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THE ENERGY DIMENSION IN RUSSIAN GLOBAL STRATEGY

VLADIMIR PUTIN AND THE GEOPOLITICS OF OIL

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Introduction

The honeymoon between the Western oil industry and Russian President Vladimir Putin ended in mid-2003 when the Russian procurator's office began arresting Yukos executives. The Kremlin's seemingly sudden attack on private industry surprised the international business community that was expecting investment-friendly behavior from the Russian leadership. After assuming power in late 1999, Putin quickly signaled interest in developing a strong energy partnership with the United States, including increased opportunities for Western firms to invest in Russia's oil and gas industry.

While Western firms had found a very uneven playing field in Russia during the Yeltsin years, the fact that Putin appeared to have personally blessed the TNK's 2003 merger with BP,¹ led some to hold out hopes that Putin's second term would lead to new and better opportunities for western investment in Russia. The arrest of Yukos CEO Mikhail Khodorkovsky in October 2003,² however, triggered speculation that conditions in the second term might be even less advantageous to foreign investors, as it came at a time when Yukos' principle owners and managers were engaged in possible merger talks with senior executives from both ChevronTexaco and ExxonMobil.³

Initially, foreign observers of Russia's energy scene attempted to put a positive face on what was occurring. In his public statements, Putin continued to emphasize the importance of attracting foreign investment in Russia's energy sector, and it was easy to view the Khordorkovsky arrest as the result of a myriad of converging domestic, political and legal factors that had nothing to do with oil.

¹ "Price-fixing Row Over BP's Russian Oil Deal," *The Guardian Newspapers*, June 25, 2003.

² Yukos CEO Mikhail Khodorkovsky was arrested on October 25, 2003 and was charged with violating seven articles of the Russian Federation Criminal Code, including personal income tax evasion, overseeing corporate tax evasion, non-compliance with a court judgement, falsifying documents, and theft. *Russian Petroleum Investor*, January 2004. See Appendix 1 for biographical details.

³ Black, David. "Kremlin Threat to U.S.-Yukos Deal." *The Guardian*. August 4, 2003. White, Gregory. "Yukos' Legal Woes Continue Despite a Possible Exxon Deal." *Wall Street Journal*. October 7, 2003. Warren, Susan, Gregory White, and Anita Raghavan. "Exxon Signals Interest in a Deal with Yukos." *Wall Street Journal*. December 12, 2003.

With time, however, it became clear that Khodorkovsky's *incarceration* might be something of a red herring. While not a forewarning that the country's leading oligarchs would all be marched in turn to Matrosskaya Tishina pre-trial detention facility, Khordorkovsky's arrest did accurately foretell a dramatic shift in how Russia planned to do business in the energy sector.

Signs of this shift were visible even before the presidential elections. In January 2004, the Russian government announced that it wanted over \$1 billion for a license to explore and develop one of the three Sakhalin-3 parcels, the choice Kirinsky block, the rights to which would be won through a tender process. This decision effectively annulled the results of a 1993 tender, in which ExxonMobil, ChevronTexaco and Rosneft received the same exploration rights. It was a particular blow to ExxonMobil, which had already invested over \$80 million in the project⁴ and had been withholding further investment in the project in the hopes of being able to develop it through a production-sharing agreement.⁵

After the March 2004 presidential elections, signs began to emerge that these events of 2003 were no aberration but rather the calculated implementation of a plan and vision for the future of the Russian oil sector. President Putin was not going to use his increased political power simply to "open the door" for foreign investment in the Russian oil and gas industry as Western observers had supposed. Rather, he intended to reorganize the Russian oil and gas industry to enhance the power of the Russian state. Only then, after the reorganization was complete and the state's capacity to protect national interests in this strategic sector was reaffirmed, would Western firms be invited in to participate in the Russian market.

This paper argues that Russia's energy policy changed in predictable ways, as Vladimir Putin has gained better control of the levers of power that are associated with Russia's presidency. Moreover, it asserts that earlier public statements by Putin and the career paths of people with whom he sought counsel, foreshadowed these policy changes.

⁴ Sakhalin-3's Kirinsky block, the largest of the project's three blocks with estimated reserves of 453 million tons of extractable oil and 700 billion cubic meters of gas. Korchagina, Valeria. "Energy Minister Says State is Seeking \$1 Billion for Exxon Sakhalin-3 License." St. Petersburg Times. February 6, 2004. RBC News "New Tender to Be Held for Sakhalin-3 Project." January 29, 2004.

We will demonstrate that President Putin is genuinely eager for the development of an energy partnership between Russia and the United States, which he sees as a cornerstone of an improved U.S.-Russian relationship but under certain conditions that were not previously well understood. Putin appreciates that increased investment by Western energy firms in Russia is necessary to attain this, but for Putin, this investment must be made in a manner that is consistent with the Russian state's ability to exert guardianship over the country's oil and gas assets.

Guardianship can be asserted in a number of ways, under the vision about to be imposed, including state regulation, partial state ownership, and state control of energy transport, but the primacy of the Russian state in the country's energy sector is non-negotiable. While Vladimir Putin recognizes the importance of market forces and the need to protect private property, he believes that both must be managed to insure that neither takes precedence over the interests of the state, which exercises its control in the name of the Russian people.

As we will discuss in this paper, Russia's oil and gas reserves serve as a source of income for reinvestment in the country's economy and provide an attractive lever for use in Russia's foreign relations. This Russian president is not willing to give up control of such lucrative and potentially authoritative instruments of power.

Vladimir Putin's First Term in Office

Vladimir Putin markets himself as a supporter of "managed democracy," a phrase he used in an interview with New York Times correspondent Steven Lee Myers, in October 2003, to describe a political system that is built upon top-down control, but which, in Putin's opinion, provides Russian citizens with many of the same legal protections of developed democracies.⁶ This kind of system, the Russian president maintains, is in accordance with Russian history and cultural values, something that he believes is critical for any sort of democratic system to work in Russia.

⁵ When ExxonMobil realized that this project would not be added to the list of those eligible for PSAs by the Duma, they were prepared to develop it under ordinary licensing terms. But by then 10 years had elapsed since the initial agreement, providing the loop-hole for the Russian government to annul the agreement.

⁶ Myers, Steven Lee. Interview with President Putin. The New York Times. October 6, 2003.

Vladimir Putin has made the strengthening of the Russian state a priority of his presidency while not placing any real importance on the need to strengthen the rights of Russian citizens. Putin clearly views the political system of post-Soviet Russia as a work in progress. Moreover, the Russian president believes that the state will not be strengthened unless it backs away from a number of decisions made by his predecessor, Boris Yeltsin, Russia's first president.

By early 2004, Putin was able to remove virtually the entire Yeltsin team, who still dominated the Putin presidential administration in the early period of his first term, including many members of Yeltsin's so-called "family." This inner Yeltsin circle was left in place by Putin through the December 2003 parliamentary elections.⁷ But more recently, Putin has replaced the Yeltsin family, appointing instead his own close associates, as well as a number of technocrats who had only the most tenuous ties to the administration of his predecessor.⁸ The continued tenure of Yeltsin's men through Putin's first term of office seems to have been part of a deal that was made when the former chose the latter as his successor in December 1999.⁹

Midway through Putin's first term as president, however, it was already quite clear that the former KGB official intended to leave his own stamp on Russia's evolving political system.¹⁰ Key for Putin was expanding the powers of the Russian presidency, an institution that had been created by Yeltsin in 1991.

Russia under Yeltsin was a country in turmoil, its economy and political system rocked by the sudden collapse of the Soviet Union. Moreover, Yeltsin himself was physically frail—ill for part of his first and all of his second term in office. Yet despite these obstacles, Boris Yeltsin was determined to hold power. He did so, in part, by sharing his constitutionally provided powers of

⁷For example, in October 2003 Aleksandr Voloshin, a member of Yeltsin's family, resigned as Putin's chief of staff. He was replaced by Dmitri Medvedev. Rosbalt, October 31, 2003.

⁸Vladislav Surkov and Igor Sechin were appointed administration deputy heads and aides to the president. Dmitry Medvedev kept his post as presidential chief-of-staff. Interfax, March 26, 2004. Early in Putin's second term both men were moved into the energy sector, Sechin as head of Rosneft, and Surkhov was sent to Transneftprodukt.

⁹http://www.pbs.org/newshour/updates/december99/yeltsin_12-31.html;

<http://www.people.fas.harvard.edu/~gestewar/putinobserved.html>;

<http://www.newsmax.com/articles/?a=2000/5/1/42928>

¹⁰ See Appendix 1.

the presidential apparatus with the Parliament and with the country's regional leaders and by trading economic favors for political support.¹¹

Putin bided his time before making major changes, but it was clear at the outset that Russia's new president was not pleased with the system he inherited. There were simply too many independent centers of power for Putin's liking.¹²

Russia's "independent" media was the easiest to attack, as most of the key figures associated with it, both owners and well known commentators, and had not been offered protection in the bargain that Putin made with Yeltsin before assuming the presidency. Taking away licenses from Russia's most-outspoken media outlets served to sharply reduce criticism of the new Russian president and his policies,¹³ and it also struck a blow against a few annoying and relatively vulnerable oligarchs (Boris Berezovsky and Vladimir Gusinsky),¹⁴ who had made the mistake of presuming that their access to Yeltsin would be repeated in the new administration. The attack on these men was intended to serve as a warning to Russia's other powerful business figures but not fully appreciated at the time on this target audience.

Putin obviously recognized that the so-called oligarchs–business magnates who survived the 1998 financial meltdown–were an extremely powerful lot. Collectively, these men had helped define modern Russian political life when they bailed out Boris Yeltsin in the 1996 “loans for shares” scheme, allowing a destitute Russian state to pay back salaries and pensions.¹⁵ Without

¹¹ For details see Shevtsova, Lilia. *Yeltsin's Russia: Myths and Reality*. Washington, D.C.: CEIP, 1999.

¹² For details see Shevtsova, Lilia. *Putin's Russia*. Washington, D.C.: CEIP, 2003.

¹³ NTV, Russia's leading independent television station owned by Vladimir Gusinsky's Media-Most, provided critical coverage of the Chechen war. In April 2001 Gazprom acquired a major stake in NTV. In January 2002, TV6, in which Boris Berezovsky still maintained a financial stake, was shut down. Another television channel, TVS, was shut down in 2003 on the basis of illegal use of frequency licensed by the Moscow Independent Broadcasting Corporation. Interfax, June 22, 2003.

¹⁴ Hoffman, David. *The Oligarchs*. NY: Public Affairs, 2001, pp. 127-149. See Appendix 1 for biographical details.

¹⁵ The loans for shares program began in 1994. Under this program the government would allow private businesses to manage the state stake in a group of key companies in exchange for loans. The government listed the loans as additional budget revenues, thereby appearing to reduce its budget deficit. Not able to pay back the loans, the state would auction off the right to manage its shares. This was supposed to be an open and competitive process, but in reality it was dominated by insider deals and lobbying of the future oligarchs. The loans for shares scheme operated until September 1996. As a result, through rigged auctions Vladimir Potanin privatized Norilsk Nickel and SIDANCO (sold off in 2001 for \$1.1 billion), Mikhail Khodorkovsky -- Yukos, Mikhail Fridman -- Tyumen Oil, Boris Berezovsky and Roman Abramovich -- Sibneft. For details see Hoffman, David. *The Oligarchs*. NY: Public

this, Boris Yeltsin would almost certainly not have been elected president in 1996, and the communists would have been restored to power.

By the 2000 election, the communist party's power was dwindling. Collectively, the economic power of Russia's twenty-five richest men far outstripped that of the Russian state,¹⁶ making it virtually impossible for the Russian president to move against these men as a group. While these oligarchs sought to establish the same relationship they had enjoyed with Boris Yeltsin, Vladimir Putin tried to keep these men at arms length, limiting their individual direct access to him. Putin preferred that a redefined version of the Russian Union of Industrialists and Entrepreneurs serve as a quasi business advisory board for the Presidency.¹⁷ He also began a slow process of replacing the members of the presidential administration, bringing in people with whom he worked during his years in St. Petersburg in the 1990s, or men with whom he felt some affinity toward as a result of their service in one of the various branches of Russia's security services.¹⁸ This further reduced the access of the oligarchs to the levers of presidential power.

Like wealthy men everywhere, Russia's oligarchs wanted to continue to accumulate more wealth and sought to influence the development of the Russian state in ways that would maximize their economic growth potential. Given the cunning—the combination of business and political sense—that each of these men showed to accumulate their fortunes, it would not be unfair to say that most probably thought themselves far smarter than Russia's political leaders, who were men of far more modest economic resources. In fact, many of the oligarchs, especially those whose principal holdings were in the oil sector, were getting wealthier and wealthier by the year, and it was becoming increasingly more common for a single firm, such as Yukos or TNK, to have several billionaires in its top management.¹⁹

Affairs, 2001 and Freeland, Chrystia. Sale of the Century: Russia's Wild Ride from Communism to Capitalism. NY: Crown Business, 2000.

¹⁶ Forbes World's Richest People List for 2004.

¹⁷ For details see Shevtsova, Lilia. Putin's Russia. Washington, D.C.: CEIP, 2003, p. 180.

¹⁸ For example, Minister of Defense Sergei Ivanov, Minister of Internal Affairs Rashid Nurgaliev, Igor Sechin and Viktor Ivanov, who served as deputy heads in Putin's first administration, all had long careers in the security organs. See Medetsky, Anatoly. "Siloviki's Pyramid of Power Revealed." St. Petersburg Times. January 20, 2004.

¹⁹ TNK's Viktor Vekselberg is worth \$5.9 billion. Yukos' Mikhail Khodorkovsky is worth \$15 billion, Leonid Nevzlin -- \$2 billion, Mikhail Brudno -- \$1.8 billion, Platon Lebedev -- \$1.8 billion, Gherman Khan, TNK-BP's executive director -- \$2.9. Forbes World's Richest People 2004 List.

These men began looking for other arenas of political influence, focusing their attention on Russia's elected Duma,²⁰ and on the regional governments in which their enterprises were located.²¹ This strategy also helped them develop influence in the Federation Council, Russia's upper house, in which local governments were represented.²²

Putin too sought control of the parliament, and the nomination process for the upper house made it easier for Russia's president to turn this into a more predictable body than the lower house, whose deputies had been elected in the political free-for-all of Yeltsin's last year in power.²³ While the majority of the Duma members were generally loyal to the new president, they were not "his men," and even those affiliated with pro-presidential factions might decide to vote with the liberal, communist, or nationalist blocs on a particular issue.

The more controversial the question, the harder it was for Putin to secure an easy victory, and this was particularly true on issues in which the Russian president's position differed from that of key oligarchs, as the latter were able to donate freely to sustain the various liberal parties (and on pro-government blocs as well).²⁴

The influence of these men, sometimes as individuals other times as a loose grouping, was particularly visible on legislation to regulate trade, taxation and foreign investment. While most of Russia's leading businesses were strong proponents of corporate transparency,²⁵ there was

²⁰ For example, in the 1999-2003 Duma, Vladimir Dubov, Vladimir Ryzhkov, Konstantin Kagalovsky, Alexander Osovtshev, and Galina Antonova were the initiators of many legislative victories for Yukos, while Igor Annensky lobbied for TNK.

²¹ For example, Yukos vice-president Boris Zolotarev was chosen as governor of the Evenkia District in April 2001, Norilsk Nickel General Manager Aleksandr Khloponin was elected governor of the Taimyr Autonomous Region in September 2002, Sibneft's Roman Abramovich became governor of Chukotka Autonomous Region in December 2000, and gold magnate Hazret Sovmen became the head of the Adyghea Republic in 2002 o Martha Brill Olcott. "Reforming Russia's Tycoons." *Foreign Policy*. May/June 2002, pp. 66-73.

²² According to article 95 of the constitution, two deputies from each subject of the Russian Federation are elected to the Federation Council: one from representative and the other from executive body of state authority. A Russian citizen over 30 years old could be elected or appointed a member of the Federation Council. There are 178 members in the Federation Council www.council.gov.ru

²³ See Appendix 2 for the make up of the 1999 elected Duma.

²⁴ For example, Khodorkovsky has been funding Yabloko and the Union of Right Forces since the late 1990s. Mereau, Francesca. "Yabloko Counts on Khodorkovsky." *Moscow Times*. July 16, 2003.

²⁵ They also supported legislation that increased minority stock-holder rights, for the same reason, that it was required if they wanted their shares traded on western exchanges.

general consensus that the tax structure must be transparent and that there must also be a variety of legal ways for major Russian firms to reduce their tax bills.²⁶

To this end, the oligarchs most favored legislation was a bill that allowed them flexibility to pay taxes where either they or their assets were located. This increased the likelihood that they could reduce their tax bills through cooperation with the local authorities. Some oligarchs even became the local authorities or got senior members of their enterprises elected to local office. Sibneft's Roman Abramovich became Governor of Chukotka, and for years his personal income served as the major source of revenue for this largely frost-bound, under-populated region of Russia's Far East. Senior officials from Yukos, TNK, and Norilsk Nickel also entered politics, helping to protect the interests of Mikhail Khodorkovsky, Mikhail Fridman, and Vladimir Potanin, respectively.²⁷

While the oligarchs split on most questions relating to trade, depending upon whether or not the profit from their principle commodity would benefit from a free trade regime, all favored the idea that foreign firms be free to invest in Russia.²⁸ The oligarchs disagreed with the Kremlin on whether foreign firms should be offered preferential tax and royalty terms as an incentive for investment. Consequently, the issue of production sharing agreements (PSA)—the negotiation of special terms on natural resource projects of particular strategic interest—produced the strange alliance of communists voting with representatives tied to some of Russia's largest oil companies. The legislation on PSA discusses license holders negotiating special terms without reference to whether they are Russian or foreign. Some Russian oil companies, namely Yukos and Sibneft, believed that the existence of a PSA would benefit Western firms and work to the disadvantage of Russia's oil barons, who could otherwise benefit from their insider position within Russia while other Russian companies, like Rosneft, Tatneft and TNK-BP believed they might benefit from PSAs under certain conditions.

²⁶ See Appendix 5. Russian companies have used transfer pricing and domestic off shores to reduce taxation. The off-shore boom started in 1994 when the federal authorities granted certain regions the right to set reduced tax rates, including profit tax and VAT. But as of January 1, 2004, the last three Russian regions with federal tax concessions, Mordovia, Kalmykia and Chukotka, lost the investment privileges on profit tax.

²⁷ For details see Shevtsova, Lilia. *Putin's Russia*. Washington, D.C.: CEIP, 2003, pp. 126-128.

²⁸ For example, aluminum oligarch Oleg Deripaska is against Russia's entry to the WTO. Vladimir Potanin, Khodorkovsky, and Mikhail Fridman are among supporters of Russia's entry into the WTO.

For men like Khodorkovsky, it was not a question of whether foreigners would invest in Russia's oil industry but rather, with whom would they invest—with the state or as equity partners in Russian oil companies. For those interested in cashing out on their assets, it was far preferable for Russian domestic firms to preserve an advantage and become the point of entry for foreign investment capital, as the management of TNK did in their merger with BP.²⁹

On this issue, President Putin disagreed with some of Russia's richest men, for reasons this paper discusses at some length below. The legal environment related to Russia's oil industry was one of a large number of issues, which Vladimir Putin understood as vital to return to the exclusive control of the president. For this reason, it was very important to Putin to insure that the parliament elected in 2003 was far more pliant than the parliament of his predecessor. Outcome was more important than process for Putin, a man schooled in the communist tradition, especially when process, as defined by proponents of free and fair elections, gave considerable advantage to those who had access to large amounts of capital.

Several public statements by Mikhail Khodorkovsky—combined with swelling rumors, which Khodorkovsky, himself, made no effort to dispel—implied that the successful Yukos' CEO would throw his newly gained legislative influence to try and severely limit the power of the Russian presidency, attempting to move the country toward a parliamentary democracy, in which the parliament, and not the president, would appoint the head of government.³⁰

For Putin, parliamentary democracy represented taking Russia in exactly the wrong direction—away from a strong state that would protect the interests of the Russian population. He resented using Western-style institutions, of which ordinary Russians had little understanding, to move Russia's assets abroad to the benefit of a privileged few, as critics of the oligarchs believed a

<http://english.pravda.ru/usa/2003/04/08/45745.html>; <http://www.ceip.org/files/events/2003-05-15-potaninsum.asp?pr=2&EventID=615>

²⁹ TNK-BP started to operate on September 1, 2003, becoming Russia's third largest oil company in terms of reserves and output. BP and Alfa Group/Access/Renova Holding each own a 50 percent stake in TNK-BP. http://www.tnk-bp.com/eng/home_800.asp

³⁰ <http://www.ceip.org/files/events/events.asp?pr=2&EventID=649>

parliament elected through the funding of such men would do.³¹ In the parliamentary elections of December 2003, pro-government candidates won a resounding victory,³² strengthened by changes in the election law that worked to the detriment of independent and opposition candidates.³³ According to the Organization for Security and Cooperation in Europe, these elections fell short of international norms.

Irregularities notwithstanding, Putin took the elections as a mandate for his bid for a second term as president. Though many prominent opposition figures criticized the conduct of these elections,³⁴ virtually all serious political figures in the country viewed Putin as unbeatable. Put aside the fact that Putin would try to win “by hook or by crook,” the Russian president was the country’s most popular (as well as most powerful) political figure. Putin’s popularity, as well as some sense that “the fix was in,” allowed the incumbent Russian president to face little competition in the presidential elections.³⁵

On March 14, 2004, Vladimir Putin was reelected president with 71 percent of the vote and a reported voter turnout of 64 percent (about 49 million people).³⁶ This overwhelming endorsement left Putin freer to shape Russia’s economic and political system. As we will argue, his past actions and statements serve as important clues as to his future behavior now that he has the mandate and freedom of action.

³¹ <http://www.mironov.ru/english/publications.phtml?id=7020> <http://northstarcompass.org/nsc0401/duma.htm>

³² See Appendix 2 for the 2003 Duma election results.

³³ In June 2002, the Duma approved a Kremlin-backed law on political parties designed to reduce the number of parties that appear in the Duma ballot. From July 14, 2003, to qualify as a political party, an organization must have at least 10,000 members and branches with at least 100 members each in at least 45 of the country’s 89 regions. Only registered political parties are allowed to participate in elections. The 2003 Duma elections were conducted under the November 2002 electoral law. See Appendix 2 for the changes in the law.

³⁴ During the campaign, opposition candidates complained that the state-controlled media’s lavish coverage of Putin gave them little opportunity to get their message to voters. They also charged that regional government officials hampered their campaign appearances. <http://www.tampabaylive.com/stories/2004/03/040315putin.shtml>

³⁵ Opposing Putin were communist candidate Nikolai Kharitonov, independent candidates Sergei Glazyev and Irina Khakamada, LDPR candidate Oleg Layshkin, and Federation Council Chairman Sergei Mironov, who drew 14, 4, 4, 2, and 1 percent of the votes respectively. Three and a half percent of Russians voted “against all candidates.” U.S.-Russia Business Council Report on Russian Government Recap, March 16, 2004.

³⁶ Russia’s election law requires a 50 percent turnout on the first ballot, in addition to a majority vote for the election, to be considered valid.

Yukos and the Khodorkovsky Affair

It seems useful to look closely at the situation surrounding the arrest of Mikhail Khodorkovsky and the campaign against Yukos in analyzing the future policies in the oil sector. Although publicly some may claim otherwise, no serious observer of Russia believes the arrest of Mikhail Khodorkovsky was anything other than the selective application of Russian law, designed to remove the billionaire from Russian political life and deliver a strong message to Russia's other oligarchs, both inside and outside of the oil industry.

As intended, the arrest and subsequent treatment of Mikhail Khodorkovsky had almost theatrical quality from the onset (theatrical at least for those watching from the outside—certainly not for the figure at the center of the drama).³⁷ In the early morning hours of October 25, 2003, approximately twenty armed, black-uniformed agents boarded Khodorkovsky's private jet and arrested him. Khodorkovsky was put in a cell with five other inmates at the Matrosskaya Tishina pre-trial detention facility. Although his physical conditions were later modified, he has been held in detention for over a year. Several aspects of Khodorkovsky's incarceration violate the European Convention on Human Rights to which Russia is a signatory.

Formally, Khodorkovsky's arrest is linked to the 1996 privatization of the Apatit fertilizer company by Menatep,³⁸ the holding company of which Khodorkovsky is a principal owner.³⁹ Menatep took control of Yukos from the Russian state in the "loan for shares" scheme that financed Boris Yeltsin's 1996 presidential reelection campaign.⁴⁰ In fact, all of the Yukos

³⁷ "Khodorkovsky's lawyers to meet PACE representative," Pravda.ru, <http://newsfromrussia.com/main/2004/05/26/54126.html>

³⁸ Apatit, a major producer of raw materials for phosphate fertilizer enterprises headquartered in the Murmansk region, was privatized in 1994. The government auction to privatize 20% of Apatit was won by Volna, a firm controlled by the Menatep group. According to the tender, Volna paid \$225,000 for the stock and had to invest \$283 million within a year. The regional officials, however, charged that Volna failed to meet its investment obligations. http://iicas.org/2004en/25_03_an_en.htm

³⁹ Group Menatep owns a 44.1 percent stake in Yukos. In 2002, Menatep disclosed that its main shareholders were Khodorkovsky (9.5 percent), Nevzlin (8 percent), Platon Lebedev (7 percent), Vladimir Dubov (7 percent), Mikhail Brudno (7 percent), and Vasily Shakhnovsky (4.5 percent). Another 50 percent is held in trust. Catherine Belton. "No Individual Menatep Owners Left" *Moscow Times*, February 13, 2004.

⁴⁰ Bank Menatep obtained a control stake in Yukos at investment and collateral auctions in 1995. Menatep was nominated an organizer of the loan for share deal and was also a bidder in the auction and investment tender for the 78% stake in Yukos. The three banks who were bidding for Yukos' stake were disqualified from the tender because

officials arrested in 2003-2004 are shareholders in Menatep.⁴¹ Following their arrest, the Yukos Corporation had a large portion of its stock seized by the Russian Prosecutor General's office to cover over \$2 billion in back taxes allegedly owed to the Russian government.⁴²

There are any number of reasons why Putin, or those close to him, targeted Khodorkovsky and his colleagues in Menatep. The arrest of such a prominent a figure could not have occurred without a confluence of factors, some of which are likely to remain hidden. Part of the answer may well lie in the corporate history of Menatep and the fate of early stockholders or silent partners who helped provide the enterprise's start up capital. Some stockholders and silent partners may have felt they sold their "shares" too quickly or at too low a price given their current (not to mention their projected) value after the aborted Yukos/Sibneft merger and possible sale to a Western oil firm. Khodorkovsky also made some powerful enemies in the wake of the August 1998 Russian financial meltdown, when Menatep Bank reorganized its holdings and "freed" itself of debt obligations in a highly selective fashion.⁴³

Further, the reorganization inside the Kremlin may have brought some of these people into prominent positions, but none of these men could have successfully "cashed in their chips" and had Khodorkovsky arrested without the approval of President Putin himself.

The pattern of arrests suggests that Putin's preference would have been for Khordorkovsky to modify his behavior of his own accord. His associates were arrested first and only later, after Khodorkovsky had ample time to permanently leave the country (an option he showed no interest in taking up) was the Yukos CEO arrested. Certainly, none of these arrests could have occurred without Putin's authorization or, at the very least, his tacit consent.

they failed to deposit \$350 million in cash in a special auction account but proposed to pay some part of the sum in state securities. The winner of both the share auction and investment tender for Yukos shares was Bank Menatep. As a result of the investment auction Menatep pledged to invest \$350 million in development of Yukos during the 1996-1999. Kommersant, December 15, 1995.

⁴¹ Platon Lebedev was arrested on July 2, 2003; Mikhail Khodorkovsky – on October 25, 2003; and charges were filed against Vasily Shakhnovsky on October 17, 2003. Russian Petroleum Investor, January 2004.

⁴² Russian Petroleum Investor, January 2004.

⁴³ After the 1998 crisis, Menatep St. Petersburg Bank (a former subsidiary of the Menatep Moscow Bank) received the main assets and the extended network of 42 regional branches established by Moscow-based Menatep. The latter was declared bankrupt by the Moscow Arbitration Court on September 29, 1999 and at the time the bank deposits on 15,000 accounts were estimated at \$50 million. Shcherbakova, Anna. "Bank Menatep St. Petersburg's Fortunes Rise Amid Crisis." St. Petersburg Times, July 6, 1999. Izvestiya, November 25, 1998.

From Putin's point of view, there seem to have been two separate issues: 1) Khodorkovsky's political ambitions, and 2) the evolving international posture of Yukos.

Simply put, the Russian president was not going to allow Mikhail Khodorkovsky to use his personal fortune to seize political power. Once Khodorkovsky implied he intended to do so by seeking to bankroll the election of "like-minded" pro-democratic figures to the Russian parliament, he gave Putin three choices: submit, force him into exile, or jail him. Putin had no interest in submitting and was also smart enough to recognize that even if he outmaneuvered Khodorkovsky in the 2003 parliamentary elections, the disgruntled billionaire would certainly continue to seek ways to use his personal fortune to achieve his desired outcomes throughout Putin's second term as president.

Putin accurately assessed that Khodorkovsky is not a man who accepts defeat. Khodorkovsky preferred jail to exile, as in the months before his arrest there were clear signals from Kremlin circles that leaving Russia permanently was a prudent option.

Putin obviously also wanted to modify some of Yukos' policies and possibly regain control of some of the company's key assets, but the power of the presidency was adequate to forestall the threats that he seems to have believed that Yukos' policies were posing to Russia's national interest. It did not have to include jail time for its management, which is further reason to suspect that the roots of the grievances against the Yukos officials are very deep and do not solely involve oil.

Putin was determined to keep Yukos from setting the priorities in Russia's oil industry. Yukos' ability to do this would have greatly increased had they arranged the sale of 25-40% of their stock to either ChevronTexaco or ExxonMobil. Such a partnership with a western firm would have increased the likelihood that Yukos, rather than the Russian government, would choose the route of the East Siberian pipeline. Yukos' preference was to stretch a pipeline from their oil-fields in Eastern Siberia to Daqing in China rather than the route to Japan via Nakhodka favored

by the Kremlin. If Yukos joined TNK with a foreign partner, the Russian government would lose control of many key decisions in the development of the country's oil and gas reserves.

President Putin was supportive of western investment in the Russian oil industry and actively encouraged the investment of western companies in technologically challenging projects. He was not against western investment in Russian oil firms. He is said to have given BP's president the go ahead for the BP/TNK merger in a personal meeting between the two men. His clear preference, however, was for Russia's policy on partnership with western firms to slowly evolve over time, setting the limits of what was (or was not) possible on a case by case basis through consultation rather than through the decisions of Russia's oil magnates.

Vladimir Putin must also have felt personally offended by Mikhail Khodorkovsky's singular approach to finding a western partner, and the latter's seeming belief that Yukos' assets were his to dispose of as he wished. Prior to Khodorkovsky's fall from grace; the Russian president seemed quite amenable to the merger of Yukos and Sibneft, a merger, which greatly enhanced the value of Khodorkovsky's personal assets.⁴⁴ The merger collapsed after Khodorkovsky's arrest, presumably because Sibneft shareholder Roman Abramovich was pressured by the Kremlin to pullout.⁴⁵ While Yukos management initially fought the unraveling of the merger, they eventually accepted it as a *fait accompli*.⁴⁶

The confrontation between Khodorkovsky and Putin was not necessarily intended as such, but it will undoubtedly serve as is a defining event in the future development of Russia's oil, effectively setting the terms and conditions of future western investment. Once the two men

⁴⁴ In April 2003 the Russian authorities approved the Yukos and Sibneft merger under which Yukos would acquire 92% in Sibneft in return for \$3 billion in cash and 26% of Yukos stock. The merger was completed in October 2003. According to the merger agreement, Yukos purchased 20% minus one share in Sibneft for \$3 billion and another 72% plus one share was swapped for a 26.1% stake in Yukos. As a result, Sibneft shareholders were to control 26.01% in united company Yukos-Sibneft that was expected to start operating on January 1, 2004.

⁴⁵ After Khodorkovsky's arrest, Sibneft's leading shareholders, including founder Roman Abramovich, requested a bigger stake in the merged company than the 26% they had been allocated under the original merger agreement. They also requested greater representation on the merged company's board. Yukos' new management rejected both requests, prompting Abramovich to pull Sibneft out of the merger in December 2003.

⁴⁶ Finally, in early 2004 Sibneft and Yukos' shareholders signed a deal to reverse the merger without any penalties or compensation. The deal about the demerger was struck between Menatep Bank and Millhouse Capital, which represent Yukos and Sibneft's shareholders. Petroleum Economist, no. 3, March 2004, p. 42. Inzhenernaya Gazeta, February 10, 2004, p. 2.

locked horns, there was no reason at all for Putin to hold back and show restraint with regard to Russia's other privately held oil giants, and in fact, pressure on Sibneft, in particular, has increased. Not only will Abramovich be forced to pay a \$1 billion penalty for backing out of the transaction,⁴⁷ but after an audit in December 2003, Sibneft was handed a \$1.5 billion bill for allegedly unpaid taxes dating back to 2000-2001.⁴⁸ Instead of “reforming” Russia’s leading oil firms on a case by case basis, Vladimir Putin choose to engage in a more systemic overhaul of Russia’s oil industry following the 2004 presidential elections.

Vladimir Putin and Russia's Strategic Resources

Putin’s reaction to the oligarchs was not simply visceral although there are certainly primal elements to his response. No president likes to be held in contempt by the country’s leading business figures, especially if these are men who enjoy much more access to and favorable treatment by the western press.

Judging by events and statements, Putin does not believe the oligarchs are acting in Russia’s best interests. The president does not want Russia to fall prey to the “Dutch disease.” Years before the Russian president even knew what the “Dutch disease” was, he believed that it would be a very bad thing for the Russian economy to be dependent on the sale of raw materials (and did not want the Russian state budget to be captive to this as well). This is a view shared by many of Russia’s leading oil-men, but where Putin and the oligarchs part company is in their understanding of how Russia’s dependency on the oil sector is best reduced.

To Khodorkovsky or TNK’s Mikhail Fridman, the transition from a communist state-owned and hyper-centralized economy is best achieved through the turning over of all property to private individuals. This is a position also held by such reformers as Anatoly Chubais, Yegor Gaidar, and Grigory Yavlinsky, all of whom talk about the lamentable and even criminal way, in which privatization was achieved. Not all the reformers are comfortable with the idea that oligarchs should play an active role in politics. In fact Yavlinsky has gone so far as arguing that those who

⁴⁷ See the previous footnote on the demerger. http://www.gateway2russia.com/st/art_207124.php

⁴⁸ <http://www.russijournal.com/news/cnewswire.shtml?nw=42776#n42776>

engaged in “criminal privatization” should be barred from holding public office.⁴⁹ The reformers do, however, share the view of the oligarchs that, in the long-run, the Russian economy will benefit from privatization, as assets held in private hands will generate a more diversified economy and more tax revenue for the state. Reformers and oligarchs alike see the economy in global terms and thus are less concerned with the nationality of the owners.⁵⁰

President Putin most definitely does not share this view. He believes that Russian ownership of Russia’s resource base is critical to Russia’s economic recovery and to the country’s reemergence as an important international actor. Putin does not believe in relying on global market forces to provide the economic opportunities and social supports necessary for the Russian people to make a successful transition from communist rule to a modern, European-style economy and political system. Instead, he believes that premature globalization of the Russian economy will lead to greater hardship for the majority of Russian people and that it will lead to the concentration of vast wealth in a relatively limited number of hands of people with little or no incentive to reinvest in the Russian economy.

Putin has given a lot of thought to these questions. He wrote a candidate of science dissertation on the topic of “Mineral Raw Materials in the Strategy for Development of the Russian Economy” at St. Petersburg’s prestigious State Mining Institute, which, beginning in the 1990s, began to focus on questions of developmental economics and how to introduce western management-style into Russia’s raw material sector.⁵¹

Moreover, Putin published an abstract of his dissertation in the January 1999, “Notes of the Mining Institute,” issue.⁵² Given that Putin was a senior official when he prepared his degree,⁵³ and making moves to be a major national figure when the article appeared, there is real reason to wonder whether Putin was the actual author of both the dissertation and the article. In both

⁴⁹http://www.pbs.org/wgbh/commandingheights/shared/miniextlo/ufd_privatizerussia_full.html#grigoriivlinsky.

⁵⁰ For details see Åslund, Anders. *Building Capitalism: the Transformation of the Former Soviet Bloc*. NY: Cambridge University Press, 2002.

⁵¹ Western corporate partners of the St. Petersburg State Mining Institute include DeBeers (South Africa), Hewlett Packard (U.S.), Analytik Jena (Germany), and Phoenix Geophysics Ltd. (Canada). <http://www.spmi.ru>.

⁵² Putin, Vladimir. “Mineral Raw Materials in the strategy for Development of the Russian Economy.” *Notes of the Mining Institute*, January 1999.

⁵³ See footnote 8.

Soviet and Russian practice, it is common for others to write in the name of leaders. In the current context, however, it is irrelevant as to who was the author of the piece. Whether or not Putin wrote it himself, he obviously authorized its publication in his name and so subscribed to its contents. He endorsed the contents with knowledge of his political future.

In the article, Putin argues that Russia's natural resource base will not only secure the country's economic development but will also serve as the guarantor of the country's international position. Moreover, he argues this quite strongly, in a language that should have served as ample warning for the owners and managers of Russia's privately held oil companies that the state would set the priorities in the oil industry. It is honestly not clear if many of the oil oligarchs took Putin seriously enough in his first years in power to take the time to figure out how the new Russian leader viewed these issues.

Putin argues in the treatise that state planning must be at the core of Russia's resource management. He writes: "The stable development of the Russian economy in the coming years needs to be based on the planned growth of its component parts, including in first place, the potential of its mineral resources ... which will serve as a guarantee of the country's economic security." Putin also argues quite forcefully that Russia cannot simply be an exporter of raw materials but rather, "the development of the domestic processing industry ... is the main source to turn Russia into a leading economic power with a high standard of living for the majority of the population in a relatively short period."

Putin notes that this is not possible without the support of the state or without the development of "large financial-industrial corporations" that cut across economic sectors and "are able to compete on an equal basis with the West's transnational corporations." In order for these firms to be competitive, the state must simultaneously use market means to regulate their development while giving every possible assistance to the development of a mineral processing sector.

As the final section of this paper shows, Putin will take steps to both strengthen and increase the number of state-dominated, vertically-integrated financial-industrial corporations in the oil and

gas sector in the coming year. Critical to this goal is the reorganization of Gazprom (discussed below) and its acquisition of Rosneft. If reform goes well, Gazprom will dominate both the oil and gas sectors, serving as partners for foreign firms in most important projects.

As Putin himself notes in his thesis, despite the country's very rich reserves of natural resources, Russia will be unable "to provide additional significant financial revenue from the country's budget for large state investment in its own processing industry" in the immediate future. Hence, Putin supports the idea of state-sponsored foreign investment in Russia's extractive industries as properly managed large-scale investments, including foreign capital, allow the state to earn hard currency from the export of its natural resources.

For Putin, there is no question of Russia giving up full control: "The Russian mineral raw material complex plays an important role in all aspects of the state's vital functions ... The development of the raw material sector helps form a strong industrial base which is capable of satisfying the needs of both industry and agriculture; it makes an important contribution to the income of the country as its products remain the basic source of foreign currency."

After discussing the importance of the raw material complex in contributing to the country's gross domestic product (GDP) and serving as a major source of employment for whole towns and regions, Putin argues that, "The structural reconfiguration of the national economy on the basis of the country's existing raw materials will be a strategic factor of Russia's economic growth in the near term." As Putin elaborates, the task of this transformation is complicated by the fact that the Soviet oil and gas sectors, which form the basis of the Russian oil and gas industry, were developed in complete isolation from market forces.

To compensate for this fact, Putin argues, there must be a fusion of the state and private sectors, which can be achieved by the creation of vertically integrated financial industrial groups established with the assistance of the state and with the explicit goal of developing Russian firms that are capable of competing on equal terms with western multi-national ones.

In return for state support, these financial industrial groups will have to provide the country with a steady source of mineral resources and products, increase the efficiency of how mineral resources are used, further develop the raw material base, and support and expand the country's export potential, in part by changing its structure in favor of trade in processed and industrial products.

These financial industrial groups will operate within the framework provided by the state, and if they serve the state in this way, they can expect to hold onto their assets. From this list of tasks set for the new financial industrial groups, it is evident that Putin views their control of Russia's assets as a form of guardianship from which the management and "owners" are free to profit. It is also clear that Putin does not understand this *stewardship* as *ownership*, as it is often construed in the West, where owners have full control of their assets and the authority to determine the direction of their firms' development.

Putin goes on to state this rather clearly: "The state has the right to regulate the process of the acquisition and the use of natural resources, and particularly mineral resources, independent of on whose property they are located; in this regard the state acts in the interests of society as a whole, as well as in the interests of private owners whose interests conflict and who need the help of the state organs of power to achieve a compromise."

His treatise and recent presidential actions both show that Putin does not believe in the sanctity of property awarded in the first years following the collapse of the Soviet Union. He views the ceding of control of this strategic sector to private hands as a costly mistake that must be reversed. "At the beginning of market reforms in Russia, the state let go of the natural resource complex for a time. This led to a stagnation of the potential of the nation's natural resources, to a breakdown in the geological sector that had been formed over the course of many decades, as well as having a number of other negative consequences. The pro-market euphoria of the first years of economic reform has gradually given way to a more considered approach, an approach which assumes the possibility of and recognizes the need for the regulating influence of the state on the economy as a whole and on those developing natural resources in particular. There are

many examples of effective state involvement in long-term projects for developing natural resources found in countries with developed market economies.”

Putin blames private ownership of natural resources for the collapse of the sector, and not simply the conditions surrounding the collapse itself. Discussions in other settings make it clear that Putin is less impressed with the efficiencies of Western management introduced by the oligarchs than he is disturbed by what he sees as a pattern of privately owned firms developing current assets to increase the resale value at the expense of reinvestment in their companies.

Putin’s rejection of Western management practices comes without offering any direct evidence to demonstrate that the stewardship exerted by a state controlled sector would be more responsible. Although he does not threaten re-nationalization, his article implies that the state should consider modifying the legal structure that was in place at the time he wrote the article. As the next section discusses, Putin has begun this modification through the overhaul of the licensing of natural resource deposits and the tax structure in general and with relation to the oil industry specifically. In an argument he develops in the next section of the article, Putin argues that a mixed system, with some state and some private ownership, is best for Russia.

“The modern strategy of rational resource use cannot be based exclusively on the possibilities of the market as such. This is particularly true in conditions of transitional [economies]... Even in developed countries the market mechanism does not provide for developing strategies of natural resource use, environmental protection or stable economic security.”

Putin goes on to say that the system of state regulation should give the private investor legal guarantees and financial-credit support, as well as insurance against extraordinary and natural disasters, but the key element is that the state must provide the infrastructure (and information) necessary to support development.

Then Putin elaborates on nine specific strategic tasks for the state vis a vis the management and regulation of natural resources, including:⁵⁴

“--- completing the changeover to a rational combination of administrative and economic [i.e. market driven] means in the state regulation of natural resources

--- creating an efficient system of state organs of management in the area of natural resources, that includes the clear delineation of their functions and base of coordination

--- developing a legal basis for stimulating innovation and investment in the area of natural resource use

--- optimizing the volumes and increasing the diversification of sources of investment in the production, consumption and protection of natural resources

--- developing state regulation of export-import operations in the sphere of natural resources

--- ensuring the delineation of rights and functions of both the federal organs and of the subjects of the Russian Federation in the area of natural resources

In his article, Putin's then notes that these tasks cannot be accomplished all at once, but rather, must be addressed in stages. First, questions of taxation and issues related to licensing of rights to development must be addressed and general order needs to be brought to the legislative foundation that governs the use of natural resources. This, he claims, will provide the criteria and requirements for delineating state and other types of ownership of natural resources, which in turn, will allow the state to strengthen the use of administrative and criminal sanctions for those who violate the law.

⁵⁴ The others are “implementing state support for scientific research [in these areas], creating the conditions for the balanced use of natural resources as the basic factor in the country's stable development --- accounting for regional features in the use of natural resources to improve the functioning of the Russian economy as a whole.”

Thus, Putin's article provides a partial answer to questions of the timing of the Yukos persecutions. In the eyes of the Kremlin, Russia has accomplished sufficient reforms in the legal environment as it affects the oil and gas industry to begin holding private oil company officials more accountable. Or maybe the timing was hastened by political expediency. Private industry was held accountable during the run-up to a critical parliamentary election that Yukos' CEO was seeking to influence, certainly reinforcing the salience of the chosen timeline. If Khodorkovsky had managed to prevent the election of a pocket parliament, then Putin's policy of reclaiming control of the natural resource sector to serve as an engine for economic development would have been at risk.

In the article, Putin casts himself as a defender of private property, but his understanding of market forces is really quite different from that of the oligarchs, who developed Russia's oil industry. Putin's view seems to rest on the creation of a level playing field for all property owners, which he sees as critical if market principles are to operate in the development of Russia's natural resources. He is, however, against a level playing field between private interests and state interests though there is nothing in the article to suggest that the state is exempt from the need for transparency.

Putin also argues that during the first phase, the government must expand the list of resources available for development on a fee basis, as well as use funds collected from this to provide a fund for the protection of natural resources.

He also discusses the priorities of a second phase, which, during his second term as president, he is attempting to translate into policy. In this second phase, a completely unified system of normative and legal guarantees would be developed, the elaboration of the tax system sufficiently completed, and rents fully eliminated. The efficiency of state management of natural resource use would be maximized, and as part of the process, there would be clear delineation of ownership of natural resources between the center and the subjects of the federation, by which the rights of the center would be reaffirmed. In his proposal for constitutional changes that would

return to the president the power to appoint Russia's governors, there is some indication of how Putin intends to achieve this second phase.⁵⁵

Analysis of this article shows the steps that Putin has taken, in recent years, to regulate natural resource development. The article makes an otherwise contradictory series of policies seem much more coherent and well thought out.

Putin Puts His Ideas into Practice

Given Putin's ambitious checklist and the limitations of his power-base at the time he assumed the presidency, it was not until the middle of his first term as president that Putin systematically began to address these goals laid out in 1999. He has continued in a more focused fashion since beginning his second term, though the direction in which he is moving has often sparked more criticism than praise from both foreign and Russian investors.

Over the last four years, Putin has certainly asserted the importance of the oil and gas sector in the Russian economy, seeking to simultaneously increase its attractiveness to foreign investors while enhancing Russian state control.

Two separate documents outlining the country's energy policy have been prepared since Putin took office. Both are titled *Energy Strategy up to 2020* and are designed to supplant the *Energy Strategy up to 2010*, issued in 1995. The first of the "2020" strategies was issued in 2000, and the second in September 2003. These strategic plans encompass oil and gas, as well as coal and hydroelectric power. The 2003 version is a lengthy document that focuses on concrete steps for improving wasteful patterns of usage rather than provide guidance for reorganizing the legal infrastructure governing the energy sector.⁵⁶

⁵⁵ Following the attacks in Beslan, President Vladimir Putin announced plans Monday, September 13, 2004, for a "radically restructured" political system that would bolster his power by ending the popular election of governors and eliminate the party list system in choosing deputies for the State Duma. While these proposed changes were said to be in response to the enhanced terrorist threat that Russia faced, they are consistent with Putin's whole philosophy of government.

Far more important are the actual legislative changes introduced. A new tax system took effect on January 1, 2003, bringing increased coherence to the tax system⁵⁷ in the areas of natural resource development and the export of raw materials.⁵⁸

After Putin's reelection, armed with a more supportive legislature, but one in which private oil interests were still represented, he continued to make more changes.⁵⁹ In the first weeks of this presidency, Putin further streamlined the government in general, as well as with regard to the oil and gas sector,⁶⁰ which had already been modified during his first term.⁶¹ Now, he brought “new blood” from the oil industry into key posts in both the government and presidential administration.⁶²

⁵⁶ A complete text of the Energy Strategy up to 2020 in Russian can be found at <http://www.gazprom.ru/articles/article4951.shtml>

⁵⁷ Amendments to the tax code of Russia were adopted by the State Duma on July 19, 2000 and the Federation Council approved in on July 26, 2000. A new tax regime became effective on January 1, 2003. Extraction and refining companies in Russia are subject to profit tax (which was reduced from 35% to 24% in 2002) and value added tax (VAT) in addition to all specific taxes and allocations established for oil and gas extraction enterprises in the Tax Code the law “Concerning Subsurface Resources,” and other legislative acts. <http://www.garweb.ru/project/mns/nk/10800200/10800200-029.htm>

⁵⁸ In January 2002 a single mineral resources production tax was introduced and three tax payments were rescinded: payment for the use of mineral resources in the course of production (royalty), royalty to reproduce the mineral resources and raw material base, and excise payment on crude oil and gas condensate. The new single mineral resources production tax is based on the amount of crude oil produced from January 1, 2002, through December 31, 2004. From 2005 the production tax will be 16.5% of the oil price. In addition, as noted in fn 26 as of January 1, 2004, the last three domestic off-shores with federal tax concessions. EIU Country Profile Russia 2003 CCPR Analytical Reports, December 20, 2003.

⁵⁹ Several oil business representatives were elected in the Duma in December 2003: former TNK vice president Vyacheslav Timchenko, former Alfa-Group manager Konstantin Vetrov, Alexander Shibalkin from TNK interests; former Yukos board of directors chair Sergei Muravlenko. Lyudmila Maltseva and Valery Prozorovsky from Lukoil interests; Sergei Kaprlov and Liliana Pepelyaeva from Sibneft. CCPR analytical reports, January 18, 2004.

⁶⁰ Putin reduced the number of deputy Prime Minister from six to one and ministerial posts from 23 to 15. The economy ministry now incorporates the Goskomstat, the customs committee, and the energy tariffs commission. The finance ministry has taken over the former tax ministry. The industry and energy ministry now includes the energy ministry, atomic energy ministry, and Russia's space agency. BOFIT Russia Review, April 2004.

⁶¹ Kotov, Vladimir. “Russia's Mineral Resources: Reconfiguration of Institutional Framework.” Paper presented at the International Conference on Natural Assets in the Philippines, January 2003. See also Shevtsova, Lilia. Putin's Russia. Washington, D.C.: CEIP, 2003, pp. 188-190.

⁶² Former deputy Prime Minister Viktor Khristenko was appointed to lead the industry and energy ministry; former governor of Perm Region Yuri Trutnev was appointed the minister of natural resources; former vice-president of the Rosneft Sergey Oganessyan was appointed the head of the Federal Energy Agency. Oganessyan also worked for the Sakhalinneftgaz association before his new appointment. Oksana Polishchuk, “Fradkov makes 12 new appointments,” ITAR-TASS News Agency, March 13, 2994.

With his new leadership in place, Putin sought to accelerate what he saw as reform of the energy sector. In August 2004, the export tariff on oil was modified to make it more market sensitive.⁶³ When plans for it were first announced in March, Finance Minister Andrei Kudrin noted that this would net the Russian government an additional \$10 million per day, if oil sold for \$30 a barrel.⁶⁴ Obviously, the gains resulting from this change far exceed the original goals.

The change in the export tax was part of an election pledge by Putin to raise taxes on oil and gas, in order to create more revenue for stimulating the development of non-resource extractive sectors of the economy. While the revenue base of the Russian government increased, however, neither this policy, nor other legislation, set an actual economic investment strategy in place.

This caused some consternation in Russia's privately-owned oil industry, but the affect of the increased taxes has been muted somewhat by unexpectedly high global oil prices, turning the export-centered larger oil companies as well as the Russian government into potential winners. The high prices, however, did little to mute complaints by Russia's smaller producers, including partly local government owned firms like Tatneft and Bashneft (partly owned by the governments of Tatarstan and Bashkortistan, respectively). These firms are heavily involved in the Russian domestic market and so disproportionately affected by the increase in production tax, while receiving relatively little compensation from rising prices on the world market.

In contrast to smaller, government owned firms, the privately owned Russian oil companies (as well as western and other outside investors) are far more disturbed by changes in how Russian licenses are granted. The latter group was already concerned about changes in the tax structure, which though regularizing and limiting the taxes due, effectively marked the end of prospects for new production sharing agreements. This, in turn, led to reevaluation of the potential profit of

⁶³ In June 2004 Putin announced that effective in August oil companies would pay higher export tariffs whenever the price of Ural crude averaged over \$20 per barrel for two months, a modification of the system of indexing of export duties which was first introduced in June, 2002. "Moscow slaps oil firms with higher taxes," (Copyright © 2004 Energy Intelligence Group, Inc.) *Energy Compass* Friday, May 14, 2004.

⁶⁴ See Appendix 4. Under a flexible system designed by the finance ministry, the export duty will increase with the rise in the price of oil. Kudrin said that at current oil prices this could generate an extra \$3 billion in export duties. Ostrovsky, Arkady. "Russia Pledges to Increase Export Duties for Oil Groups." *Financial Times*. March 23, 2004, p. 6.

firms interested in, or engaged with, the development of Russia's largest and most long-term exploitation projects.

Most disturbing, from the point of view of private investors, is that the Russian government has begun revoking some licenses that do not conform to Russian law. While the newly appointed Minister of Natural Resources, Yuriy Trutnev, promised in March 2004, that “clear-cut principles on the procedure of issuing licenses” will be created in the near future, changes in policy were seen as "clarifying" the situation in ways that would work to the disadvantage of existing investors.⁶⁵ The rights of several important deposits, including a new tender for the rights to Krivishin block of Sakhalin-3 are at risk.⁶⁶

The most publicized case is that of Kovytko gas condensate field, the rights for which are held by Rusia Petroleum, a joint venture of BP-TNK and Potanin's Interros, a project likely to cost \$20 billion to develop fully. This license is at risk because Rusia Petroleum has not made significant progress in developing these fields, but progress cannot be made until the problem of transport of the gas from the fields is solved. BP-TNK would like the gas to be sold in China and South Korea and originally hoped to build their own pipeline to do this. On the other hand, Gazprom does not want its gas transport monopoly threatened, and coincidentally would like to get an equity share in the project in return for transport considerations.⁶⁷

While Putin began the process of recasting the state-owned energy companies in his first term, he is going much further down the road of creating a dominant state-owned national energy

⁶⁵ Licensing for the oil and gas sector is described in the law “Concerning Subsurface Resources.” Under this law licenses may be granted to both Russian and foreign legal entities. In 2003 a working group within the Natural Resources Ministry was formed to do comprehensive checks of the oil and gas companies that have been granted licenses. About 2,600 licenses for development of hydrocarbon field were issued over the last decade in Russia and when the working group completed its investigation in January 2004, it only embraced about 15% of the license agreements. The Natural Resources Ministry officials stated that they were prepared to take licenses for development of oil, gas, and gas condensate fields from oil and gas companies that did not follow the terms of the licenses. Alexander's Gas and Oil Connections. “Russia's Oil Industry is Taking New Shape.” April 2, 2004.

⁶⁶ These include Exxon Mobil's rights to Sakhalin-1, Rosneft's rights to Vankorskoye, and Rosneft and Gazprom's Shtokmanovskoye. In addition Royal Dutch/Shell, Lukoil and Yukos were called in to explain production delays with their Salym, South Khylochuya and Tersko-Kamovsky projects respectively, discussions that were intended to lead to new agreements that would compensate the Russian government for production delays. Russia: Yukos attacks frighten investors (Copyright © 2004 Energy Intelligence Group, Inc.) Energy Compass Friday, July 2, 2004

company during his second. Putin intends for state sector companies to function like the financial industrial groups outlined in his thesis.

Gazprom was the first to come under Putin's scrutiny, and Putin's attempts to recast Gazprom testify to the survival skills of those who dominated the Soviet-era oil and gas bureaucracies. Not only did it take a while to force Gazprom head Rem Viakhirev out and for Putin to begin to put his own people into high ranking posts in the company,⁶⁸ the initial reorganization left Putin's control of this gas giant far from complete. Several linkages between Gazprom and privately held daughter companies were broken, but the partly state-held company was left far from fully transparent.⁶⁹ As a minority share holder, the Russian government could not insure its dominance, and now they promise to eliminate the "ring fence," which limited the amount of shares of Gazprom available to foreigners.

In September 2004, the Board of Directors made a dramatic announcement: Gazprom would merge assets with Rosneft, giving the Russian government a majority stake in the reorganized company.⁷⁰ This merger would also give Gazprom a major stake in Russia's oil industry.

The problem of dealing with Rosneft and Zarubezhneft had been a vexing one. These two fully state-owned companies hold licenses for the Russian state in a number of major projects within and outside Russia.⁷¹ State officials sit on the boards of these two companies, and their corporate management is still heavy with people from the old Soviet oil and gas ministries although increasing numbers of people with some understanding of western management techniques have been appointed.⁷²

⁶⁷ Simon Ostrovsky, "BP Makes Room for Gazprom," *The Moscow Times*, September 29, 2004.

⁶⁸ Alexei Miller replaced Viakhirev as CEO of Gazprom on May 31, 2001.

⁶⁹ See Appendix 3 for Gazprom's shareholder structure.

⁷⁰ RIA Oreanda, September 28, 2004.

⁷¹ Rosneft has a joint-venture with Total and BP, a refinery in Ukraine, a 50% ownership of the Adajsky block in Kazakhstan, a 50% stake in the Yug block in Algeria, and a 45% stake in the Surroiente field in Colombia. Zarubezhneft has extensive operations in Kazakhstan, Turkmenistan, Vietnam, and Syria. www.rosneft.ru; www.zarubexhneft.ru.

⁷² For example, Rosneft's vice-president Sergei Alekseyev graduated from the London School of Economics in 1994.

For now, at least, the issue of Rosneft is decided, and the new oil and gas giant, which still awaits a new name, will both protect Russian government interests in its projects with foreign investors and dramatically increase the role of the Russian government in the production of oil. There is a great deal of speculation as to what assets it will seek to acquire, and many expect it to take a stake in Yukos' Yuganskneftegas, which could be sold to meet that company's outstanding tax bill, especially since the price for the unit is rumored to be well below its market worth.⁷³

There remains the question of whether Gazprom will be able to keep its monopoly on transport, or whether that will go to some new entity created on the foundation of Transneft, to transport both oil and gas. Regardless, Transneft seems unlikely to disappear anytime soon, and the management and bureaucracy charged with oil transport seems to have a better understanding of what is necessary to produce commercial viability in oil transport than their colleagues in the state gas industry.⁷⁴ While Transneft is likely to move into commercial partnership with oil producers for purposes of pipeline construction,⁷⁵ the company will almost certainly remain an instrument of Russian government policy in deciding what routes will be chosen and what oil producers will have preferential access to these routes.

The existence of Transneft, and its role as a mouthpiece of the state (separate from the lobbying that is done by Transneft officials to get the state to embrace decisions that they view as favorable ones) makes Vladimir Putin more amenable to the continued existence of privately owned oil companies, as it creates an easy and effective lever for their management. It is clear, however, that privately owned firms will have to behave differently than they did in the past.

Lukoil, whose state-parcel, 7.59% of shares, was recently sold to ConocoPhillips for \$1.99 billion,⁷⁶ is regularly touted as an example of a good partnership between the private sector and the state. This point was very publicly made when Putin helped inaugurate Lukoil's first gas

⁷³ Erin E. Arvedlund, "Russia to Sell Big Yukos Unit at Low-End Price," New York Times, October 13, 2004, p. w1.

⁷⁴ Gorst, Isabel. "Pipelines and Politics." Paper presented at the U.S.-Russia Energy Summit Executive Seminar at the Carnegie Moscow Center. June 18, 2003.

⁷⁵ For details see company's press releases available at <http://www.transneft.ru/press/Default.asp?LANG=EN&ATYPE=8>.

⁷⁶ http://www.conocophillips.com/news/nr/092904_moscow.asp

station in New York City during his September 2003 visit to the United States.⁷⁷ The Lukoil auction, and the stake on offer, which is rumored to be capped at between ten and twenty percent, is in line with the Russian president's views of optimal collaboration with the West.⁷⁸

With an apparent nod from the Kremlin, Lukoil is also pursuing an aggressive policy to acquire assets in the Persian Gulf, having gained rights to the much sought after A block of a 30,000 square kilometer gas field in the Rub al-Khali desert in the south of Saudi Arabia in March 2004.⁷⁹ Lukoil is also rumored to have gained rights to the West-Kurna oil field in Iraq.⁸⁰ The Saudi acquisition in particular followed a great deal of Russian government lobbying of the Saudi government⁸¹ while Lukoil's putative success in Iraq comes as a result of the Russian government's willingness to forgive \$4.5 billion in Iraqi government debt.⁸²

Conclusion

This paper focuses on Putin's strategy for the development and management of Russia's raw materials and how this may have lead to the eventual arrest of Mikhail Khodorkovsky. To gain insight into Putin's future priorities, this paper also looks at some of the president's key decisions in the past five years, regarding the natural resource sector.

Vladimir Putin aims to maximize the role Russia's oil and gas plays in Russia's foreign policy. He remains eager to have an energy partnership with the United States, to cooperate closely with the Japanese and Chinese, and to work closely with Western European governments and firms on both oil and gas issues but only after he gets his own industrial house in order. These trends toward cooperation will likely increase during Putin's second term in office since Putin no longer

⁷⁷ Johnson's Russia List # 7339, September 27, 2003.

⁷⁸ Lukoil's Vagit Alekperov stated in the last two years that Lukoil could give ten to twenty percent to foreign partners who would be interested in collaborating on the Caspian Project. www.lukoil.ru

⁷⁹ RFE/RL Newswire. March 9, 2004.

⁸⁰ For details see "Lukoil to Stay in Iraq." *Nezavisimaya Gazeta*. March 17, 2004.

⁸¹ Saudi Crown Prince Abdullah Ibn Abdul-Aziz Al Saud visited Moscow in September 2003 where he met with Putin and other officials. His three-day visit resulted in a joint statement on Iraq and a number of cooperation agreements. Closer Rhiyadh. "Saudi Prince's Visit Draws Moscow." *People's Daily*. September 6, 2003.

⁸² The total Iraq's outstanding debt to Russia is about \$8 billion. In December 2003 Russian officials said that Iraqi debt would be reduced to \$3.5 billion if Russia received "beneficial treatment in terms of oil contracts." Zaks, Dmitri. "Russia Willing off Part of Iraq's Debt in Return for Contracts." Agency France-Presse, December 22, 2003.

has to be as concerned with an electorate that might have viewed him as too western-leaning. Putin, however, will only cooperate with the West when he believes that this advances Russia's strategic interest.

Putin's priorities with regard to natural resource development are not the same as those held by most western leaders, nor are they likely to change. Putin believes that in this area, state interests must take precedent over those of individuals or private enterprise. Free markets will not direct foreign policy under a Putin administration. He believes that private property should exist and that the state has to grant property-owners legal protection, but the rights of property are not absolute and do not take priority.

While some of his recent actions may be unpopular in the West, they appear to be very popular at home. The distress over Khodorkovsky's arrest was much greater abroad than it was at home. While westerners saw it as a sign of lack of respect for the rule of law, many Russians saw it as a defense of the law and as a much needed jump-start to restitution for alleged legal malfeasances committed by Russia's largest firms and the billionaires at the helm.

Obviously, Putin and his preferred strategy for resource development is only one factor in decision-making in Russia. While the Russian presidency is becoming more powerful under Putin, it is not becoming all powerful, and much of the future course of relations in the energy sector depends upon what friendships and coalitions the Russian president forms during his second term.

One key question that Putin will have to grapple with rather quickly is whether he pushes for constitutional changes that would extend his term of office.⁸³ If he does, this could introduce some stability in the oil and gas sector, although this might not be good news for western investors. If Putin plans on leaving in 2008, he will become a lame duck quite rapidly in political terms, making it very difficult to predict what comes next. At present, however, there is no

⁸³ Article 81 of the Russian Constitution states that no one may hold the office of President for more than two terms in succession. But the wording of Article 81 does not make it clear if two terms not in succession are possible. The complete text of the constitution in English is available at <http://www.departments.bucknell.edu/russian/const/constit.html>

reason to believe that his successor will be more reform minded than Putin, especially on energy questions. As long as Putin remains in power, it would be a mistake for U.S. firms or the U.S. government to exaggerate how much leverage they have on oil and gas related questions. These questions will be decided with an eye to what it means for Russia's overall economic development and the implications for its international position. The debate over whether the east Siberian pipeline should go directly to China or through Japan highlights this point quite clearly. Nevertheless, the Russian president is going to be a strong decision-maker, managing Russian assets in the name of greater goals, and the only real selling point a foreign actor has is that what he is proposing is not simply good for himself, but good for Russia as well.

Appendix 1: Brief Biographies of Key Figures Discussed

Roman Abramovich, 33-year-old, lost his parents as a child Volga town of Saratov, went first to Moscow to live with his grandparents, and then to the Arctic region of Komi to stay with his uncle, an oil official. After military service, he may or may not have graduated from the Moscow Institute of Oil and Gas. By his mid-20s, he had made a fortune (initially, it is thought, in tires and commodities trading), then graduated from the Moscow State Academy of Law, and was rapidly building a business empire (now including a roughly 80 % stake in the oil company Sibneft, half of the aluminum monopoly RusAl, and a quarter of Aeroflot). An ability to spot opportunities regardless of geography helped, as too may have a willingness to seize illegal opportunities: In his mid-20s, he was supposedly implicated in the seizing of dozens of wagons of diesel oil en route to Kaliningrad. Somehow befriended in 1992 by Boris Berezovsky, then Russia's richest man and now wanted by the Russian police, he shared in some of Berezovsky's big projects, gained other massive holdings, wealth, and also influence in the coterie around President Boris Yeltsin, notably Yeltsin's daughter, Tatiana Diachenko.

By 1995 Abramovich's fortune really took off after having teamed up with Boris Berezovsky to take over oil giant Sibneft at a fraction of its market value. When Berezovsky fled Russia in 2000 to escape fraud charges, he sold out to Abramovich. Now, besides Sibneft, Abramovich has interests in aluminum, TV and automobiles—all held by British-registered Millhouse Capital. He is spending his fortune conspicuously, including \$400 million to buy London's Chelsea football club and some of the world's best players. Moreover, as governor, of the desolate and remote region of Chukotka between 2000 and 2002, he has looked even further eastward, floating the idea of building a hugely expensive 96 km tunnel across the Bering Sea to Alaska. Now, with the purchase of Chelsea, he is heading westward.

http://stk.ruserv.com/people/roman_abramovich.html and
<http://www.gasandoil.com/goc/news/ntr33214.htm>

Boris Berezovsky was born in Moscow in 1947. He got his degrees from the Moscow Forestry Technical Institute and the Department of Mechanics and Mathematics of the Moscow State University. In 1983 he received a doctorate degree and worked in the Management Research

Institute of the USSR Academy of Sciences. He has been involved in private business since 1989. He founded the Logovaz auto dealership and then expanded his business holdings to the media and natural resources extraction industries. In 1995 he joined the Board of Directors of the ORT television network and in 1996 he joined the Sibneft's Board of Directors. Berezovsky served as the Deputy Head of Russia's Security Council and as the Executive Secretary of the CIS under Yeltsin. In 1999, Berezovsky was elected Deputy of the State Duma representing the Republic of Karachaevo-Cherkessia. After the presidential election in March 2000, Berezovsky's relationship with Putin deteriorated. He resigned as the Duma Deputy and in November 2000 he left Russia under threat of arrest for alleged improper financial dealing, in particular the embezzlement at Aeroflot. He was forced to give up his controlling stake in the ORT channel. In December 2000 in New York Berezovsky established the International Foundation for Civil Liberties with the original grant of \$25 million to support Russia's civil society. He is currently in self-exile in London. <http://209.235.228.197/english/bio.htm>

Mikhail Fridman, 39, an engineer turned multi-purpose entrepreneur making money in oil trades and various import-export schemes, grew up in the Ukrainian city of Lvov. Fridman came to Moscow to study at the Institute of Steel and Alloys in the 1980s. He founded Alfa Group in 1988 with a group of college friends. Now it's a diverse conglomerate with oil, retail, telecom and Russia's largest private bank. He has strong Kremlin connections, including a former subordinate who serves as President Vladimir Putin's chief political advisor. Last year he merged his oil company, TNK, with the Russian oil interests of BP, in an \$18 billion deal—quite an achievement, considering that five years ago BP was in a bitter fight against what it claimed were Fridman's unorthodox methods in taking over a partly BP-owned oil field. His fortune is estimated \$5.2 billion.

<http://www.forbes.com/finance/lists/75/2004/LIR.jhtml?passListId=75&passYear=2004&passListType=Person&uniqueId=FND3&datatype=Person>

Vladimir Gusinsky was born in 1952. He graduated from the Moscow Institute of Petroleum and Gas Industry of Gubkin. Then he studied at the State Institute of Theatrical Art. In 1988 he formed a consulting group Most. The banking affiliate of Most Group, the Most Bank, became one of the main depositories for Moscow municipal funds. He also bought a radio and TV

network Echo and NTV, a newspaper Sevodnya and several magazines. In June 2000, Gusinsky was arrested on charges of embezzling millions of government property. He was held for four days before being released. Those charges were later dropped for the lack of evidence. In November 2000 Gusinsky lost control of the Mediya-Most holding company. He said he had been forced to agree to the sale of the company to Gazprom-Mediya, a subsidiary of Gazprom, to which Media-Most was heavily indebted, in return for withdrawal of the charges against him. New charges were brought against Gusinsky in April 2001. He was accused of a role in a \$97 million money laundering scheme. The Russian government filed an international arrest warrant with Interlope. Gusinsky was in Spain at the time the warrant was issued, but the Spanish government declined to extradite him. In August 2003, Gusinsky was arrested in Greece, but then the Greek court has denied his extradition. Gusinsky paid 100,000 euros for his release. <http://www.future-of-russia.org/issues/gusinsky.html> Itar-tass, October 14, 2003.

Mikhail Khodorkovsky was born on June 26, 1963. Having graduated from the Mendeleev Institute of Chemical Technology, Khodorkovsky in 1986 opened his first business, a private café, an enterprise made possible by perestroika and glasnost with partners from Komsomol, and technically operating under its authority. Successful, they also imported computers, other technology, brandy and a wide range of goods to sell at a profit. He proved himself a capable entrepreneur building an import-export business with a turnover by 1988 of 80 million rubles a year or US\$10 million. Armed with cash from his business operations, Khodorkovsky and his partners bought a banking license to create Bank Menatep in 1989. As one of Russia's first privately owned banks, Menatep expanded quickly, by using most of the deposits raised to finance Khodorkovsky's successful import-export operations. By 1990, critics suggest the bank was active in facilitating the large-scale theft of Soviet Treasury funds that went on at the time prior to and following the collapse of the USSR in 1991. Bank Menatep provided the foundation for Khodorkovsky's bidding for Yukos in 1995. Yukos says that approximately US\$1.5 billion has been spent purchasing the assets that now make up Yukos, with a market capitalization of US\$31 billion. When the Russian ruble collapsed in 1998, Bank Menatep collapsed with it as it had borrowed much money in foreign currencies. It lost its banking license. Three banks, the Standard Bank of South Africa, Japanese Daiwa Bank and German West LB Bank, had lent \$266 million to Menatep secured by Yukos shares. Khodorkovsky offered oil instead. They dumped

the shares very quickly, collecting less than half of their loan, prompted in a panic sale by Khodorkovsky's public threats of massively diluting their stake with new shares.

As of 2004, Khodorkovsky is the wealthiest man in Russia, and the 16th wealthiest man in the world, due primarily to his holding in the Russian petroleum company Yukos. On October 25, 2003, Khodorkovsky was arrested at gunpoint on a Siberian airport runway by the Russian prosecutor general's office, on charges of tax evasion. Shortly thereafter, on October 31, the government further took the unprecedented step of freezing shares of Yukos due to tax charges. Khodorkovsky's supporters see the Kremlin's actions against him as retaliation for Khodorkovsky's support of political groups that oppose the government's policies, while opponents believe that he must answer for wrongdoing related to the privatization of state assets during the 1990s. <http://www.nationmaster.com/encyclopedia/Mikhail-Khodorkovsky>

Dmitry A. Medvedev was born on September 14, 1965, in Leningrad. He graduated from the Law Department, Leningrad State University, in 1987. Upon completion of the post-graduate program at the University in 1990, he obtained Ph. D. (Law), and assistant professorship. Medvedev taught at St. Petersburg State University from 1990 to 1999. Between 1990 and 1995 he served as Adviser to the Chairman, Leningrad City Council, and Expert Consultant, Committee for External Relations of the St. Petersburg Mayor's Office. Medvedev was appointed Deputy Chief of Staff of the Government of the Russian Federation in 1999. In 1999-2000 he was Deputy Head, First Deputy Head of the Presidential Administration. He was Chairman of the Board of Directors, Gazprom, from 2000 to 2001, and Deputy Chairman of the Board in 2001-2002. He has been Chairman of the Board of Directors, Gazprom, since June, 2002. Medvedev was appointed Head of the Presidential Administration on October 30, 2003. Dmitry A. Medvedev is married, one son. <http://www.gazprom.ru/eng/print/articles/article8822.shtml>

Alexei B. Miller was born on January 31, 1962, in Leningrad. In 1979, he graduated from high school and became a student of the Leningrad Finance and Economics Institute named after N. A. Voznesenskii. After graduation Alexey Miller worked as an engineer-economist in the general planning division of the Leningrad research institute of civil construction, "LenNIIProekt." In 1986, A. B. Miller became a postgraduate student at the Leningrad Finance and Economics

Institute, and in 1989 he received a Ph.D. in economics. In 1990, he was employed as a researcher at the Leningrad Finance and Economics Institute, and then as head of section of Leningrad City Council Committee on economic reform. From 1991 to 1996, Mr. Miller served in St. Petersburg Mayor's office Committee on External Relations. He was the head of Markets monitoring department at the Foreign Economic Relations directorate. Later, he was head of the directorate, and vice-chairman of the Committee. From 1996 to 1999, Mr. Miller was Director (Development and Investments) at the St. Petersburg Seaport. Between 1999 and 2000 he served as General Director at the Baltic Pipeline System company. In 2000, Mr. Miller was appointed Deputy Energy Minister of the Russian Federation. He is Chairman of the Management Committee of OAO Gazprom since 2001. Miller has been presented with the Merits before Fatherland Award of II degree; the Award of Sergiy Radonezhskiy of II degree of the Russian Orthodox Church and the Patriarch Honorable Award.

<http://www.gazprom.ru/eng/articles/article8603.shtml>

Vladimir Potanin was born on January 3, 1961 in Moscow. In 1983 graduated from the Moscow State Institute of International Relations (specialized in international economy). 1983–1990 worked in the USSR Ministry of Foreign Trade; 1990-1992 president of Interros Foreign Trade Association; 1992-1993 vice-president, president of the Joint Stock Commercial Bank «International Company for Finance and Investments» (MFK); 1993-1996 president of the United Export Import Bank (UNEXIM BANK). From August 1996 to March 1997 he served as First Deputy Prime Minister of the Russian Federation Government. As First Deputy Prime Minister, he supervised economic issues and headed about 20 federal and governmental committees. Between 1997-1998, Potanin was president of UNEXIM BANK and since May 26, 1998 holds positions of the president and the chairman of the board of directors of the Interros Company. He is a member of the Board of the Russian Union of Industrialists and Entrepreneurs (Employers) as well as a member of the RF Governmental Council on Entrepreneurship. Reportedly, he maintains a stable position among 10 top influential Russian businessmen. In June 1999, Mr. Potanin was awarded the honorary diploma of the President of the Russian Federation for the Interros Company's charity projects in the field of art and culture. In May 2002 Mr. Potanin donated personal funds for the purchase by the Russian Ministry of Culture of Kazimir Malevich's painting «Black Square». The masterpiece was included into the permanent

display of the State Hermitage. In January 2002 Mr. Potanin was elected member of the Board of Trustees of the Solomon R. Guggenheim Foundation, where he represents the interests of the Hermitage. <http://nccg.ru/en/site.xp/051055124.html>

Vladimir Putin was born in 1952 in St. Petersburg. After graduation from St. Petersburg State University with a major in civil law in 1975, Putin was recruited by the KGB. After studying espionage and foreign intelligence in Moscow, where he learned German and earned a black belt in judo, Putin began working in counterintelligence. Later he joined the KGB's First Directorate as a foreign intelligence agent. From 1985 to 1990 he worked in East Germany. In 1990, he returned to St. Petersburg to take an administrative post at the St. Petersburg State University. After Anatoly Sobchak's election as mayor of St. Petersburg, Putin was appointed his deputy and served in St. Petersburg's administration 1994-1996. In 1997, Putin was appointed the deputy to the head of the Kremlin property department in Moscow. Boris Yeltsin appointed Putin as chief of the Federal Security Service in 1998. In August 1999, Putin was named a Prime Minister and after Yeltsin's resignation on December 31, 1999 Putin became acting president. Putin won the presidential election on March 27, 2000 and then again on March 14, 2004. www.kremlin.ru

Vladislav Surkov was born on September 21, 1964, in the village of Solntsevo, Lipetsk region. He completed his studies at International University. Starting in mid-80s-early 90s, Surkov ran a number of private organizations and enterprises. Between 1991-1996, he held senior positions at the Menatep Credit and Financial Enterprises Association, later called Menatep Bank. In 1996-1997 Surkov was a deputy head, then head of public relations at Rosprom (closed joint-stock company); first deputy council chairman of Commercial Innovation Bank Alfa Bank. Between 1998-1999, he served as a first deputy general director, director for public relations of Public Russian Television (ORT). In 1999, he was appointed an aide to the Chief of Staff of the Presidential Executive Office. Since August 1999 he was a deputy Chief of Staff of the Presidential Executive Office. In March 2004 he was elevated to the position of a Deputy Chief of Staff of the Presidential Executive Office, and aide to the President. In August 2004, the Kremlin named him to the board of oil products pipeline operator Transnefteprodukt. <http://president.kremlin.ru/eng/subj/22172.shtml> and "Russia: Putin keeps closer eye on oil" (Copyright © 2004 Energy Intelligence Group, Inc.) *Energy Compass* Friday, September 3, 2004

Yuri Trutnev was born on March 1, 1956, in Perm to a family of oil industry workers. Having completed his secondary education in 1973, he entered the Perm Polytechnic Institute, which he finished in 1978 with a degree on mining engineering.

During his practical training in college, he worked at "Polaznaneft" and "Komineft" as an assistant drill-operator, an operator on extraction of oil and gas. Since 1978 he was an engineer and a junior research fellow at the PermNIPIneft. From 1981 through 1988 he worked at the Perm municipal as well as oblast Komsomol committee and oblast sport committee. In 1988 he formed and headed a recreational association called "Kontakt." Since 1990 Trutnev was a Director General of an enterprise "EKS LIMITED;" since 1996 he is a president of a joint stock company "E.K.S. International," which united the enterprises of the group "EKS." In 1994, Trutnev was appointed Chairman of the Committee on Economic Policy and Taxation of the regional Legislative Assembly as well as a deputy of the Perm municipal Duma. In December 1996, he won the elections for the position of Chief of Perm city at the first round. 61.42% of Perm residents who came to the polls voted for Yuri Trutnev. So since December 9, 1995, he is a head of the city of Perm. In December 2000, Trutnev won the gubernatorial elections in the Perm oblast at the first round. 51.48% of Perm residents voted for him. Trutnev is married and has two sons. <http://www.trutnev.ru/biograph.asp>.

Appendix 2: Duma Elections Results

	% of votes won	
	1999	2003
Turnout (%)	61.8	55.5
Major parties		
United Russia	-	37.4
Communist Party	24.3	12.7
Liberal Democratic Party	5.9	11.6
Motherland	-	9.1
Yabloko	5.9	4.3
Union of Right Forces	8.5	3.9
Voting against all party lists	3.3	4.7

Source: PONARS conference report at the Center for Strategic and International Studies, December 12, 2003.

Appendix 3: Gazprom Shareholder Structure Prior to Slated Reorganization

Owner	Share percentage
Government	38.4
Other domestic owners	34.4
Ruhrgas local (including Gerosgaz)	5.5
Gazprominvestholding	4.8
Gazpromfinance B.V.	4.6
Gazfund	4.6
1996 ADR IPO	2
2001 ADR Placement	1.4
Other treasure stock	1.4
Ruhrgas ADR	1

Source: Renaissance Capital Report "Gazprom, Don't Miss It." April 7, 2004.

Appendix 4: Export Duties on Oil

	The old system	Government revenue from export duties on oil	The new flexible system designed by the finance ministry	Government revenue from export duties on oil	Daily average oil exports in 2003
world oil price (\$ per barrel)	export duty (\$ per barrel)	(million \$ per day)	export duty (\$ per barrel)	(million \$ per day)	(million barrels per day)
\$35.00	\$4.50	\$24.30	\$6.50	\$35.10	
\$30.00	\$2.25	\$12.15	\$3.25	\$17.55	5.4
\$25.00	\$1.75	\$9.45	\$2.25	\$12.15	
Sources: EIA annuals reports; Financial Times reports					

Appendix 5: Oil Tax Rates and Off Shores

	Year	1999	2000	2001	2002	2003 (1H)
Company						
Lukoil		15%	32%	31%	29%	19%
Sibneft		3%	10%	15%	12%	5%
Yukos		25%	33%	18%	20%	21%
Official profit tax rate		24%	24%	24%	35%	35%
Source: companies' financial reports; CCPR analytical reports.						
Note that the official tax rate was 35% until 2002 and then was lowered to 24%. Most of the companies never paid the profit tax in full thanks to domestic off-shores, investment privileges under which a company could spend up to 50% of its profits on investment, writing off a large part of the profit as amortization, or reevaluating the fixed assets.						