable point. Vladimir Bogdanov is convinced that there is nothing more important than his job and SNG's prosperity. He is an iconoclast but, at the same time, not an adventurer who likes to rock the boat. Surgut, mirroring his image, is patriotic, paternalistic and conservative.

"It is hard to work with Bogdanov, but that is what makes him interesting",-stated Yuri Shafranik, the former Minister of Fuel and Energy. "Like any workaholic, he is very exacting with respect to himself, his co-workers and his company, which explains why he always succeeds."[7] Indeed, he experienced surprisingly few defeats over the last two decades. Probably, his most important failure was in the struggle for his petroleum product distributors in St.Petersburg in the mid-1990s when SNG lost control over some subsidiaries to the city authorities.

---

[6] www.forbes.com; Forbes World's Richest People 2001.
[7] Russian Petroleum Investor, December 1996-January 1997, p. 73.

From the start of privatization, Vladimir Bogdanov was determined to ensure that his company did not fall into the hands of "criminals and foreigners." He achieved this by buying through Nefteinvest (an entity fully controlled by Surgut Holding) 39.16% of shares of SNG in the investment tender held in 1994 and an additional 40.12% stake in the 1995 loans-for-shares auction.

In 2003, Bogdanov further consolidated control over his company. After the BP-TNK alliance and the anticipated (and now largely unwound) YUKOS-Sibneft deal, new mergers and acquisitions were expected in the sector. Surgutneftegas was considered to be the prime candidate for a hostile take-over by Sibneft or TNK. In spring 2003, indications appeared that the Sovlink brokerage firm acting for TNK was actively purchasing common stock of SNG. In a counter-offensive, Surgut aggressively bought (largely heedless of price) a necessary block of its own stock to ensure a controlling interest for Vladimir Bogdanov and his colleagues. As a safeguard, Surgutneftegas Oil Company, the key subsidiary that holds the biggest block of SNG shares (about 40%), was transformed from an open JSC to a limited liability company. Presumably, it will make the corporation even more closed and less transparent, which is one of the key criticisms aimed at SNG.[8]

Vladimir Bogdanov does not like to borrow funds or ask for state handouts, preferring to be independent and self-reliant. He runs the company to live within its means. In 2000, he described his position in one of his rare interviews, "We never ask for anything from the state except normal, clear and stable rules of the game. Surgutneftegas is a strong and highly competitive company; we do not need crutches and supports. Create a favorable climate, and we'll accomplish the rest ourselves. That's what appeals to V. Putin in our position. He did not praise Surgutneftegas aloud, but made it unambiguously clear: the way we take care of the interests of the state will be reflected in the way the state will take care of our interests. Otherwise, we'll have what we have now: enterprises and citizens deceive the state in all imaginable ways, and the state deceives them in its turn."[9] This definition of the "fair play *à la Russe*" requires just a small comment: the recent history shows that the Russian state has the unfortunate habit of deceiving totally blameless and honest citizens from time to time.

[8] Gazeta, 16.04.03.
[9] Oil and Gas Vertical, # 4, 2000, p. 18.

Surgutneftegas very carefully selects its partners among companies that are close to it in spirit and vision. In the mid-1990s, it acquired a stake in Nafta-Moscow, an oil trader that evolved from the former state monopoly Soyuznefteexport, and, in the words of one observer, “The patriotic spirit of the alliance should ensure and already ensures its protection by the government.”[10] This spirit and its arms-length relationship with foreigners are likely to serve SNG especially well now as the sentiment of “oil and gas patriotism” is gaining strength in Russia.

SNG was the only oil major in Russia that did not establish joint ventures with foreigners. According to Bogdanov, “Oil produced by most JVs could be produced by domestic enterprises using our technology and would cost the Russian side much less.”[11] There might have been another reason for rejecting JVs that other companies regarded as an important vehicle for increasing export volumes: SNG was already exporting more crude than its counterparts.

Nevertheless, Bogdanov’s position on the issue of joint ventures clearly depicts his strategic vision, and the following commentator’s quotation provides a good insight into his logic. “In the early 1990s, when the JV movement was at its prime, … the head of Surgut stubbornly resisted many tempting Western proposals. He was regarded as a renegade; his counterparts who tasted the previously forbidden ‘convertible currency’ fruits of joint venturing ridiculed him on the sly; his own subordinates who dreamt about such fruits were angry with him; but Bogdanov was adamant and called JVs ‘nonsense.’ But a couple of years later many of those who mocked Bogdanov had to admit that the ‘Surgut Hermit’ turned out to be a leader with a long-term vision. His strategic course permitted SNG to maintain its independence. Five years ago, Bogdanov did not give foreigners access to his fields; with the beginning of privatization he managed to protect his company from establishing too close relations with the banking community. He was able to find money to purchase 40.12% stake in Surgut and did not fall into a credit trap of some banking group. The result is obvious: today, the leadership of SNG firmly holds the controlling interest in the company, and there are no visible prerequisites for changing the *status quo.*”[12] It is clear now, after the events of 2003, that this 1997 statement was a sound prophecy.

[10] Oil and Capital, # 5, 1997, p. 12.
[11] Russian Petroleum Investor, December 1996-January 1997, p. 74.
[12] Oil and Capital, # 9, 1997, p. 6-7.

The history of Surgutneftegas, similar to its peers in Russia, is colored by lawsuits with minority shareholders, and it is in this sphere that the company is bitterly criticized by investors. Although Surgut strategies combine an entrepreneurial attitude with financial conservatism, it has displayed a somewhat cavalier attitude towards shareholders' rights. However, its track record gives an interesting slant on the traditional question of whether managers work in the interests of shareholders.

Minority shareholders have frequently been unhappy about Bogdanov's dividend policy though Surgutneftegas' financial solidity has made it one of the few Russian oil companies able to pay ordinary dividends in the mid-1990s. The international investment fund, Russian Prosperity, took SNG to court in 2001 for its practice of calculating profit that allegedly led to the understatement of dividends on preferred shares. Russian Prosperity, however, lost the case. As the magazine *Oil and Capital* commented, "The company might have distributed this money to different offshores representing American and European funds but instead invested it in its own development. Whether it is good or bad for the national economy is a rhetorical question."[13]

The latest disagreement is connected with a lawsuit by Harvard University, which claims that, over the last six years, Surgutneftegas has intentionally declared dividends far below the amount mandated by the company's charter and the prospectus by using an artificially understated "net profit" figure. Since SNG management controls the bulk of the company's common shares, the plaintiff argues that retention by Surgut of virtually all the company's earnings benefits its executives at the expense of preferred shareholders. Harvard's demand cites a February 2001 letter from Vladimir Bogdanov to Mikhail Kasyanov, the then Russian Premier, where he argues that the calculation of net profits as required by the charter "results in a considerable part of cash flow in the form of dividends leaving abroad to shareholders who are mostly registered in off-shore zones."[14]

SNG has retorted that preferred stock in Russia was issued not to raise capital, but to motivate employees whose salaries are still much lower than in the West. Harvard bought Surgut's ADRs after Russian courts of all levels the previous lawsuits on the same issue,

[13] Oil and Capital, # 4, 2001, p. 18.
[14] PR Newswire, 06.29.04.

resolved in favor of the company, thus confirming that it acted strictly within Russia's law. The eight-year dividend policy track record of Surgutneftegas showed that, in order to modernize its facilities, the company deducts capital costs from retained profit before calculation of cash available for dividends. This strategy is chosen because Russian legislation puts a very heavy fiscal burden on any investment project. SNG channeled the lion's share of funds for the development of reserves and upgrading of facilities. As a result, over the last five years, oil output has grown by 161.7 million barrels. Moreover, Surgut reports the lowest level of wear-and-tear of fixed assets in Russia. During the same period, its capitalization increased by more than 300% and its preferred stock appreciated ten-fold from \$0.04 to \$0.42 per share. Thus, acting in the interests of all shareholders, SNG constantly stepped up its investments, and today it has the strongest production, human and financial potential in Russia.[15]

Seen through this prism, it is clear that the legitimate short-term interests of shareholders sometimes come into conflict with the strategic longer-term objectives of the corporation. Thus, although SNG is one of the most financially sound companies in Russia's oil sector, it is probably not the most attractive opportunity for investors aiming at high dividends on preferred shares.

Take Care of the Cents and the Petrodollars Will Take Care of You

Over the last decade, SNG has ranked consistently third in Russia in terms of oil extraction (1.08 million barrels a day in 2003). Since the recent TNK-BP merger, SNG was pushed to fourth position. Surgutneftegas is also the biggest gas producer in Russia after Gazprom (13.9 bcm in 2003).[16] SNG aspires to be the top Russian oil company in terms of oil output, operating efficiency and management quality. In 1991, when the country was falling apart and the oil industry was collapsing, Vladimir Bogdanov predicted that SNG would soon successfully compete with international mid-size oil companies. Then, it seemed a pipe dream, but Bogdanov managed to turn it into reality against formidable odds.

[15] www.surgutneftegas.ru.
[16] To be more precise, it produces associated gas from its oil fields, but characteristics of this associated gas are very close to non-associated natural gas produced by such companies as Gazprom.

SNG was able to achieve this due to its early strategies. "Subsidiaries of Surgutneftegas Oil Company were carefully handpicked, thus ensuring a serious competitive edge over its rivals. Out of all the VICs created in early 1990s, Surgutneftegas has, probably, the most logical fit between subsidiaries and the most efficient corporate structure,"[17] according to one analyst. In addition to the Surgutneftegas oil producing unit, the company has the Kirishi refinery strategically located not far from St.Petersburg with output of 111.7 million barrels of oil in 2003,[18] as well as several petroleum product distributors in the country's northwest. Recently, it acquired the Surgut Gas Processing Plant. This was a logical step given its strong positions in gas production.

SNG top management has elaborated a clear strategy of step by step improvement. It believed that the E&P subsidiary, Surgutneftegas, was the mainstay of the VIC and deserved the company's full attention. In the first stage of Surgut Holding's development plan (up to the end of 1995), its efforts were aimed at improving Surgutneftegas' oil production parameters. SNG was streamlined through restructuring and liquidation of unprofitable divisions. After satisfactory initial progress was made, Surgut Holding's attention shifted downstream. The plans to upgrade the Kirishi refinery are currently under implementation, with the focus on adding deep conversion capability including a new hydrocracking unit and on an enhanced quality control system meeting ISO-9000 standards. In 1996, Surgut Holding started share swaps to establish full control over its subsidiaries.

SNG aims have been constant, emphasizing upgrading its facilities and stabilizing output. Its production decline during 1994-95 was much lower (2.4% p.a.) than the sector's average (8-10% p.a.), and it was putting on stream new fields (e.g. Tyanskoye and Konitlorskoye with reserves of 2.2 billion barrels in 1994), while most other companies, "were living off the fields discovered in Soviet times with state funds, when no one counted the money being invested in the sector's development. Surgutneftegas is one of the few companies thinking about the future."[19] As a SNG manager observed in the mid-1990s, "We always counted money here and never splashed out on fast cars and lavish offices. We did only what was

---

17 Jeremy Hudson et al., Vertically-Integrated Companies, Russian Oil, Salomon Brothers, volume 3, March 1996, p. 157.

18 Kinef Ltd. accounts for more than 40% of automotive gasoline AI-96 and AI-98 produced in Russia and some 70% of high-quality diesel fuel with sulphur content no greater than 0.05%; as well as 100% of Russia's output of synthetic detergents (Surgutneftegas Annual Report 2002).

19 Russian Petroleum Investor, December 1996-January 1997, p. 70.

economically prudent and as a result we are still drilling new wells, while most of our competitors have almost stopped."[20]

At the operational level, SNG has always targeted exploration drilling to ensure adequate reserve replacement (see Exhibit 2) and was the only oil Russian company to establish an exploration division in 1995. Surgut tries to increase resources through drilling in its own territories rather than through acquisitions. It is noteworthy that Surgutneftegas can produce 588 million barrels on its current reserve base, but Bogdanov does not want to repeat the Samotlor fiasco[21] and says, “We need to ensure that something is left to our grandchildren.”[22]

Surgutneftegas has been a trend setter in the Russian oil sector. It was the first Russian company to install three gas-turbine power stations with the total capacity of 43.5 MW to utilize associated gas instead of flaring it and to meet energy needs of the Tyanskoye and Konitlorskoye fields, and now this experience is copied by its competitors.

Despite its cautious attitude towards foreigners, SNG was among the first Russian oil companies to start using Western production technologies and state-of-the-art equipment. Thus, Surgutneftegas pioneered introduction of coiled tubing in Russia. It purchased the first unit from Stewart & Stevenson (U.S.) in 1993. Currently, the company has 15 workover teams that are equipped with coiled tubing.[23] From 1996 to 2000, the number of workovers using coiled tubing rose from 195 to 1,614, and, in 2000, this meant an additional 9.6 million barrels of oil.

By the mid-1990s, Surgut was Russia’s leader in the usage of modern crude extracting technologies and one of the few Russian oil companies capable of horizontal drilling and hydrofracking,[24] which it performs itself rather than contracting foreign service companies. In 2001, Anatoliy Nuryaev, the first deputy general director of Surgutneftegas, explained that the company preferred to do frac jobs itself not only because it is cheaper. “Another side of

---

[20] Financial Times, November 4, 1998.
[21] Samotlor is the super-giant oil field now operated by TNK-BP which at its peak produced about 150 mt/yr and was ruined by excessive flooding during the Soviet “oil fever”: currently its water cut is approximately 98%.
[22] Oil and Gas Vertical, # 6, 2002, p.8.
[23] Oil and Gas Eurasia, June 2001, p. 41.
[24] See, for example, Alexander Blokhin, Surgut Holding/Surgutneftegas, Paribas Capital Markets/UFG, June 27, 1996, p. 15.

the coin is: why should we give jobs to foreigners; don't we have unemployment in our country? If with appropriate training our specialists can work not worse, but better, why should we provide jobs for anybody else? Let's stop kissing the ground when we hear a name of any international company. There are good arms and brains in Russia. If you want to see for yourself that these arms and brains are not inferior to foreign ones, come to Surgut. Equity analysts who recently visited the city and the fields came to the conclusion that we can easily surpass Schlumberger and Halliburton."[25]

This unambiguous statement made in 2001 is in tune with the general trends in Russia's oil industry. Domestic companies are getting increasingly stronger in operating and financial terms. Increasingly, Russian companies are no longer satisfied with playing the roles of junior partners in joint activities with foreign corporations.

Recently, Surgutneftegas formulated a strategic objective to replace 50% of imported technologies and materials with domestic analogues. In particular, it plans to cooperate with the former defense enterprises to help convert them to produce oilfield equipment. The company calculated that import substitution would permit up to a 30% cost savings. In 2003, SNG placed orders for 106 types of equipment and spare parts at 22 Russian enterprises**.** Given SNG's large outlays for high-tech, it might mean significant private investments in Russia's indigenous R&D potential[26] and an effective implementation of the popular slogan of "support the domestic producer."

This concept is also demonstrated by SNG's approach to its own scientific potential. SurgutNIPIneft, an R&D institute within SNG, initially started to use Schlumberger technology to create geological models for eight fields, but gradually, it shifted from foreign to domestic methods of digital geological and hydrodynamic modeling. The institute, that was awarded a TUV quality certificate in accordance with international ISO 9000 requirements, created a petro physical complex that is considered one of the most advanced in the world.[27]

[25] Oil and Gas Vertical, # 9, 2001, p. 10.
[26] World Energy, July-August 2004, p. 17.
[27] Oil and Gas Vertical, # 9, 2001, p.125.

Another aspect of Surgutneftegas operating policy differs from the conventional approach in the Russian oil sector. International majors generally have reserves in their books sufficient for 10-15 years of production. For the Russian companies, this indicator is 30-50 years on average and even 100 years for some companies. Such hoarding was necessary in the 1990s largely because the sector was devouring resources discovered during the Soviet era. In the past decade, there were few prospecting and exploration efforts taken in new provinces. Some companies, however, regarded resources as a way of speculating: they bought low, "sat on licenses" for a while, and later tried to sell high, increasing their market capitalization in the process.

In 2001, SNG had active reserves sufficient for 26 years of production. It generally starts working in new territories approximately a year after it obtains the required license.[28] This practice is commented upon by Valeriy Garipov, the former Deputy Minister of Fuel and Energy, who indicates that many companies did not observe the deadlines for commencing commercial production established by the terms of licenses. "Today, claims against YUKOS can be brought against any other corporation. Maybe with the exception of Surgutneftegas."[29] The Ministry of Natural Resources has begun to put a much stronger pressure on oil companies in the licensing sphere (with YUKOS being the main target) by threatening to revoke licenses of offenders.[30]

The Ministry is inspecting the "suspect" operations, and the main fault it accuses subsurface users of is their failure to observe the schedule of field development.[31] There is, however, another side of this coin. In many cases, oilmen have been unable to stick to the timetable because real obstacles, often created by the bureaucracy, interfere. Another sin of the oilmen, in view of the Ministry, is the large proportion of idle wells in the total well count. SNG looks quite virtuous on this score with 12% while YUKOS has 31%, and Sibneft leads the list with 56% (see Exhibit 2).

---

[28] Oil and Gas Vertical, # 9, 2001, p.124.
[29] Oil and Gas Vertical, # 8-9, 2004, p. 17.
[30] Kommersant, 19.01.04.
[31] The list of "suspects" includes Kovykta (RUSIA Petroleum), Shtokmanovsk (Sevmorneftegas, a JV between Gazprom and Rosneft), Verkhnechonsk (TNK-BP), Vankorsk (Rosneft), Talakansk (Surgutneftegas), Inzyreisk and Yuzhno-Hilchuisk (LUKOIL), Salymsk (Shell) and Tersko-Kamovsk (YUKOS) fields (Vedomosti, 17.06.04).

SNG's E&P activities have always been concentrated geographically.[32] One expert noted that, "In its upstream operations, Surgutneftegas has taken the opposite approach to LUKOIL's broad-based and aggressive expansion program. Surgutneftegas' management has focused on controlling costs and improving existing assets, a strategy, which has strengthened its near-term operational and financial condition much more quickly than has been the case with other Russian oil companies."[33]

Surgut stayed away from the "asset-grabbing fever" in Russia in the mid-1990s. Thus, in 1997, during the "second oil war," investment analysts noted that "Surgutneftegas probably feels that it should not spread itself too thinly. Its management wants to focus on maximizing the return from its already good quality asset base, rather than empire building."[34] Later, SNG itself confirmed that, "for us expansion of activities is determined solely by efficiency. It is possible to buy everything that is sold. But it is not an end in itself… We are not against moving to new regions in principle. When it becomes more efficient to work there we'll start working there."[35]

Analysts, however, often perceive this attitude as excessive cautiousness for a corporation of such caliber. "The problem that we saw with the company was limited expansion drive and opportunities in the past. The company was the fastest-growing one in the Russian oil sector on its own reserve base (almost 7% annual production growth rate is outstanding by any world standards), yet it still did not fully utilize its financial and operational resources" according to one representative analysis.[36] But in the last couple of years, Surgutneftegas shifted from a stable organic growth to a more balanced combination of internal growth and external expansion. This transition became necessary because the development of fields in its traditional area of operations permitted moderate output increases but only at higher costs. To improve its financial and production performance, SNG had to conquer new frontiers.

[32] It produces 54 mln tons of oil from 32 fields in the Khanty-Mansi Autonomous District, while LUKOIL extracts 78 mln tons from 252 fields all over Russia and abroad.
[33] James Bunch, Surgutneftegas–Excellent Performance in a "Taxing" Environment, Renaissance Capital Group, Equity Research: Oil and Gas, September 17, 1996, p.1.
[34] Ian A. Partridge, Nina Poussenkova, Update on Sector: Oil Generals at War, Lazard Capital Markets, July 25, 1997, p.4.
[35] Oil and Gas Vertical, # 6, 2002, p.7.
[36] Andrei Gaidamaka, Surgutneftegas. Getting Leaner for Growth, Morgan Stanley Dean Witter, Equity Research, February 2, 2000, p.2.

In 2003, Surgutneftegas shed its reputation as a Khanty-Mansi recluse by obtaining the rights for the Talakansk field with 124 million tons of reserves in Yakutiya (Sakha). Initially, Sakhaneftegas, controlled by YUKOS, won the license for Talakan during an investment contest in 2001. Its results were annulled because Sakhaneftegas was unable to pay the $501 million bonus. Another investment contest was planned, but last year Surgutneftegas, as a bidder that offered the second biggest bonus ($61 million), asked the arbitration court of Yakutiya to recognize it as the winner. In late 2003, it was decided to grant the license to Surgutneftegas and, in April 2004, SNG and the government of the Sakha Republic signed an agreement for the development of the field.

Theoretically, the state might have received more money if the field was again put up for an auction. But the license was probably awarded to SNG for political, rather than economic considerations. Presumably, it was more important for the government to let the loyal Surgutneftegas get the field in order to consolidate the state's influence in the promising East Siberian and Far East petroleum provinces. The newly appointed Minister of Natural Resources Yuri Trutnev has said that he might dispute the right of Surgutneftegas for Talakan. In June 2004, however, the ministry concluded that the company got the field on legitimate grounds; as the newspaper Vedomosti stated: "What do you want, it's a 'royalist' company."[37] This comment shows the new direction of interaction between the state and oil companies in the licensing sphere. The government will provide "most favored nation status" to the corporations that are close to it in spirit while putting pressure on their less "loyal" counterparts.

As recent developments show, SNG was late to start its outward expansion, but it was to start it with a flourish. In 2003, Surgutneftegas teamed up with the state companies Gazprom and Rosneft in the development of East Siberia. This venture confers Kremlin strategic control over important oil and gas projects in this part of the country and turns Vladimir the Conqueror into a formidable force in the new petroleum frontier of Russia.

In contrast to many technocratic companies headed by engineers who focus primarily on production and technology and care somewhat less about the bottom line, SNG's leadership shows surprising shrewdness and sophistication in financial matters, where it is often a

[37] Vedomosti, 17.06.04.

trailblazer. Thus, in early 1995, it was the first Russian company to make an additional issue of shares.

When journalists asked how Surgutneftegas managed to be an island of financial stability among its virtually bankrupt peers during the early 1990s, they usually got a laconic answer: "Nobody steals in our company." This fact is truly extraordinary given the generally lax business and work ethic in Russia. Vladislav Barankov, SNG vice-president for finance and economy, explained that such unprecedented honesty was achieved by very strict financial control over the subsidiaries and tough monitoring of procurement contracts that are granted only through tenders, be they for work mittens or spare parts for compressor stations.[38]

SNG's financial solidity shows that Vladimir Bogdanov knows how to adapt to new realities. Originally, Surgutneftegas' leadership, either recalling previous unfortunate experiences, or fearing outsiders' interference in the company's affairs, or wishing first to adapt to the new market economy, emphasized that external financing was not a priority since internal cash flows were sufficient for its investment requirements. Despite this initial reluctance to turn to outsiders, when Bogdanov was persuaded that a shift in strategy was needed, he wasted no time in changing tack. SNG issued first level ADRs in 1997, becoming the fourth Russian oil issuer (after LUKOIL, Chernogorneft and Tatneft) to enter Western stock markets.

Over the years, Bogdanov has overcome some of his prejudice against foreign investors. Since the mid-1990s, SNG has been working on its image and providing considerably more information on its activities; it also partially lifted obstacles to brokerages and outside investors. Yet, even now, it is more closed than its peers and lags considerably behind them in improving corporate governance (see Exhibit 4).

Despite claims that SNG is managing its cash reserves inefficiently, this monetary cushion turned out to be a very useful shield since it helped Surgut to preserve its cherished independence. Also, as one analyst has noted, "With close to $2 billion in cash and liquid assets in the balance sheet, $3-4 billion in treasury stock earmarked for strategic acquisitions and almost zero debt gearing the company certainly is the most potent bidder for any Russian

[38] Expert, June 9, 1997, p. 32.

oil assets that would be up for grabs."[39] This financial strength might be one of the reasons why Surgutneftegas was invited to join the Gazprom-Rosneft consortium in East Siberia where the development of this virgin area will require enormous investments. Also, the cash-rich SNG is one of the likely contenders for YUKOS' assets if they are sold off.[40]

Bread upon the Waters

SNG has been a conscientious taxpayer, avoiding tax optimization schemes and wage arrears (despite the fact that its salaries are higher than in many other oil companies). This has given the company an important competitive edge. In the mid-1990s, then Deputy Minister of Fuel and Energy Yevgeniy Morozov said, "The government assesses an enterprise's activities in terms of three parameters: the absence or availability of outstanding debt to the federal budget, the pension fund, and the wage fund. Surgutneftegas has no debt, which makes it different from other oil majors."[41] It is an even stronger point in its favor in the current situation.

Another part of Vladimir Bogdanov's success has been focused on the social sphere and benefits to his workers. SNG did not divest social facilities by transferring them to municipalities, which was the fashionable thing to do among other Russian oil companies (see Exhibit 4). Contrary to the advice of western consultants, he continues to pay for schools and higher education for students in target areas as well as for accommodation for his staff and provides medical insurance and a generous non-state life-time pension scheme with established guaranteed payments.

In return, Bogdanov gets the loyalty of his workers, who have more faith in their management than in the federal government. There is fierce competition in Surgut even for the most menial job in the company. With the advantage of 20/20 hindsight, one might say that the recommendations of international experts to improve financial efficiency of Russian oil VICs by divesting social facilities might have undermined their "social efficiency." This measure, although arguably appropriate in other countries, might have been too premature and disruptive for the Russian oil sector in the 1990s given the lack of "safety net" in Russia

[39] Andrei Gaidamaka, Surgutneftegas. Getting Leaner for Growth, Morgan Stanley Dean Witter, Equity Research, February 2, 2000, p. 7.
[40] See, for example, Vedomosti, 13.08.04.
[41] Russian Petroleum Investor, December 1996-January 1997, p. 72.

in general and the low level of social development in West Siberia specifically. Oil production centers are virtually "company towns" in this part of Russia, and residents depend on corporations for their very existence.

Surgutneftegas is the only vertically-integrated oil company which left its headquarters in Surgut instead of moving them to Moscow. As a result, the company gives needed attention to the city of Surgut, helping it to flourish; it is clearly a place that has a caring master. Even the highways around Surgut are superior to general Russian standards. Long before the theme of "corporate social responsibility" appeared on the agenda in Russia, Surgutneftegas was "one of the few in Russia where workers have benefited from market reforms and display no signs of nostalgia for the Communist era." SNG might have implemented a social policy that seemed old-fashioned and "Soviet" to Western advisors and its rivals, but, "…such is the paradox of recent Russian history that it is Mr. Bogdanov, a local 'red' director, who has used his Russian know-how to build a profitable enterprise in which the workers are the most effective advocates of capitalist economy."[42] Another paradox is that the company, which is completely under private ownership, has always pursued a policy that meets the national interests much better than the strategy generally implemented by the state.

When Vladimir Putin began to urge big business to be more socially responsible and, in spring 2004, gave Surgutneftegas a public tribute (at the same time taking a jab at YUKOS by saying that Surgut and Nefteyugansk are as different as day and night), it became clear that Bogdanov's 20-year-long strategic course found keen appreciation at the very top. Investment analysts who had previously said that SNG was becoming too old-fashioned[43] immediately took notice. Roland Nash, chief strategist at Renaissance Capital, among others, has noted that Surgutneftegas is "the biggest and the best corporate citizen in Russia."[44]

As a permanent resident of Surgut, Vladimir Bogdanov presumably has a greater incentive to take care of the local environment than other petroleum tycoons who spend most of their time in Moscow. Surgutneftegas is one of the few oil companies that have given up the practice of

---

[42] Financial Times, November 4, 1998.
[43] Thus, Renaissance Capital listed SNG among its least favorite stocks in summer 2003. (Renaissance Capital, Company Handbook, June 2003, p.4).
[44] Moscow Times, April 30, 2004.

dumping waste waters into natural reservoirs and instead channels them-after purification-to the system of reservoir pressure maintenance.[45]

Although Bogdanov's personal fortune is estimated by *Forbes* magazine at $1.7 bln,[46] he is not perceived as an oligarch, giving him a very important psychological edge right now. Dubbed the "general who walks to work," Bogdanov shuns the trappings of wealth; he does his own grocery shopping and often spends vacations in the village where his parents live.

Vladimir Bogdanov represents something of a puzzle in the crucial area of politics. Surgutneftegas is one of the most punctual tax payers in Khanty-Mansi Autonomous District and has the firm support of the local authorities. SNG is able to lobby its interests successfully with the federal government and obtains more benefits than its competitors. Thus, in 1996 the government permitted the company to export 73.5 million barrels of oil for two years to finance the construction of an export terminal in the Batareynaya Bay, and SNG was able to pump the whole allocated volume, while the export schedules of its rivals were curtailed.[47]

At the same time, Vladimir Bogdanov avoids politics. He is not in the list of 100 leading politicians of Russia and, though he was Putin's envoy at the 2000 elections, refused the president's offer to become the energy minister. He was never a political heavyweight, unlike certain chiefs of other oil companies. By contrast, Vagit Alekperov, head of LUKOIL, the first Deputy Minister of the Oil Industry in the last years of the Soviet Union, allegedly had Victor Chernomyrdin among key shareholders of the company; Vladimir Potanin of SIDANCO was the first Deputy Premier (though it did not save SIDANCO from being acquired by TNK); Boris Berezovskiy, co-owner of Sibneft, was the acknowledged *eminance grise* during the 1990s.

Apparently, Bogdanov disproves the maxim that Russian companies are more frequently judged in terms of the political muscle of their owners rather than by their efficiency. In Russia, political influence quickly comes and goes as the experience of the last decade proves. This is especially obvious now given the scandals that shook Bogdanov's more

[45] Oil and Gas Vertical, # 3, 2004, p. 29.
[46] Forbes.com, Forbes World's Richest People 2004.
[47] Oil and Capital, # 2, 1997, p. 26.

politically well connected rivals. Meanwhile, Surgutneftegas' consistent focus on social programs and its patriotic spirit won it government's support throughout the turbulent 1990s. This formula seems to be more reliable in contemporary Russia than western models pursued by other peers.

The Romantic: Mikhail Khodorkovskiy/YUKOS

> *[An opportunist is] a person who takes advantage of opportunities… It has always been held in disrepute–especially by those who had the same opportunities and didn't take them.*
>
> *-M. Mitchell, Gone with the Wind*

The Sky is the Limit

YUKOS and Mikhail Khodorkovskiy are aptly described as "the most" and "the first"; the leader in oil production and corporate governance initiatives, the most spectacular success and the most tragic destiny in Russia's oil sector. Symbolically, having nominated Mikhail Khodorkovskiy "the entrepreneur of 2002," Russia's popular newspaper *Vedomosti* named him "the victim of 2003."[48] Analysis of his "fall from grace" is important for understanding the specifics of the current situation in the Russian oil sector. It is clear that Khodorkovskiy's somewhat unorthodox business methods are clearly just a convenient pretext for the authorities. Other companies used tax optimization schemes just as zealously. This selective investigation of "fiscal abuse" and "privatization machinations" was viewed as a foil to stop his political endeavors and to change ownership over YUKOS.

Khodorkovskiy's involvement in YUKOS began in 1995. The company was in a sorry state. Oil production by Yuganskneftegas had dropped from 1.4 million barrels a day (1987) to 0.5 million barrels a day (1995). In 1995, the oil producer had to practically curtail all drilling for lack of funds.

From 1993 to 1996, tax debts of YUKOS to the federal budget increased by 2.8 times to exceed $2 billion. The company was managed extremely inefficiently. Financial flows were dispersed; there was virtually no strategic planning; investments in production development were practically nil; and costs were soaring. Social tension was also mounting due to huge

[48] Vedomosti, 30.12.03.

wage arrears. This resulted in strikes in Nefteyugansk. Most analysts named YUKOS a prime candidate for bankruptcy.

Mikhail Khodorkovskiy quickly turned YUKOS around. To begin, he gained a profound understanding of the way the company operated by making prolonged field trips to Nefteyugansk and Samara. He embarked on a program of centralization by consolidating financial flows and introducing efficient planning processes and cost controls. Then, corporate restructuring was initiated with the involvement of Western advisors.

Such restructuring was essential since during the 1990s three main oil producing enterprises of YUKOS (Yuganskneftegas, Samaraneftegas and Tomskneft) demonstrated practically no growth, and, therefore, the VIC was consistently in the red. At the end of the decade, its management worked out a new strategy to revamp aggressively E&P units.

YUKOS' vision was to create a world-class international energy company and to become a natural gas producer. It has set a target of extracting 2.65 million barrels a day of oil and 15 bcm/year of gas, and to generate 13 bln kWh of electricity at its own power stations by 2010.

Its leadership put all upstream operations under the YUKOS-EP division, which was established in 1998, and downstream units under the umbrella of YUKOS-RM. The management system was adapted to international practices. Production and financial responsibilities were delegated to YUKOS-EP and YUKOS-RM while YUKOS-Moscow was put in charge of planning and strategy. Non-core activities were largely divested as early as 1995.[49] Thus, social facilities were transferred to municipalities while auxiliary units, such as drilling, construction or transportation, were spun off into individual service enterprises. These measures were accompanied by significant downsizing. (However, even now YUKOS' headcount is about 110,000 people, i.e. much larger than that in Western peers). This new management approach began renaissance of the company, which yielded impressive results.

[49] Production associations established in the Russian oil sector in the late 1970s joined under their umbrella a whole range of activities in a region: prospecting, exploration, production, construction, drilling, transportation and repair. They also had social infrastructure facilities on their asset roster, such as hospitals, kindergartens, schools, farms, etc. Thus, Yuganskneftegas consisted of 4 NGDUs (oil and gas production units–Maiskneft, Mamontovneft, Pravdinskneft and Yuganskneft), 5 drilling brigades, 53 service and support units and subsidiaries of social infrastructure.

After a decade of decline and stagnation, YUKOS currently leads the sector in oil output growth, demonstrating a double-digit increase in the new millennium (from 0.89 million barrels a day in 1998 to 1.63 million barrels a day in 2003). Its viability was confirmed in 2003, when it overtook LUKOIL in crude extraction volume in Russia despite its disastrous run-in with the state authorities (see Exhibit 2). When Khodorkovskiy came to YUKOS, its production costs were $12 per barrel. Now they are the lowest in the oil sector at $1.50 per barrel.

During the 1990s, the financial position of YUKOS was quite precarious; however, in the new millennium, following its production recovery, the company has achieved remarkable success in improving its cash flows. The firm lost $477 million in 1996 and broke even in 1997. In 1998, the financial crisis in Russia and the worldwide fall of oil prices hit the company much harder than its Russian peers-it reported an $815 million net loss. The situation radically changed in 1999,[50] which marked a turning point in YUKOS financial history. This breakthrough was the result of sound management, fiscal optimization and, admittedly, higher world oil prices.

Discussing the “YUKOS miracle,” Adam Landes, analyst at Renaissance Capital, noted that, “its upstream assets look quite attractive relative to other Russian portfolios, but this alone does not explain YUKOS' lead. What appears to distinguish YUKOS is the way in which the assets are managed. In our view, much of YUKOS’ success is a reflection of talented, and empowered senior management, efficient organization, and having put the right incentives in place for today’s performance to improve. YUKOS itself describes how it has shifted from being a company with poor incentives, insufficient financial resources, limited technical expertise, and stubborn adherence to traditions to one with aggressive production and financial goal-driven performance, stringent financial goals and financial muscle after consolidating the company, the best available technology and know-how, and an intensive training culture to overcome tradition.”[51]

Since the late 1980s–even before Mr. Khordorkovskiy-YUKOS has been a leader in establishing JVs with international majors. Back in 1989, Yuganskneftegas, Canadian

[50] In 1999, a U.S. GAAP profit of $1.1 billion was posted. It grew to $3.7 billion in 2000, $3.1 billion in 2001, $2.9 billion in 2002 and $3.5 billion in the first nine months of 2003.
[51] Adam Landes, YUKOS: Enjoying Growth, Renaissance Capital, March 14, 2003, p. 43.

Fracmaster and Shell Russia established Yuganskfracmaster, the first Russian oil joint venture that successfully applied western technology in the Russian oil sector, in this case in the Sredne-Asymkinsk field. Management was determined not only to invest in foreign technology but also to send employees to Western training courses in order to ensure uninterrupted and self-sufficient hydrofracking in the future.

In the mid-1990s, analysts commended this approach. "The number and quality of Yuganskneftegas JVs reflects very positively on the management of the company. Of the 40 JVs registered with Russian oil companies, Yugansk is a participant in nine. The benefits of JVs to Yugansk are the introduction of new technology, foreign capital and enhanced foreign visibility,"[52] noted Jeremy Hudson of Salomon Brothers.

This course of close cooperation with foreign companies continued. In 1998, YUKOS signed a strategic alliance with Schlumberger to enhance production efficiency. (YUKOS was the first Russian company to adopt the Schlumberger Quality, Safety, Health and Environment (QSHE) system at its fields). Operational indicators were improved through wide-scale hydrofracking that was performed with the use of Tip Screen-Out (TSO) technology developed by Schlumberger and YUKOS. The technology was fully adapted to Russian geological conditions and used for the first time in the country.[53]

The company also applied another advanced principle-pattern management technology-that permits YUKOS to divide its reservoirs into more than 3,000 basic cells, facilitating performance analysis against objectives. Under this system, state-of-the-art fractional flow software and know-how are coupled with production enhancement methods to achieve the target potential of each pattern. Stream tube technology is used to determine sweep efficiency and find areas of bypassed oil.[54]

During this company turnaround, YUKOS focused on maximizing reserve potential. To this end, it was decided to operate part of its fields at the regime close to saturation pressure. Yuri Beilin, then president of YUKOS-EP, commented, "In the West, this regime has been in use

[52] Jeremy Hudson et al., Yuganskneftegas: Increasing Capital Expenditure: Increasing Debt, Salomon Brothers, June 25, 1996, p. 24.
[53] Owing to creation of an ultra-wide fracture, the TSO technique significantly improves productivity: by a multiple of five on average in typical Siberian wells, compared with previously used conventional fractures.
[54] Oil and Gas Eurasia, June 2001, p. 35.

for at least a quarter of a century. Acceleration of oil recovery permits to radically improve technical and economic performance of the fields. The volume of extracted crude increases while operating costs decrease."[55]

YUKOS introduced a new concept of "wellstock efficiency" - that is, measuring the actual output as percentage of calculated production potential of the well. In 2002, the average figure for the Russian oil industry was 8% versus 27% for YUKOS and 50-60% for the international majors operating in other parts of the world. Three-dimensional seismic, reservoir modeling, horizontal wells, new fracturing techniques and revised water flood patterns permit increased field recovery factors from 25-30% to 40-45%. YUKOS daily output of all wells is 202.9 barrels a day versus Russia's average of 71.3 barrels a day. Against Russia's average daily output of new wells at about 296.2 barrels a day in 2003, YUKOS reports 1,073 barrels a day.[56]

In the inevitable discussions about different approaches to crude extraction by two schools of thought in the Russian oil industry, Joe Mach, YUKOS senior vice-president for production, explains his vision, "We often hear: why hurry, oil should be left to our grandchildren… But if we leave oil without developing it or decrease output people will lose their jobs today. And it's better to pay salaries than unemployment benefits. It's impossible to create jobs and to leave oil for our grandchildren simultaneously."[57]

Mikhail Khodorkovskiy responded to the concern that a more rapid development of fields may result in the "second Samotlor" in one of his interviews. "In what way do we differ from those who worked on Samotlor? We pay an extremely careful attention to flooding. We pay an extremely careful attention to depressions in wells. We also develop several layers simultaneously. But we spent a lot of money to buy Y-TOOL equipment to study wells, to ensure separate injection of water in layers in injection wells. We created models of fields where we scientifically assess recovery by layers. Yes, our rates are more aggressive than when traditional methods are applied. We'll complete the development of fields earlier. But it is the right way to do it. Integrally, we extract more."[58]

[55] Oil and Gas Vertical, # 6, 2001, p. 33.
[56] Company data.
[57] Oil and Gas Vertical, # 4, 2003, p. 21.
[58] Oil and Gas Vertical, # 16, 2002, p. 7.

Despite the criticism that faster recovery leads to lower ultimate recovery, YUKOS operational results show that with the use of modern technologies and careful monitoring of wells, it is possible to increase rapidly output without damaging reservoirs. Thus, the water cut in YUKOS wells is gradually decreasing from about 74.1% on average in 1999 to 70.1% in 2004.[59]

Factory of the Stars

YUKOS is well aware that its future growth depends on a strong Russian workforce familiar with the latest advanced technologies. Its training program is one of the best educational projects in the oil sector in the world; professors who wrote the books, rather than those who read the books, teach these courses. Employees in Nefteyugansk, Samara and Tomsk study reservoir engineering and management, formation damage and remedial decisions, production fundamentals, seismic surveys, and the like. In 2003, 1,500 students took retraining courses at the Moscow Field Development Planning Center, which is equipped with the latest in computer technologies and sophisticated 3D visualization facilities.

The top graduates, who are awarded black belts in a symbolic gesture, become world-class specialists, competitive internationally and eagerly sought by other oil companies. YUKOS puts these young, highly qualified Russian professionals graduating from the training into key jobs.

YUKOS education programs incorporate the best international achievements. In autumn 2001, it established the retraining center for oil and gas specialists in Tomsk Polytechnic Institute in order to develop world-class engineers for the company. The institute is a joint project with Heriot-Watt University in Edinburgh, a world leader in professional training for oil companies. Building on this commitment to develop world-class petroleum engineers, YUKOS EP and NExT (Network of Excellence in Training)[60] also began to provide customized technical training to YUKOS field managers, engineers, and production specialists. In 2000, YUKOS commissioned the French Petroleum Institute to create education programs for its employees. The company is developing relationships with leading

[59] Company data.
[60] An international consortium backed by Heriot-Watt University, Texas A&M University, the University of Oklahoma, and Schlumberger.

international business schools, such as the International Institute for Management Development (IMD) and Yale University, to provide executive development courses adapted to its needs.

This education initiative, if it is not undermined by the current events swirling around the company, will ensure that the Russian oil sector will be rich in internationally competitive specialists. Owing to this pool of talent, Russia will be recognized globally not only as a country possessing significant crude reserves but also a leader in terms of its advanced oil workforce.

YUKOS is also preserving and enhancing Russia's scientific potential. The country used to have this strategic competitive advantage but it was largely eroded in the 1990s because of the lack of state funds for R&D and the ensuing brain drain. Aware that the private sector must take the initiative to restore the country's intellectual leadership, YUKOS imports rather than exports brains. It acquired Davy Process Technology and John Brown Hydrocarbon to develop surface infrastructure of fields. In 2000, it signed a deal with France's Technip to cooperate in field construction and pipeline system development.

Interestingly, production specialists in YUKOS contend that Compaq and Microsoft are crucial to its success. The company's leadership also realized that information technology was a key to enhancing efficiency. The 1998 crisis prompted YUKOS to improve management through introduction of IT. This initiative helped the company achieve considerable cost reductions. Together with Schlumberger GeoQuest, YUKOS launched a project to develop the Production Monitoring System, with the aim of creating an information system that would optimize field development and assist all stages of production. The Priobskoye field was chosen as a pilot project for gathering and managing all oil field data. After a successful launch the system was applied in all divisions of the company.[61]

The focus on IT is getting consistently stronger. Using the experience of specialists from the University of Texas and Stanford and leading industry experts, the Moscow scientific center of YUKOS developed the YUSIM hydrodynamic simulator that permits engineers to see reservoir processes directly on screen. Actually, this effort aimed at revitalizing the national

[61] Oil and Gas Vertical, # 6, 2001, p. 72-73.

science might alleviate the popular concern that Russia is turning into a fuel and energy "banana republic;" its oil industry will be a real high-technology haven, and it might produce a multiplier effect for other sectors.

The Reformed Rake

Mikhail Khodorkovskiy also turned YUKOS around in terms of corporate governance. Having earned the reputation of a bandit company because of its battles with minority shareholders (primarily with Kenneth Dart),[62] YUKOS began cleaning up its act in 2000. Over three years, the company established an international, independent Board of Directors with mostly non-executive directors. The board includes representatives of the global business community (seven out of ten directors are foreigners) and leading Russian scientists, such as Alexei Kontorovich, head of the Institute of Oil and Gas Geology. YUKOS also developed a corporate governance code, published financial statements in accordance with U.S. GAAP audited by outside accountants, and, in general, overtook all its peers in this sphere (see Exhibit 4). YUKOS became very open in terms of information disclosure for financial analysis. An unprecedented step was taken in June 2002 when Group MENATEP revealed the ownership structure for a 61.01% stake in YUKOS, making the shares of Mikhail Khodorkovskiy, Leonid Nevzlin, Platon Lebedev, Vladimir Dubov, Mikhail Brudno and Vasiliy Shakhnovskiy public knowledge.

Also, YUKOS drastically raised dividends on common stock from $300 million in 2000 and $500 million in 2001 to $2.0 billion in the first nine months of 2003. Presumably, this generosity is an irritant for the state authorities since the huge sums were paid only to a handful of its top executives. The company made efforts to increase its free float (by reducing the stake of Group MENATEP from 61% to a controlling interest) and motivated managers and employees to accept a shareholder value driven culture. Thus, earnings of top management were made directly dependent on corporate growth and stock appreciation. The most highly qualified and valuable employees became shareholders while mid-level managers were awarded stock options.

[62] Kenneth Dart accumulated from 12% to 18% of the shares in YUKOS' subsidiaries and was fighting YUKOS plans for share issue in Tomskneft, Samaraneftegas and Yuganskneftegas which were to be sold in closed subscriptions to offshore companies. This decision sparked a storm of protest from minority shareholders who said this move would severely dilute their equity in these subsidiaries (NefteCompas, June 3, 1999, p. 4). After a long fight, when Dart was initially able to block YUKOS decisions, he was bought off and quit Russia.

Indeed, YUKOS was the most visible initiator of "Westernization" in the Russian oil sector. It was the first Russian oil giant to actively hire foreign specialists. Currently, the company employs about 40 expatriate executives, including in crucial positions, such as CFO (Bruce Misamore) and senior VP for production (Joe Mach). Steven Theede[63] came to YUKOS in 2003 to fill the newly created post of COO. In June 2004 he was appointed Chairman of the Managing Board.

Mikhail Khodorkovskiy transformed YUKOS into the investors' favorite. From summer 1999 to spring 2003 (the tenth anniversary of YUKOS), its market capitalization grew from $320 million to $21 billion, and in March 2004 reached the peak of $36 billion (see Exhibit 5). S&P (in 2002) and Moody's (in 2003) awarded it the highest long-term credit rating among Russian companies. In July 2003, *Fortune* magazine named YUKOS a world leader in terms of return on investment and number two in terms of return on sales. In May 2004, YUKOS headed the list of Russian private companies in the annual rating of the *Financial Times*-500.[64]

In recent years, social activities have been utilized to improve the image of the company. In 2003, the corporation allocated some $100 million for social programs in 22 Russian cities and settlements in its areas of operation. In December 2002, YUKOS was the winner of the All-Russian Contest "Socially Efficient Organization" in the categories of "Remuneration and Social Payments" and "Implementation of Social Programs." It is implementing the Veteran Program for relocation of its long-time employees.[65] YUKOS supports the local Khanty tribes in the Khanty-Mansi Autonomous District and compensates them for the use of their traditional territories by donating money, hunting and fishing gear, modern amenities, fuel and lubricants.

But it is its effort to nurture the spirit and minds of Russians that makes YUKOS different. Mikhail Khodorkovskiy wrote in his letter from prison: "For me, Russia is my Motherland. I

[63] Formerly ConocoPhillips' President, Exploration & Production for Europe, Russia, and the Caspian.
[64] www.yukos.ru.
[65] In May 2001, YUKOS created the Veteran Petroleum Trust. 10% of all outstanding YUKOS shares serve as the Trust's endowment, and will be held for the benefit of the company's employees who will retire after 2005 as part of the YUKOS Veteran Program established in 1999. Beginning in 2005, the Veteran Program will enable company retirees working in Siberia and the Extreme North to move to southern Russia. It is expected that about 40,000 YUKOS employees will participate in the program (see YUKOS 2001 annual report).

want to live, work and die here. I want my descendants to be proud of Russia and of me as an element of this country, of this unique civilization. Possibly, I understood it too late: I started my charitable activities and investments in the civil society infrastructure only in 2000. But better late than never."[66]

In this short period of time, YUKOS set up many charitable efforts. YUKOS supplies rural libraries with new books and periodicals that they cannot afford. The Open Russia Foundation, created in 2001, supports educational and cultural projects aimed at developing young people. Through its establishment of the not-for-profit Federation of Internet Education, YUKOS promotes technology know-how in Russia. In 2000, it implemented "pokoleniye.ru," a computer literacy program for teachers and schoolchildren. Since 1996, YUKOS has been sponsoring New Civilization, a program designed to teach Russian schoolchildren the basics of market economy and the rule of law. They familiarize themselves with the institutions of civil society (parties, parliament, court, etc.) in the context of a game.

In April 2003, YUKOS began funding the Russian State Humanitarian University, allocating $100 million over 10 years. The idea was to establish a model of university financing resembling the ones already existing in the U.S. and U.K. Demonstrating his long-term vision, Khodorkovskiy tried to develop young leaders of the next generation through the Young Leaders program founded in 2001. Annually, the program brings together twenty of the brightest Russian, American and British 25-35 year old leaders in business and finance, the arts and sciences, government and politics to network and discuss global issues affecting young professionals. The company also sponsors the Hermitage museum and the Moscow Art Academic Theatre, two pillars of Russian culture.

Judging, however, by the attacks by the authorities on the Russian State Humanitarian University immediately after Khodorkovskiy's arrest, these initiatives in the spiritual and intellectual spheres may have seemed unpalatable for government officials because they were taken by a private company that had a vision of a future different from that of the state.

[66] Vedomosti, 29.03.04, M.Khodorkovskiy, Crisis of Liberalism in Russia.

Building the Empire

From the start, the Khanty-Mansi Autonomous District was too small for YUKOS' ambitions. Symbolically, the company's website says: "It is no longer interesting for us to compete within the sector. It is interesting for us to compete with the world majors." This rather arrogant statement might have tempted Providence somewhat because it was the sector's players that contributed to YUKOS' downfall.

YUKOS' intention to compete internationally on equal terms was clear from the start of Khordorkovskiy's tenure. In 1998, when the first alliance between YUKOS and Sibneft was established, Mikhail Khodorkovskiy warned potential Western investors that "Russia is not a Klondike from which you can take everything that you can."[67] YUKOS management stuck to the view that Western companies should play second fiddle to their Russian partners in local projects, anticipating the trend that is prevalent now.

YUKOS has been active in new petroleum frontiers; it conducts additional exploration in Fedorovskiy block in Kazakhstan and has acreage in the Caspian Sea (together with Gazprom and LUKOIL), and the Black Sea (with TOTAL).

By acquiring Eastern Oil Company and East Siberian Oil Company, as well as the controlling interest in Sakhaneftegas, YUKOS became the key player in East Siberia and the Far East, the region that might open a window to the rapidly developing oil markets of the Pacific Rim. YUKOS regards Evenkiya Autonomous District where the Yurubcheno-Tohomsk zone is located as its strategic area. Major oil and gas fields were discovered in this zone in the 1970s and 1980s. This territory was essentially ignored during the 1990s amidst the general decline in the oil sector. Then, after YUKOS and Slavneft came to the district, the local situation has improved radically. YUKOS was planning to complete exploration of the Yurubcheno-Tohomsk zone within the next 5-7 years and it forecast that oil production in Evenkiya would amount to 40,000 to 100,000 barrels a day by 2010. The Governor of Evenkiya says that the company generates half of the region's budget revenues and implements programs in health protection, education and support of entrepreneurship. "When events around YUKOS started

[67] NefteCompas, January 22, 1998, p. 1-2.

people were afraid that the company would leave Evenkiya and everything would be as bad as it was 2 years ago."[68]

YUKOS increased its production capacities through aggressive acquisitions. In 2002, YUKOS carried out 12 major M&A transactions worth $1.2 billion (Arktikgas, Eastern Oil Company, Urengoil, Rospan, and Tomsk Petroleum). Newly acquired gas assets will permit the company to implement its ambitious plans of expanding into the gas business. Its production increased from 1.7 bcm in 2001 to 5.6 bcm in 2003, and it is aiming at 15 bcm by 2005. In 2003, it bought a stake in Geoilbent that significantly strengthened its resource base in the Yamal-Nenetsk Autonomous District.

From the very start, YUKOS was keen on overseas opportunities. In 1995, Yuganskneftegas received an exploration and development license for 500,000 hectares in Peru. This was the first time a Russian oil company obtained a sole position to develop concessions abroad.[69] Though this experience was not an unqualified success, it did not deter YUKOS. Later, it investigated investment opportunities in Africa and the Middle East, in particular in Libya.

YUKOS is also rapidly stepping up its downstream potential, which amounted to 280 million barrels of oil refined in 2003. In addition to three refineries in the Samara region obtained during privatization, the corporation acquired the Achinsk and Strezhevoi refineries of the Eastern Oil Company and later added the Angarsk Petrochemical Company (initially operated by SIDANCO) to its portfolio.

YUKOS has resolutely targeted Eastern Europe in its downstream operations. Recently, it purchased control of the Lithuanian Mazeikiu Nafta oil complex with refining capacity of 58.5 million barrels. It is noteworthy that, after 10 years of losses (totaling over $100 million), the Mazeikiu complex posted a $72 million profit in 2003, its first full year of being operated by the oil VIC. YUKOS acquired 49% and management rights over the Slovak Transpetrol oil transportation company in 2001. This pipeline in the center of Europe eased oil deliveries to Slovnaft refineries in Slovakia to the Czech Republic and to the south of Germany. YUKOS sponsored the project of the Adria pipeline modernization and reversal to

[68] Oil and Gas Vertical, # 1, 2004, p. 24.
[69] Jeremy Hudson et al., Yuganskneftegas: Increasing Capital Expenditure: Increasing Debt, Salomon Brothers, June 25, 1996, p. 24.

facilitate transportation of Russian crude to the Mediterranean markets. It partners with Hungary's MOL in the development of Zapadno-Malobalyksk field, and this partnership helps YUKOS to secure a niche in the Hungarian retail trade. It has ensured stable crude deliveries to Poland through its contract with PKN Orlen, one of the biggest refiners in Eastern Europe. To guarantee sales, YUKOS plans to discontinue work with intermediaries and to establish its own distribution network in Europe.

YUKOS also sees the U.S. as a prospective market and would like to ship up to 0.7 million barrels a day in the future; it already started trial oil exports there in 2003, delivering its crude oil to Texas where it has been refined by ExxonMobil.[70]

Russian Roulette

Just as the Khanty-Mansi Autonomous District was too small for YUKOS, the role of a businessman proved too restricting for Mikhail Khodorkovskiy. As he said, "I am a crisis manager by nature. To get into a new fight–that's what is really interesting." Indeed, the ten-year history of YUKOS has full of battles and setbacks that the company usually successfully overcame in the past. In the mid-1990s, it was nearly "deprivatized for tax debts."[71] YUKOS also had a prolonged dispute with Amoco over the Priobskoye field and finally decided to "go it alone." In the late 1990s, Mikhail Khodorkovskiy struggled with the former management of Eastern Oil Company, including Victor Kalyuzhniy who later became Minister of Fuel and Energy. Indeed, Khordorkovskiy has had many opportunities to strengthen his fighting spirit. Now, the latest battle might turn into his last because this time he has challenged enemies too powerful to be bested. It seems that certain influential groups used his financial support of the opposition parties and parliamentary democracy-an idea that Khodorkovskiy promoted-to convince Vladimir Putin that a dangerous "oligarch conspiracy" and political challenge represented a risk to the status quo. Psychologically, they might have played on the clash of two personalities who had opposite views of Russia's future.

In the foreign policy domain, Mikhail Khodorkovskiy was the initiator of important pipeline projects that could significantly expand Russia's export potential and strengthen its overall energy security. Khodorkovskiy noted that, "Russia is not a supremely interesting region

[70] NefteCompas, July 25, 2002, p.2.
[71] See Oil and Capital, # 4, 1997.

because of the problems with transportation infrastructure... Until transportation problems are resolved, foreign investors are willing to work only under preferential tax regime."[72] In 1999, YUKOS proposed the 147 million barrels a day (to be expanded to 220.5 million barrels a day by 2010) $2.5 billion Angarsk-Daqing[73] pipeline. The pipeline was to have been commissioned in 2005-2006. This idea, however, conflicted with the government's plans for Russia's exports to the region. State monopoly Transneft supported construction of a $5.2 billion Angarsk-Nakhodka pipeline to be completed in 2005. Though the latter option could make exports to the Pacific Rim more flexible by not tying them to a single Chinese market since Nakhodka is a major port, it was unclear whether East Siberian reserves were sufficient to ensure its economically feasible loading capacity at 1 million barrels a day. The choice of routes would likely be determined by a complex of foreign policy, rather than solely business, considerations.

Another important export pipeline initiative linked to YUKOS is the Murmansk pipeline in which LUKOIL, YUKOS, Surgutneftegas, TNK and Sibneft were prepared to invest up to $4.5 billion. That line could have made exports to the U.S. a commercial reality. A letter from these five respective CEOs addressed to the former Premier Mikhail Kasyanov concerning the need to build the Murmansk pipeline shows that the rivals grasped the need for coordinating their lobbying efforts. "It is a new phenomenon in the sector which was largely created through the efforts of M. Khodorkovskiy who was the only one among the oil generals to systematically describe his position to mass media and outline the role of oil companies in the economy and politics of the country."[74]

This unprecedented initiative of promoting private pipelines in Russia (and the role of YUKOS in it) must have seemed threatening to Transneft and Gazprom, who were not eager to share their monopoly in oil and gas transportation with an ambitious outsider. It might also have angered state authorities since export pipelines in Russia represent more than purely an element of transportation infrastructure. In fact, given the shortage of Transneft's export capacities, pipelines serve as an important "stick-and-carrot" tool of domestic policy. For example, during the 1990s the access to export pipelines was successfully used to force oil

[72] Oil and Gas Vertical, # 4, 2003, p. 11.
[73] The pipeline would have started at the eastern end of the Transneft pipeline system currently reaching Angarsk where YUKOS' refinery is located. It would have gone to the city of Daqing roughly to the north of Beijing where a major refining complex is situated.
[74] Oil and Gas Vertical, # 02, 2003, p.16.

companies repay their tax debts. Apparently, the government officials were not prepared to lose this crucial lever.

Still, perhaps, the riskiest initiative was YUKOS' failed mega-merger with Sibneft that would have established Khodorkovskiy's leadership in the Russian oil sector. The aggregate production of YUKOS and Sibneft amounted to 2.1 million barrels a day in 2002, which would have made the new giant the world's number four oil producer. The combined company would have owned 19.4 billion barrels of oil reserves, making it second only to ExxonMobil. YukosSibneft would have had the mightiest downstream potential in Russia by controlling 35% of oil refining and 39% of gasoline production in the country[75] and possessing Russia's largest network of more than 2,500 gasoline-filling stations. This alliance would also have made YukosSibneft the master of "big oil" in East Siberia and the Far East. The heft of the new company would greatly have increased the political weight of its owners and the effectiveness of their lobbying efforts and, hence, their influence over the further development of Russia's economy.

Therefore, the rivals of this contemplated giant might had incentive to discredit Russia's leading oligarch. As observed in one magazine, "In this light, the fate of YukosSibneft was predetermined long before the handcuffs snapped shut on the wrists of the oligarch in disgrace–at the conception of the ill-starred supercompany. The pending birth of the oil supergiant went against the vital interests of all other Russian oil majors that inevitably became much weaker in comparison..."[76]

Publicized plans to sell up to 40% of YukosSibneft to ExxonMobil or ChevronTexaco must have seemed even more heretical to Russia's authorities. A couple of years earlier Khodorkovskiy had predicted that most Russian oil companies would belong to foreigners in the nearest future. Presumably, after that Russian government officials began to look differently at the rapid growth of YUKOS' (and Sibneft's) market capitalization–once they approached magnitudes that made them worthwhile target for Western buyers. As one analytical magazine dramatically put it, "Then farewell to security, strategy and development, all these things that the Russian officials feel their holy responsibility for and that can be

[75] It would have had six major oil refineries in Russia (in Omsk, Achinsk, Angarsk and three in the Samara region), Mazeikui Nafta in Lithuania, a stake in the Moscow refinery, as well as stakes in the Yaroslavl refineries and Mozyr refinery in Belarus (after Sibneft and TNK gained control over Slavneft).
[76] Oil and Gas Vertical, # 1, 2004, p. 9.

termed as the ability of the state to interfere in the affairs of big business. If we imagine, say, ExxonMobil, BP, RD/Shell and ChevronTexaco at the places of LUKOIL, YUKOS, Sibneft and TNK, no other Apocalypses will seem more frightening for Russian bureaucrats. They will no longer consider themselves masters of their own country and creators of their own history."[77]

With increasing globalization business inevitably loses its "national identity," and political barriers to capital, technology and labor flows are greatly eroded. Russian government officials perceived this trend as a threat to national primacy and security. The alliance of YukosSibneft with a foreign major might have carved a new place for Russia in the international oil business and bought a new level of Russian integration into the world economy in the future. "There was a place for Russian capital conquering the world in this future. There was a place for President Putin who would have become one of the key players of G-8. There was a place in this picture of the world for all those who think in terms of geopolitics and earned billions; but there was no place for the officials who think in categories of petty redistribution and stolen millions. The officials won," Novaya Gazeta wrote.[78] This intention of Mikhail Khodorkovskiy might have been one of the key reasons for his current problems because it is becoming increasingly clear that the state would never allow foreign companies to establish their control in the sector that generates the lion's share of export revenues and that is used as a key foreign policy lever.

Another political initiative that Mikhail Khodorkovskiy undertook and that was closely connected with these plans also ran strongly counter to the objectives of many Russian oil companies. He launched an active campaign against production-sharing agreements (PSAs), claiming it was unfair to create a more favorable investment regime for foreign investors than for domestic ones. YUKOS officials, however, privately admit that in fighting PSAs, the company was also trying to protect its current leading position. After making huge investments in oil extraction technology, YUKOS became the biggest producer in Russia. But this high-tech edge could be eroded if foreign majors start working under PSA, which offers privileges over the existing tax regime.[79] Another possible explanation for YUKOS position

[77] World Energy Policy, July-August 2002, p. 53.
[78] Novaya Gazeta, 21.06.04.
[79] See, for example, International Petroleum Finance, April 2003, p. 8.

on PSAs is that the company wanted to leave foreign oil investors with no significant alternatives in Russia other than purchasing equity in local companies.

In this respect, Mikhail Subbotin, a leading Russian expert on PSAs, believes that "YUKOS' victory [over PSA] 'cut off oxygen supply' for the companies that tried to launch new major investment projects."[80] Therefore, Khodorkovskiy might have made additional powerful enemies among Russian oil VICs.

All of these events taken together promote the idea that Khodorkovskiy may have been trying to create his own rules of the game. Thus, it is hardly surprising that the state machine responded very promptly to this "bear baiting"-risky in most societies, but virtually fatal in Russia. The psychological factor might also have played a critical role. As *Vedomosti* wrote recently in a very tongue-in-cheek article, "The state showed very toughly that those whose fortunes have dubious origins (as almost of all those who got rich on privatization), whose business methods were on the verge of a 'fall'… had no right to lecture the authorities and make statements contradicting 'the line of the party.' Khodorkovskiy thought that he had such a right. He said that Russia should support the U.S. in the Iraqi crisis and that the state should fight with corruption in its own home. In addition, in an unheard of impertinence in the year of elections, he financed the Union of Right-wing Forces and Yabloko instead of the Unified Russia. What's more, he visited the president without wearing a tie!"[81]

This backing of the political "also rans" such as Yabloko by a person who was always famous for his pragmatism in political matters–"with no affiliation to a specific party or power group he always bets on the winner"[82]-shows that Khodorkovskiy took the threat of authoritarianism in Russia very seriously.

His arrest marked the beginning of a new era characterized by further strengthening of the state's role in the oil sector and the new round in redistribution of petroleum assets. There are many powerful contenders for YUKOS. Perhaps renationalization in the oil sector is not really needed. It is enough to replace the rebels with loyal vassals, warning and intimidating

[80] Alexei Mikhailov, Mikhail Subbotin, Yabloko and PSA, Moscow, EPIcentre, 2003, p. 124.
[81] Vedomosti, 30.12.03.
[82] NefteCompas, 12 February 1998, p. 11.

other potential dissenters in the process as all of them have skeletons in the cupboard that can be used against them, if necessary.

Ready for Rebirth?

> *They could and did harass and hamstring them with conflicting regulations about the operation of their business, the wages they must pay their servants, what they should say in public and private utterances and what they should write in newspapers.*
>
> *-M. Mitchell, Gone with the Wind*

Recently, *Nezavisimaya Gazeta* wrote that "YUKOS is a company with management philosophy that is totally different from that of the old oil barons. It is the philosophy based on the studies of Western experience. And it practically does not trace its origins to the Soviet-type economy."[83] Indeed, YUKOS is the most Westernized, ambitious and outward-looking Russian company, which contributed a lot to the achievement of national objectives proclaimed by the government, including strengthening Russia's energy security. The company pioneered the Russian model of corporate governance. Still, YUKOS' complete alienation from the socialist past might have been its Achilles heel because the majority of Russia's population and its economic and administrative systems are still largely Soviet.

It is not only the contrast between the rich and the poor that is so stark in Russia. There is also a huge gap between the progressive, entrepreneurial and market oriented few who value democracy and freedoms and the backward many who still cannot recover from many centuries of serfdom, who are characterized by inherent parasitism, and who were morally and mentally crippled by 70 years of socialism. Presumably, it was unrealistic to expect that a decade would be enough to overcome the aftereffects of the Soviet era in the minds of most Russians who were forced to jump without a parachute from socialism to the wild capitalism. The Russian people's nostalgia for the "good old days" is aggravated by the gross mismanagement of the transition to the market economy. Mikhail Khodorkovskiy summed it up in his address to the Young Leaders program: "The right to private property meant at the same time the right and duty to be personally concerned about your own well-being, to be personally concerned about your family's income, to be personally concerned about your

[83] Nezavisimaya Gazeta, 19.03.04, p.9

future. This is hard work. Very many of my fellow citizens, especially those of the older generation, continue to try to lay this responsibility on the state. ‘We may not be as well off, but at least we won't have to think!’”

It seems that Khodorkovskiy introduced too many revolutionary changes and progressed too far and too fast. He threw down the gauntlet to bureaucrats and officials, challenging them with his ideas about restricting the role of the state in the economy and selling oil companies to foreigners. This could be one of the reasons for his current predicament: the system punished him not only for his political ambitions, but also for attacking its very pillars. In this situation, money and personal connections were not enough to protect him from the state machine. Public opinion was no help to Khordorkovskiy. The typically Russian aggressive and destructive envy allowed the 2003-2004 election campaigns successfully to utilize a slogan that “a bunch of oligarchs who grabbed our natural resources are a cause of the current poverty of the Russians.” The campaign proved popular with average Russians.

The recent events with YUKOS showed that Vladimir Putin, either explicitly or implicitly, gave important messages to the business community, in particular to the oil sector. They can be summarized as “five commandments of doing petroleum business in Russia.”

1. Be a good corporate citizen.
2. Be a conscientious taxpayer.
3. Be politically correct.
4. Be patriotic
5. Be sensible about your licenses.

The state appears to make a sharp distinction among Russian oil companies, toughly suppressing non-conformists and supporting those who follow these “unwritten” rules.

In this light, it is clear that Vladimir Bogdanov met all the criteria of Vladimir Putin’s formula for business success long before people started asking, “Who is Mr. Putin.” Presumably, this could strengthen Surgutneftegas’ position in Russia over the next few years. Bogdanov, whose evolutionary approach has developed along with the system, does not appear a threat to the bureaucracy. He minds his own business; he always demonstrated an appropriate *“etatist”* attitude; he is strong enough to resist hostile take-overs; he does not fraternize with foreigners. Bogdanov was also sufficiently far-sighted to see that the focus on "supporting the domestic producer" and the social sphere would give him a regional political safe haven as well as a permanent competitive edge, especially in today's Russia. Though sometimes he is accused of being old-fashioned in his outlook, it can be argued that his social programs are close to the Western concept of corporate social responsibility *à la Russe.*

In fact, Vladimir Bogdanov showed that it was possible to make a relatively smooth transition to the market economy within one individual company and one individual city. His business model might not have worked anywhere else in the world. But since it has been successfully functioning in Russia during three different periods (socialism, "gangster capitalism" and "totalitarian capitalism") maybe it is the one that is well suited to Russia's realities and the "mysterious Slavonic soul" with its penchant for paternalism, authoritarianism and communal spirit. Maybe, by chance or by design, Bogdanov discovered the "magic formula" of Russian business.

In general, the examples of YUKOS and SNG provide compelling evidence that production and financial performance in Russia is not enough to properly assess the prospects of a company. As prominent Russian financial firm Renaissance Capital notes, "Valuation represents only one side of the multilayered decision process behind choosing a stock. Other tangible and less tangible issues, such as, for example, the existence of the earnings momentum, sensitivity to newsflow, and the quality of management, play important roles behind the selection process. Such intangibles have traditionally held more weight in emerging market investment criteria than in developed ones, and continue to do so."[84]

One might go a step further and recognize the need to look at companies through ephemeral political, social and cultural lenses, since, obviously, it was these ephemerals that seem to be bringing YUKOS down, while the company was doing great in terms of "nuts, bolts and bucks." Says Sheldon Stoughton, an investment banker, who was actively involved in the Russian oil industry in the early and mid-1990s and has a good insight into the sector in general and these two companies in particular: "As a Westerner, my initial natural reaction was to cultivate YUKOS as the more open and "Westernized" company and to avoid Surgutneftegas as a company that professed not to trust foreigners and appeared to cling to

[84] Company Handbook. Renaissance Capital. Equity Research. June 2003, pp.6-7.

traditional views. However, having seen how things have evolved, I realize that people such as Mr. Bogdanov never forgot that elements of the old technocratic and paternalistic system were still present and were going to remain important–and that an abrupt break with them was not an effective survival strategy, even in the new Russia."

So, to properly judge a Russian company, it makes sense to study how it is positioned within Russia's broader political, social and cultural context, especially now, given the controversial relationship between the state and the private sector, particularly within the natural resources sphere. The experience of the 1990s proves beyond a doubt that international stereotypes, perceptions and concepts, if directly transplanted into Russia, do not always properly work in its peculiar national situation. It is noteworthy that many investment analysts were saying just a year ago that SNG was over the hill, judging it from a Western perspective and comparing it to YUKOS and Sibneft. Now SNG is stronger than ever; it is likely to inherit some of YUKOS' assets and has the lowest susceptibility to prosecution by the Kremlin among the largest businesses in Russia.[85] In this light, the immortal line by Rudyard Kipling, "East is East and West is West, and never the twain shall meet" describes Russia's current status. Russia remains a very complex and confused mixture of these two worlds painfully trying to find its own way to a full market economy.

[85] See, for example, Vladimir Putin's Second Presidential Term and the Coming Campaign of De-Oligarchization. Possible Scenarios. Preliminary Research. Russian Axis, London, 2004, p. 17.

Exhibit 1: Evolution of Russia's Oil Industry Structure, 1993-2004

	1993	**1996**	**2004**
	Winners		
LUKOIL	Langepasneftegas Uraineftegas Kogalymneftegas Permnefteorgsyntez Volgograd refinery	Langepasneftegas Uraineftegas Kogalumneftegas Permeft Astrakhanneft Nizhnevolzhskneft Kaliningradmorneftegas Permnefteorgsyntez Volgograd refinery	LUKOIL-West Siberia (Langepasneftegas, Uraineftegas, Kogalymneftegas, Pokachevneftegas) Arkhangelskgeoldobycha LUKOIL-Komi LUKOIL-Kaliningradmorneft LUKOIL-Nizhnevolzhskneft LUKOIL-Permneft Permnefteorgsyntez Volgograd refinery Ukhta refinery Nizhegorodnefteorgsyntez Odessa refinery
Surgutneftegas	Surgutneftegas Kirishinefteorgsyntez	Surgutneftegas Kirishinefteorgsyntez	Surgutneftegas Kirishinefteorgsyntez
Rosneft	Purneftegas Noyabrskneftegas Nizhnevartovskneftegas Samaraneftegas Tyumenneftegas Sakhalinmorneftegas Stavropolneftegas Krasnodarneftegas Termneft Permneft Astrakhanneft Nizhnevolzhskneft Kaliningradmornefegas Dagneft Chernogorneft	Purneftegas Sakhalinmorneftegas Stavropolneftegas Krasnodarneftegas Termneft Dagneft ArkhangelskNGgeologiya Komsomolsk refinery Krasnodarnefteorgsyntez Tuapse refinery	Purneftegas Stavropolneftegas Sakhalinmorneftegas Severnaya neft Termneft Dagneft Krasnodarneftegas Eniseyneft Taimyrneft Sevmorneftegas Polar Lights Grozneftegas Caspoil Selkupneftegas Dagneftegas

	Kondpetroleum Saratovneftegas Varyoganneftegas Udmurtneft Mgionneftegas Tomskneftegas Orenburgneft Komineft ArkhangelskNGgeologiya YenisseyNGgeologiya Orenburggeologiya Yenisseygeophysica Megionnenftegazgeologiya Vostsibneftegazserive TomskNGgeologiya PurNGgeologiya ZapolyarNGgeologiya SurgutNGgeologiya NoyabrskNGgeologiya KrasnoleninskNGgeologiya UktanNGgeologiay KhantyMansiiskNGgeologi ya Udmurtgeologiya YamalNGgeologiya UrengoiNGgeologiya Omsknefteorgsyntez NORSI Ryazan refinery Moscow refinery Tuapse refinery Grozniy refinery Yaroslavnefteorgsyntez Krasnidarnefteorgsyntez Khabarovsk refinery Komsomolsk refinery		Tuapse refinery Komsomolsk refinery
Tyumen Oil Company		Nizhnevartovskneftegas Tyumenneftegas Ryazan refinery	Nizhnevartovsk NGDP Orenburgneft Orenburggeologiya Samotlorneftegas

			Tyumenneftegas TNK-Nyagan TNK-Uvat Yugraneft Kovyktaneftegas Varyoganneftegas Novosibirskneftegas Saratovneftegas Udmurtneft TNK-Nizhnevartovsk Rospan International RUSIA Petroleum TNK-Sakhalin Orsknefteorgsyntez Ryazan refinery Lisichansknefteorgsyntez Nizhnevartovsk Refining Complex Saratov Refinery
Sibneft		Noyabrskneftegas NoyabrksNGgeophizica Omsk refinery	Noyabrskneftegas NoyabrskNGgeophysika Meretoyakhneftegas Sibneft-Yugra Omsk refinery
	The Victim?		
YUKOS	Yuganskneftegas Kuibyshevnefteorgsyntez Syzran refinery Novokuibyshev refinery	Yuganskneftegas Samaraneftegas Kuibyshevnefteorgsyntez Syzran refinery Novokuibyshev refinery	Yuganskneftegas Samaraneftegas Tomskneft Vostsibneftegas Arcticgas Urengoil Sakhaneftegas Kuibyshevneftaorgsyntez Syzran refinery Novokuibyshev refinery Achinsk refinery Strezhevoi refinery Angarsk petrochemical

			company Mazeikiu Nafta
	Losers		
SIDANCO		Chernogorneft Kondpetroleum Saratovneftegas Varyoganneftegas Udmurtneft Angarsk petrochemical company Khabarovsk refinery Saratov refinery	
Slavneft*		Megionneftegas MegionNGgeologiya Mozyr refinery Yaroslavnefteorgsyntez Yaroslavl refinery	Megionneftegas MegionNGgeologiya Mozyr refinery Yaroslavnefteorgsyntez Yaroslavl refinery
Eastern Oil Company		Tomskneftegas TomskNGgeologiya Achinsk refinery Tomsk refinery	
ONAKO		Orenburgneft Orsknefteorgsyntez	
KomiTEK		Komineft Ukhta refinery	
East Siberian Oil Company		YenisseyNGgeologiya Yenisseygeophysica Vostsibneftegazserive	

Notes: in the boxes representing vertically-integrated companies, upstream divisions are given above the line, while downstream–below the line. For the sake of simplicity, petroleum product distributors were not included in the boxes.

Tatneft and Bashneft, companies based in the republics of Tatarsan and Bashkiria, respectively, were not included since they are both not classical vertically-integrated oil companies.

* Slavneft was acquired by TNK and Sibneft in 2002 and will soon cease to exist as an independent company.

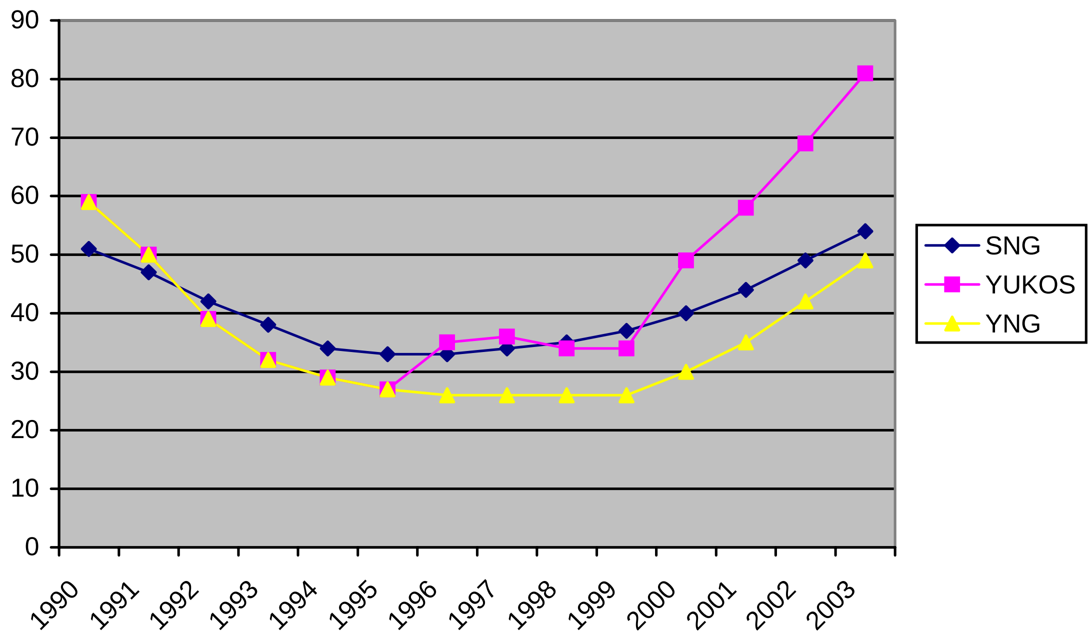
Source: Jeremy Hudson, Nina Poussenkova, *Oil Industry of Russia: Current Status and Prospects for Progress*, Salomon Brothers, volume 4, March 1996, p. 34, oil companies' websites.

Exhibit 2: Russian Oil Companies: Key Production Indicators

	Proved reserves bln bbls, 2002, SPE	Oil production, mln tons		Oil exports, mln tons		Drilling in 2003, thousand meters		Number of oil wells, Dec. 2003	
		2002	2003	2002	2003	Development	Exploration	Total	Idle
YUKOS	**13.7**	**69.3**	**80.7**	**24.4**	**26.8**	**1,180.9**	**43.1**	**17,797**	**5,536 (31%)**
LUKOIL	15.3	75.4	78.8	25.5	25.7	1,073.4	125.3	27,473	5,034 (19%)
TNK-BP	9.4		61.5						
Surgutneftegas	**6.6**	**49.2**	**54.0**	**17.4**	**18.2**	**2,777.5**	**244.1**	**16,964**	**2,137 (12%)**
TNK	7.2	37.5	42.9	12.7	16.2	399.2	21.9	16,162	6,730 (41%)
Sibneft	4.6	26.3	31.3	10.3	11.3	687.8	50.6	7,997	4,517 (56%)
Tatneft	6.0	24.6	24.6	8.7	9.3	602.5	48.2	21,477	3,120 (14%)
Rosneft	2.9	16.1	19.5	6.0	6.9	483.2	39.1	8,836	603 (6%)
SIDANCO	2.2	16.2	18.6	5.3	5.8	131.9	N/a	8,121	2,486 (30%)
Slavneft	1.6	14.7	18.0	5.4	5.7	251.8	N/a	3,953	642 (8%)
Bashneft	N/a	12.0	12.0	4.1	3.7	333.9	70.9	18,505	3,485 (19%)

Source: Statistics of *Oil and Gas Vertical*

Exhibit 3: Dynamics of Oil Production by Surgutneftegas and YUKOS, 1990-2003 (million tons)



Notes: for comparative purposes, we singled out Yuganskneftegas (YNG), the biggest oil producer in YUKOS structure that is approximately the same size with SNG to see how YUKOS would have grown without acquisitions. Samaraneftegas was added to YUKOS structure in 1995, and Tomskneft in 2000.

Source: Jeremy Hudson et al., "Oil Producing Companies, Russian Oil", Salomon Brothers, volume 2, March 1996; statistics of *Oil and Gas Vertical*

Exhibit 4: Standards of Corporate Governance in Leading Russian Oil Companies

Indicator	LUKOIL	**YUKOS**	**SNG**	Sibneft
Divestment of non-core assets	2001	**1998**	**-**	1998
Publication of financial statements under U.S. GAAP	1998	**2000**	**2002**	1997
Independent members of the Board of Directors	2002	**2000**	**-**	1998
Corporate Governance code	-	**2000**	**-**	1998
Disclosure of information on ownership structure	-	**2002**	**-**	-

Source: Oil and Gas Vertical, # 17, 2002, p. 32.

Exhibit 5. Dynamics of Surgutneftegas and YUKOS Capitalization (by Ordinary Shares), 1998-2004, million USD

Date	**Surgutneftegas**	**YUKOS**
December 1998	2,411.5	
December 1999	8,673.9	
December 2000	7,884.7	3,796.6
December 2001	10,593.8	10,636.9
December 2002	10,923.2	19,711.1
June 2003	14,823.4	29,688.6
August 2003	15,929.5	32,954.9
September 2003	15,669.0	33,481.9
November 2003	17,921.9	30,954.5
December 2003	20,512.7	27,752.2
February 2004	21,444.1	32,148.7
March 2004	25,101.0	36,933.5
May 2004	23,842.0	26,816.2
June 2004	22,971.8	18,268.5

Source: www.rts.ru

Exhibit 6. Surgutneftegas and YUKOS: Leadership Profiles

Surgutneftegas/Bogdanov	YUKOS/Khodorkovskiy
Tangibles	
- Production-minded - Advanced/conservative production methods - Internal growth - Financial conservatism	- Commercial-minded - Advanced/aggressive production methods - Expansionist growth - Financial adventurism
Intangibles	
- Insufficient reforms - Closed - Rudimentary corporate governance	- Pioneer of reforms - Open - Leader in corporate governance
Ephemerals	
- Evolutionary development - Distance from foreigners; support of domestic producer - Low key - The general who walks to work - Apolitical, but etatist - Minds his own business - Paternalism; strong on CSR	- Revolutionary development - Internationalized and Westernized - High profile - The richest man in Russia - Democratic opposition - Political ambitions - Focus on enlightenment