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## **LOST OPPORTUNITIES: ENERGY AND POLITICS IN RUSSIA**

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## FOREWORD

The rapid expansion of global energy demand, particularly in the developing economies of East Asia, has drawn the world's attention to the vast oil and gas resources of Russia, Central Asia, and the Caucasus. The politics of energy in the former Soviet Union, from Azerbaijan to the Russian Far East, pose tremendous challenges for U.S. policy, U.S. investors, relations among the former Soviet republics and regional powers, and global energy markets. The fate of the energy sector is also intimately tied to the political and economic transitions of the newly independent states. Within the Russian Federation, few issues have been more controversial than the privatization of the energy sector and the opening of natural resources to foreign companies.

In this issue of the *NBR Analysis*, Dr. Peter Rutland, professor of government at Wesleyan University, outlines the post-Soviet transformation of Russia's energy sector and the political factors shaping those changes. In this richly detailed analysis, Dr. Rutland examines the interplay among Russia's energy elite, regional industrialists, and elected officials. Dr. Rutland offers a wealth of information about the actors and the policy decisions motivating the privatization process, the rivalries—both institutional and personal—that have accompanied privatization, and the newly configured oil and gas companies themselves. In the wake of privatization, Russian legislation has failed to encourage greatly needed investment in the energy sector, disabling domestic companies and leaving foreign companies “in the role of patient spectators and petitioners.”

Russia's energy policy affects not only Western and East Asian powers but also the former Soviet Republics, known in Russian terminology as the “near abroad.” Dr. Rutland draws attention to the complex interrepublic relations involved in the transportation of Russia's energy resources. In conclusion, Rutland predicts that the current situation of “stable instability” will persist. He sees no serious challengers to the current political regime and expects foreign trade liberalization to continue. With these factors in mind, Dr. Rutland foresees a slow but incremental rise in Russia's GDP and the gradual opening of projects to foreign investors.

Dr. Rutland's paper is a product of NBR's ongoing research program on the politics and economics of energy in the former Soviet Union. Lead funding for the project was provided by The Henry M. Jackson Foundation and The International Research and Exchanges Board (IREX). In the coming months, this research series will continue with studies examining China's interests in the energy resources of the former Soviet republics, the politics of pipeline projects, and the security issues affecting Caspian energy developments.

Richard J. Ellings  
Executive Director

# LOST OPPORTUNITIES: ENERGY AND POLITICS IN RUSSIA

*Peter Rutland*

## Energy and Economic Growth

The fate of Russia's energy sector is the key to the future of the Russian economy, and perhaps to the very survivability of Russia as a nation-state. In a world with ever-growing energy needs, Russia's energy resources could be the locomotive of growth in its transition to a market economy, and could finance the reconstruction of the outdated industrial dinosaurs inherited from the Soviet Union. Thus, many Western observers eagerly predict an energy-led boom in Russia—once the remaining bricks in the edifice of a market economy are in place. A booming energy sector would generate higher tax revenues and export earnings, while boosting demand for domestic construction and engineering industries.

The political conditions for Russian economic growth look more auspicious than at any time since 1991. The political stand-off between President Boris Yeltsin and the anti-reform State Duma, which led to the bloody confrontation of October 1993, seems to have settled down to a more predictable and civilized pattern. Yeltsin's victory in the June 1996 presidential election should put to rest the idea that Russia could possibly turn its back on liberal democracy and a market economy. Likewise, the privatization program that was launched in 1992 and that transformed 70 percent of the economy from state enterprises into private corporations is essentially irreversible. The dominant figure controlling the bureaucracy throughout this period has been Viktor Chernomyrdin, prime minister since December 1992 and a close friend of the energy lobby. He was joined in March of 1997 by two energetic first deputy prime ministers, Anatolii Chubais and Boris Nemtsov, both of whom are firmly committed to market reform and the promotion of deregulation and increased competition in the energy sector. Polls show Nemtsov as the leading contender to replace Yeltsin in the next presidential election, scheduled for the year 2000.

Ambitious plans for vast new development projects in the Arctic north and offshore Sakhalin Island have been on the drawing board for nearly a decade. However, precious few of these foreign joint ventures have actually broken ground. The political opposition to foreign investment has been daunting, coming not only from communist diehards in the State Duma but also from the managers of Russian energy corporations, at the national and regional levels, who are wary of losing control of their potential riches to foreign companies. In addition, it turned out to

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be impossible to insulate Russia's oil and gas industries from the woes of the economy at large. In fact, many of the contradictions and strains of the declining sectors of the economy have shifted over to the oil and gas industry through a complex web of political and economic interactions. As Russia struggles with the transition from a command to a market economy, a huge contrast has developed between the tremendous potential of its oil and gas industries and the reality of unpaid wages and taxes, declining investment, and slumping production in the energy sector. International energy companies are accustomed to thinking in terms of decades, but even they are having second and third thoughts about whether Russia will ever emerge from its "great depression."

One does not need to be a disciple of comparative advantage theory to realize that Russia—sitting on vast reserves of oil, gas, coal, and hydroelectric power—should, logically, find its place in the global economy as a source of cheap energy. Russia accounts for 13 percent of the world's energy production, third after Saudi Arabia and the United States.<sup>1</sup> It provides 28 percent of the world's output of gas, 12 percent of its coal, and 11 percent of its oil.<sup>2</sup> Energy now accounts for about 20 percent of Russia's GDP. Exports of oil and gas generated \$39 billion in 1996—about 45 percent of Russia's total hard-currency earnings.<sup>3</sup> In 1996 Russia exported about 127 million metric tons of oil, a 3.5 percent rise compared to 1995, and 200 billion cubic meters of natural gas, a 4 percent rise. (Russia's exports were boosted by a 50-percent increase in the world oil price.) Many of Russia's other exports, such as chemicals and metals, are only profitable thanks to the availability of cheap energy. Exports have risen every year since 1992 (although they dipped in the first half of 1997), and Russia has been running a trade surplus of about \$15 billion a year—a paradoxical accomplishment in an economy that has shrunk by nearly half over the past six years.

During the transition to a market economy, the share of energy in the country's GDP and in exports has risen steadily. At the same time, however, output of oil has fallen to half the level of the 1987 peak, natural gas output has leveled off, and investment has dried to a trickle. This paper explores the reasons why Russia is failing to realize its energy potential, and examines the cross-cutting interests and competing political and economic logics (domestic and foreign) that hamstringing its energy companies and leave foreign companies in the role of patient spectators and petitioners.

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*Although the command economy was able to bring about a massive expansion of energy output, this came at the price of colossal waste and inefficiency. These distortions rippled through the entire economy, and were hard-wired into the infrastructure of plants and pipelines that Russia inherited in 1991.*

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This pattern of lost opportunities did not suddenly appear in Russia in 1991: as Thane Gustafson noted a decade ago, the dominant characteristic of the energy sector in Soviet times was that of "crisis amid plenty."<sup>4</sup> Although the command economy was able to bring about a massive expansion of energy output, this came at the price of colossal waste and inefficiency. These distortions rippled through the entire economy, and were hard-wired into the infrastruc-

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<sup>1</sup> *Energy Policies of the Russian Federation*, International Energy Agency, Paris, 1995, p. 6.

<sup>2</sup> ITAR-TASS, March 26, 1996.

<sup>3</sup> Peter Rutland, "Another Lost Year for the Russian Economy," *Transition*, OMRI, vol. 3, no. 2 (February 7, 1997), pp. 78–81.

<sup>4</sup> Thane Gustafson, *Crisis Amid Plenty: The Politics of Soviet Energy Under Brezhnev and Gorbachev*, Princeton, Princeton University Press, 1991.

ture of plants and pipelines that Russia inherited in 1991. Some of these distortions have been eased with the gradual emergence of market-like institutions (such as prices that are starting to respond to supply and demand, and the gradual introduction of property rights). But many of them are still in place, and have been joined by new distortions of the market transition, such as the intense (and at times violent) struggle for control over the stream of energy revenues.

It is not only Russia that faces the paradox of poverty amidst plenty. While energy resources have led to prosperity for countries from Kuwait to Norway, other countries have discovered that a rich endowment in energy reserves may be a burden as well as a blessing. The development of energy resources in an otherwise underdeveloped economy typically leads to a tremendous concentration of wealth and power, and is often accompanied by the rise of corrupt, authoritarian regimes. (Witness the petro-dictatorships of Nigeria, Libya, Algeria, and the Persian Gulf.) In such situations, few of the benefits of the oil riches trickle down to the poor; instead they are spent on equipping armed forces to keep the population in check. Even if this grim scenario is avoided, the very promise of natural resource revenues may serve to distort economic decision-making, leading elites to believe that their country can, to a degree, “opt out” of the global economy by trying to protect its manufacturing industry—while continuing its mineral exports. In the 1960s Brazil tried to pursue such a protectionist path, using the revenue from its mineral wealth to develop domestic industries that were shielded by high tariff barriers. Even in developed economies, the discovery of oil riches can have perverse effects. The high profitability of the energy sector may drive up interest rates and wages, pricing domestic manufacturers out of business (the so-called “Dutch disease”).

Russia seems to have avoided the worst of these fates, thus far. Unlike Turkmenistan (and perhaps Azerbaijan), it has steered clear of petro-dictatorship. Some traces of the Dutch disease may be present in the Russian economy—but it is hard to say, because so many additional factors have been causing a shortage of capital and sky-high interest rates. There is a strong and vocal lobby for Brazil-style protectionism. This lobby argues that the profits from oil and gas exports should be used to reequip Russia’s high-tech industries, and prevent the “Kuwaitization” of the economy and the conversion of Russia into “a raw materials appendage” of the West.<sup>5</sup> However, this lobby—most vocally represented in the State Duma—has largely failed to influence government policy, which has generally followed the path of trade liberalization. Nevertheless, Russia has thus far failed to realize the tremendous potential of its energy wealth. Energy output is static or falling, and the dearth of new investment means little prospect of a radical turnaround in the near future.

### **From Plan to Market**

As the command economy broke up, most of the ministerial bureaucracies that ran Soviet energy industries were simply converted into legally independent but state-owned corporations—the coal ministry became Rosugol, the electricity ministry—Unified Energy System, and the gas ministry—Gazprom. The oil industry, however, was split into a dozen independent holding companies.

#### ***Gazprom: Economic Power and Political Influence***

Gazprom is the most striking example of corporate continuity. It has survived the turbulence of market transition intact, with a monopoly on the production and distribution of gas.

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<sup>5</sup> Vladimir Sanko, “The results of Western experts’ consultations,” *Nezavisimaya gazeta*, June 24, 1997, p. 4; interview with Arkadii Volskii in *Rabochaya tribuna*, May 8, 1997, p. 1.

Gazprom avoided the fragmentation of the oil industry mainly because its operations were concentrated in a handful of major deposits. In 1996 Gazprom had sales of 116 trillion rubles (\$20 billion), and pre-tax profits of 45 trillion rubles. By June 1997, its market capitalization was \$16.5 billion.<sup>6</sup> Its annual output of 600 billion cubic meters makes it the largest gas company in the world (Shell is a distant second, with 72 billion cubic meters per year).<sup>7</sup> Gazprom has 49 trillion cubic meters of gas reserves, compared to Iran's 21 trillion. One third of its output is exported—half to Western and Central Europe, and half to the CIS. It supplies 20 percent of the gas consumed in Europe through two pipelines across Ukraine. Gazprom is the second largest company in Russia: only the electricity monopoly Unified Energy System is larger (with annual sales of about \$35 billion).

Gazprom's economic muscle is more than matched by its political influence. As the saying goes, "It is hard to say where Gazprom ends and the Russian state begins." Prime Minister Viktor Chernomyrdin previously served as Soviet oil and gas minister and in 1989 oversaw the creation of the "state concern" Gazprom, which became a joint stock company in 1992. Some 35 percent of Gazprom shares were sold for vouchers to workers and residents in gas-producing regions, but the current list of shareholders is not published so it is hard to know exactly who owns the company.<sup>8</sup> The state holds 40 percent of Gazprom shares, which have been managed "in trust" by Gazprom president Rem Vyakhirev since 1994. Vyakhirev has rebuffed reformist efforts to liberalize Gazprom—most recently the attempts of First Deputy Prime Minister Boris Nemtsov in spring 1997. As Vyakhirev once remarked, "Anybody who comes to power is going to have to manage to live with Gazprom, because without Gazprom, they won't manage at all."<sup>9</sup>

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*[Prime Minister] Chernomyrdin persuaded the government to adopt a strategy of giving natural gas priority in the allocation of investment resources over the next 10 to 15 years to increase domestic reliance on natural gas consumption.*

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Gazprom is hopeful that the low cost and cleanliness of gas as a fuel will enable the company to boost production by 50–100 billion cubic meters over the next 10–15 years. To reach this goal, Chernomyrdin persuaded the government to adopt a strategy of giving natural gas priority in the allocation of investment resources over the next 10 to 15 years to increase domestic reliance on natural gas consumption. The scarce investment resources would be steered into Gazprom, whose production could be maintained and even expanded while the more costly and inaccessible oil fields were developed. To finance investment, in 1992 Gazprom was allowed to set aside some of its earnings in a tax-free "stabilization fund"—worth an estimated 1 trillion rubles (\$500 million) in 1993. However, the IMF made abolition of the stabilization fund one of the conditions of the \$10.1 billion loan it granted Russia in March 1996.<sup>10</sup> The government gave in to IMF pressure and abolished the fund in April 1996, but took other steps to compensate Gazprom, such as cutting the duty on pipe imports and lowering the gas excise duty. Gazprom appears to be weathering these storms well.

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<sup>6</sup> *Kommersant Daily*, June 19, 1997, p. 1.

<sup>7</sup> *Financial Times*, June 10, 1997, p. 9.

<sup>8</sup> *Moskovskie novosti*, November 13, 1994, p. 29; Yurii Rytov, "Gazprom owns Russia's gas, but who owns Gazprom?" *Ogonek*, no. 49 (December 1995), pp. 22–23.

<sup>9</sup> Claudia Rossett, "Big Gas Firm Proves a Liability for Yeltsin," *Wall Street Journal*, March 5, 1996.

<sup>10</sup> Reuters, March 27, 1996.

In October 1996 Gazprom shares were quoted on the London Stock Exchange and Western investors were offered \$429 million worth of shares—in the form of American Depositary Receipts (ADRs)—in the firm. (Several oil companies have since issued ADRs, including LUKoil, Surgutneftegaz, Tatneft, and Chernogorneft.) In 1996 Gazprom managed to invest 33 trillion rubles (\$6 billion), starting work on: (1) a new \$2.5 billion pipeline to carry 40 billion cubic meters of gas a year 1,200 kilometers from the Yamal peninsula to Germany; (2) a new north-south line inside Russia to carry gas to Stavropol; and (3) a new program for introducing gas lines to rural regions in central Russia.<sup>11</sup> In March 1997 Gazprom began selling off 8 percent of its shares for cash. Gazprom also has spread its might into the financial arena: it formed Imperial Bank jointly with LUKoil; controls Mosbiznesbank and Gazprombank; and has bought into Rossiiskii Kredit and Vneshtorgbank. Gazprom has friends in all the right places: the former deputy head of Imperial Bank, Sergei Dubinin, was appointed Chairman of the Central Bank of Russia in 1995.

### *Division of the Oil Industry*

The privatization of the oil industry took a very different path from that of Gazprom. In November 1992, its 40 extracting companies and 28 refineries were divided between about a dozen legally independent holding companies. Most of these were vertically integrated companies that included extracting and refining operations, usually with a primary base in a single region.<sup>12</sup> (See Appendix I.) The division of the oil industry was also a product of the enthusiasm of local elites to control their own regions' oil fields, which found expression in the initial stage of so-called "spontaneous privatization." In 1993 the oil pipelines were divided between two 100-percent, state-owned companies, Transneft (crude) and Transnefteprodukt (refined products). The ownership structure of the industry remains murky, since the new companies have been busy swapping shares and forming and reforming subsidiary companies. Initially, the state held 45–51 percent of the shares in each company. The remainder of the shares was to be sold in investment tenders and voucher auctions, with a small proportion reserved for workers and regional governments. Foreign ownership was limited to a maximum of 15 percent of each company (although such limits have proven difficult to enforce).

Although the oil industry was initially exempted from the 1992 mass voucher privatization program, the oil companies later agreed to sell 20 percent of their shares to citizens for vouchers.<sup>13</sup> Since then, privatization of the sector has continued on an ad hoc basis by presidential decree. The parliament, dissatisfied with the results of the 1992 program, was keen to tighten public control over the process. In June 1997 the Duma approved a new privatization law that bars loan-share auctions, tightens control over the fulfillment of investment promises, and creates a list of strategic enterprises that can only be privatized with a special federal law.<sup>14</sup> As a result of the privatization efforts, the largest oil companies are LUKoil (producing 17.4 percent of Russia's oil output in the first four months of 1997), YUKOS (11.6 percent), Surgutneftegaz (11 percent), Tatneft (8.1 percent), and Sidanko (6.7 percent).<sup>15</sup>

LUKoil had net earnings in 1996 of \$8.6 billion and a market capitalization in December 1996 of \$7.52 billion.<sup>16</sup> The company maintains close ties to the government, for which it has been rewarded with a leading role in the international consortia that are developing and exporting oil

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<sup>11</sup> Interview with Gazprom president Rem Vyakhirev in *AiF-Interfax*, June 30, 1997, p. 3; *Interfax*, April 18, 1997.

<sup>12</sup> P. Zhuravlev, "The government has decided to manage the oil industry," *Segodnya*, September 21, 1994, p. 1; Vladimir Kolossov, Aleksei Krindach, and Rostislav Turovskii, "The Situation in Russia's Fuel and Energy Complex," in Klaus Segbers and Stephan De Spiegeleire (eds.), *Post-Soviet Puzzles*, Baden-Baden, Nomos, 1996, vol. 3, ch. 15.

<sup>13</sup> *Ekonomika i zhizn*, no. 51 (December 1992).

<sup>14</sup> *Kommersant Daily*, June 25, 1997, p. 1.

<sup>15</sup> Russia's total output was 100 million tons in those four months. *Interfax*, June 17, 1997.

<sup>16</sup> *Interfax*, April 18, 1997.



from Kazakstan, the Caspian basin, and even Iraq.<sup>17</sup> In September 1995 LUKoil began selling 15 percent of its stock in the form of convertible bonds, raising \$500 million. The U.S. firm ARCO bought 8 percent of the convertible bonds and saw the price triple in 18 months.<sup>18</sup> In September 1996 LUKoil created a joint venture with ARCO (with a 54 percent stake held by LUKoil), through which the American partner plans to invest more than \$4 billion in the companies' joint operations in Kazakstan and the Caspian.<sup>19</sup> YUKOS also began seeking a Western partner, setting up a joint venture with AMOCO in April 1996 to export oil from the Priobskoe field.

Another major shake-up in the oil industry came in late 1995, when several leading producers were among the 29 firms chosen for the controversial "shares-for-loans" scheme. Under the arrangement, reportedly devised by Oneksimbank president Vladimir Potanin, blocks of shares were to be auctioned off in return for cash loans. At the end of a year, if the government did not repay the loan, the lender could sell the shares. By avoiding outright sale, it was hoped that the plan would dampen the criticism from opponents of privatization in the Duma. Alas, the plan backfired. The auctions caused a storm of controversy since they seemed to be dominated by insider dealing.<sup>20</sup> In most cases the "winning" bids were made by the same bank that had been given the job of running the auction, and typically the bid was only a few hundred thousand dollars above the minimum reserve price.

### ***Oil and the Bankers***

In the 1995 shares-for-loans auctions, Oneksimbank received 51 percent of Sidanko for \$125 million, while Menatep Bank, through an intermediary, secured 78 percent of YUKOS—45 percent in return for a \$160 million loan and 33 percent through an investment tender. (Bear in mind that YUKOS has sales of over \$3 billion a year.) Menatep and Stolichnyi Bank helped Boris Berezovskii's National Oil Corporation win 51 percent of Sibneft.<sup>21</sup> (Berezovskii is a former academic who made a fortune from a car dealership and trading company, LogoVAZ).<sup>22</sup> Imperial Bank, which was founded by Gazprom and LUKoil, acquired 5 percent of LUKoil shares for a mere \$43 million (the market value was estimated at over \$500 million). In the auction of 40 percent of Surgutneftegaz, a bid from Rosneft was disqualified and the Surgut pension fund was declared the winner.

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<sup>17</sup> Mekhman Gafarly, "The Caspian's status as a lever of influence," *Nezavisimaya gazeta*, December 6, 1995, p. 3; Georgii Bovt and Stanislav Tarasov, "Iraqi oil may drown out Caspian," *Segodnya*, June 6, 1997, p. 1.

<sup>18</sup> The convertible bonds were bought for \$250 million and could be exchanged for 6.3 percent equity stake in LUKoil. Natalia Gurushina, OMRI Daily Digest, March 27, 1996.

<sup>19</sup> *Kommersant Daily*, September 20, 1996, p. 1.

<sup>20</sup> Aleksandr Protsenko, "Mortgage auctions," *Obshchaya Gazeta*, no. 1 (January 1996), p. 6; Craig Mellow, "Russia's Robber Barons," *Fortune*, March 3, 1997.

<sup>21</sup> Aleksei Fomin, "Sibneft held hostage," *Rossiiskaya gazeta*, June 14, 1997, p. 6.

<sup>22</sup> Alessandra Stanley, "A Russian's Sprint from Car Dealer to Tycoon," *New York Times*, June 14, 1997.

Rival banks that had been excluded from the auctions protested and filed lawsuits, while the Duma set up a commission to investigate the legality of the auctions. Some of the winners in these auctions had problems asserting their ownership rights and gaining seats on the board of directors in the face of opposition from incumbent managers and local politicians. However, the banks that had won control of three of Russia's top oil companies thrived, and used some of the profits from their new acquisitions to bankroll President Yeltsin's reelection campaign in 1996 (which by some accounts cost \$100 million). In return, some bankers were rewarded with top government posts later that summer. Vladimir Potanin, the head of Oneksimbank and the man credited with inventing the shares-for-loans scheme, became deputy prime minister in charge of macroeconomic policy; and Boris Berezovskii was appointed deputy secretary of the Security Council and put in charge of negotiations with Chechnya.

A year or so later the whole murky process was repeated, as the banks holding the shares had the option of taking over ownership, given that the government did not repay the "loans." In January 1997 Interros-Oil, an Oneksimbank subsidiary, won 51 percent of the shares in Sidanko with a bid just \$1 million above the minimum price of \$130 million (plus a pledge to invest \$161 million in the company). In May 1997 a firm close to Berezovskii was allowed to buy the Sibneft shares held in "trust" since 1995. It was reportedly this transaction that led to a falling out between Berezovskii and Potanin, setting the scene for a blistering fight between their rival banking groups that broke out in July 1997.

In March 1997 Yeltsin tapped the youthful governor of Nizhnii Novgorod, Boris Nemtsov, to join the government as first deputy prime minister responsible for reforming housing and social policy and tackling the "natural monopolies" (oil, gas, electricity, telecom, and railways). Nemtsov personally took over as minister of fuel and energy, and appointed a close associate, Sergei Kirienko, as deputy minister. Anatolii Chubais meanwhile continued as first deputy prime minister in charge of macroeconomic policy (and minister of finance). Chubais and Nemtsov were determined to open up the oil and gas corporations to more competition—and to press them to make good on their tax and wage arrears. Although the actions of the Chubais-Nemtsov team might seem to amount to a direct attack on Chernomyrdin's cherished energy lobby, the prime minister insists that his government is a unified team. Chernomyrdin's style is to avoid open confrontation and seek compromise behind the scenes, in the process gradually bringing others around to his position. This tactic seems to have worked with Chubais and Nemtsov, whose reformist rhetoric progressively eased over the course of 1997.

In mid-1997 the revitalized government launched a new wave of oil industry privatization, mainly as a way of raising money to plug the yawning budget deficit. State-owned shares in a half dozen oil companies were auctioned off to the highest bidder. On July 18, the Alfa banking group (which had failed to win a piece of the oil industry in the first wave of auctions) was able to secure a 40 percent stake in the Tyumen Oil Corporation (TNK) for \$810 million.<sup>23</sup> Their bid was much larger than the starting price of \$160 million—which was in sharp contrast to the 1995 share auctions, when the winners typically offered only slightly above the minimum price. TNK controls the Samotlor field, which pumps \$1.8 billion worth of oil per year, but TNK's Nizhnevartovsk oil extracting company is in financial crisis, owing 1 trillion rubles (\$160 million) in federal taxes. Some of Alfa's money will be used to pay off these debts. Despite this, the sale of TNK to Alfa was bitterly opposed by TNK's management and by local Tyumen officials, who unsuccessfully tried to stop the auction in court. They received backing from national oil industry leaders, who have struggled to limit the invasion of their industry by Moscow-based financial groups. Vladimir Medvedev, the president of the Union of the Oil and Gas Industry, complained

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<sup>23</sup> *Kommersant Daily*, July 22, 1997, p. 1; Tatyana Lysova, "The second oil war," *Ekspert*, June 30, 1997, pp. 22–24; Aleksander Novikov, "There will be no winners," *Kommersant Daily*, July 8, 1997, pp. 9–10.

of “a dictatorship of reformers” waging a struggle to eliminate the “Industrial Party” (a reference to Stalin’s purge of industrialists in 1929). Medvedev argued that “the professionals who today are running our industry, who despite all our financial confusion are managing to keep their enterprises afloat, are now being subjected to persecution and replaced by amateurs.”<sup>24</sup>

Nevertheless, later in 1997 shares in another five oil firms with 18 percent of Russia’s oil production are due to go on the auction block, along with an additional 49 percent of TNK and 66 percent of the shares in Rosneft, and are expected to raise \$1.5 to \$2 billion.<sup>25</sup> The other firms to be sold are Komi-TEK, East-Siberian Oil and Gas, NORSI-oil, Eastern Oil Company, and the Siberia-Urals Company. Rosneft is the biggest prize: although it is only the sixth largest company in terms of current output, it has a 40 percent stake in Sakhalin I, a 7.5 percent stake in the Caspian Pipeline Consortium, and a 20 percent stake in the giant Timan-Pechora field (a \$20 billion project).<sup>26</sup> In April 1997 Rosneft director Vladimir Putilov was fired for trying to defend the company’s independence from the government, and was replaced by former fuel and energy minister Yurii Besspalov. The dismissal drew protests from governors of Sakhalin, Khabarovsk, and Yamal-Nenets Autonomous Okrug.<sup>27</sup>

### Interest Groups and the Policy Process

Russia has not yet constructed a fully market-driven economy. Despite the progress made towards marketization, economic decisions still tend to be mediated through bureaucratic and political transactions.<sup>28</sup> The industries of the old Soviet economy were grouped into powerful blocks: the agro-industrial complex; the military industries; the fuel and energy lobby; and the metals industry.<sup>29</sup> To these could be added other individual industries such as construction, automobiles, and chemicals.

Since 1991, one after the other of these pillars of the old Soviet economy have collapsed. Energy is the only one of the old power blocks that has increased its share of GDP: although energy-sector output has declined in absolute terms, GDP decline has been even faster. (Some branches of the metallurgy complex have also done relatively well.) The military-industrial complex used to account for perhaps 25 percent of Soviet GDP (including spending on the armed forces), and has now sunk below 5 percent. Arms exports are running at about \$3 billion a year—less than one tenth the level of energy exports.<sup>30</sup> Russian farmers saw the share of federal spending allocated to agriculture decline from 12 percent in 1991 to 3.8 percent in 1996, when it dipped to 11 trillion rubles (\$2 billion). These subsidies cover only 8 percent of total costs.<sup>31</sup>

### *The Energy Lobby*

The small team of liberal reformers who were thrust into power by the failed coup of August 1991 were keen to break the power of the fuel and energy lobby and to force them to privatize their industries and liberalize their trading practices. The price liberalization of January 1992 and the lifting of most restrictions on exports greatly benefited the energy lobby. Energy prices

<sup>24</sup> *Ekspert*, July 6, 1997, p. 5.

<sup>25</sup> Interview with Deputy Fuel and Energy Minister Sergei Kirienko by Andrei Serov, “Who has the oil has the north of the country,” *Finansovye izvestiya*, July 3, 1997, p. 1.

<sup>26</sup> *St. Petersburg Times*, June 27, 1997, p. 2.

<sup>27</sup> Interfax, May 5, 1997.

<sup>28</sup> Simon Kordonskii, “The Structure of Economic Space in Post-Perestroika Society,” in Klaus Segbers and Stephan De Spiegeleire (eds.), *Post-Soviet Puzzles*, *op. cit.*, ch. 5.

<sup>29</sup> Yakov Pappé, “Fuel and Energy Complex Elites,” in Klaus Segbers and Stephan De Spiegeleire (eds.), *Post-Soviet Puzzles*, *op. cit.*, ch. 15.

<sup>30</sup> *Izvestiya*, July 31, 1997, p. 2.

<sup>31</sup> Rutland, “Another Lost Year for the Russian Economy,” *op. cit.*

started to rise more quickly than other commodity prices, reflecting the fact that energy was absurdly underpriced in the Soviet economy (at less than 5 percent of the world level). In the spring of 1992, the government came under tremendous pressure from farmers and industrialists to slow the rate at which domestic energy prices were increasing in order to prevent the collapse of those sectors of the economy.<sup>32</sup> By maintaining high export duties, they were able to shield domestic manufacturers to some extent from the impact of price liberalization, and at the same time raise revenue for the federal budget. The government also maintained a system of export quotas (partly through allocating access to pipelines) which enabled them to reward favored firms.

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A protectionist alliance might have been forged between energy exporters and domestic engineering plants—energy export liberalization in return for high import tariffs on manufactured goods. Such an “oil and machinery” coalition was held at bay, in part due to pressure from international financial institutions that made trade liberalization a key condition for the release of loans to the Russian government. However, the main reason such a coalition did not emerge was the contrary economic interests of the two sides. The energy producers preferred to export their oil and gas to foreign markets, where they could charge close to the world price; domestic industrialists wanted to continue buying energy at less than the world price. Second, the agrarians and many industrialists, particularly in the defense sector, were heavily dependent on budget subsidies—while the energy and metals producers had an independent source of income from exports, and were massive donors to the budget.

The larger and more farsighted energy companies, such as Gazprom and LUKoil, realized that the complete collapse of large chunks of the Russian economy would not be in their interest. These companies saw themselves as economic actors on the national and international stage, in contrast to more regionally rooted companies such as Tatneft in Tatarstan. Tatneft is also interested in selling its oil abroad and attracting foreign investment, but it is controlled by republican leaders whose goal is political stability and economic growth for Tatarstan. By and large, however, the energy industrialists cut loose from their fellow managers in other sectors and made a few, almost token, concessions to easing their plight in the interest of social stability. In spring 1993, for example, the government persuaded some oil companies to deliver fuel to farms on credit—knowing that there was little chance that the farms would repay these debts. Some oil firms, such as LUKoil and YUKOS, complied, expecting to receive favors from the government at some point in the future.<sup>33</sup> Similar exercises have taken place in each successive year.

While the energy lobby abandoned its former comrades in machine-building and agriculture, it found new allies in unlikely places among the rapidly emerging banking community and in the elite class of urban consumers who insisted on the right to buy foreign imports (goods

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<sup>32</sup> Interview with Anatolii Dolgoplatov, president of the League for Assistance to Defense Enterprises, by Svetlana Novikova; “Defense industry managers seek levers of influence,” *Rossiiskie vesti*, May 14, 1997, p. 1. On the agrarian position, see interview with Deputy Prime Minister Viktor Khlystun, *Moskovskii komsomolets*, May 21, 1997, p. 2.

<sup>33</sup> *Finansovye izvestiya*, April 1, 1997, p. 2.

that were not only higher quality, but in many cases cheaper than their Russian counterparts).<sup>34</sup> Some Russian industries, such as the automobile industry, managed to survive thanks to the preservation of import tariffs, but most sectors, from textiles to electronics, were devastated by the reduction of tariff barriers and an influx of imports.

The oil lobby did not have things all its own way, however. It found itself under attack from two opposing fronts—from market reformers who wanted further liberalization and an end to the industry's special privileges, and from domestic industrialists who wanted more controls on the energy sector. Also, many of the new banking groups who were the oil lobby's allies when it came to trade liberalization turned into bitter enemies, as the bankers sought to win control over oil companies when the state began to sell off blocks of shares. Although Prime Minister Gaidar was pushed out of office in 1992, a handful of liberals soldiered on under Prime Minister Chernomyrdin. The most notable figure was St. Petersburg economist Anatolii Chubais, who orchestrated the 1992 privatization program and then took over as first deputy prime minister with responsibility for economic policy in November 1994. Chubais was balanced in the government by fellow first deputy prime minister Oleg Soskovets, a conservative manager with close ties to the metals and military industries. Oleg Davydov, the minister of foreign economic relations in 1994, was opposed to further trade liberalization, a position that drew strong support from the newly elected State Duma. However, real power lay with President Yeltsin and Prime Minister Chernomyrdin, who remained committed to moderate reform. Conservative ministers did what they could to delay and sabotage liberalization measures. After two years of political stalemate, oil and gas export quotas were lifted in July 1994, and the system of special oil exporters (which served as a surrogate quota system) was abolished in March 1995. Many export duties were cut in the fall of 1995. The government repeatedly promised, but then postponed, lifting all export duties on oil and gas.

### ***Macroeconomic Stabilization***

While the energy lobby generally benefited from liberalization, it had little interest in macroeconomic stabilization. On the contrary, the depreciation of the ruble between 1992 and 1994 meant that domestic oil production costs shrank relative to export revenues, boosting profits. In late 1994 the government made its third attempt to introduce macroeconomic stabilization, stopping the printing of excess money and narrowing the fiscal deficit. This time, it stuck. Inflation came down, from 215 percent in 1994 to 131 percent in 1995 and to 22 percent in 1996. In July 1995 the Central Bank introduced the "ruble corridor," declaring its intention to intervene in currency markets to maintain the ruble's value within certain parameters. The policy was successful, and even produced a real appreciation of the ruble in 1995–96. Exporters complained that by slowing the depreciation of the ruble, the corridor made exports less profitable—yet the figures show that exports continued to rise, both in terms of volume and value. In July 1996 the Central Bank switched to an inclined corridor (akin to a crawling peg), under which the ruble is allowed to gradually depreciate in line with domestic inflation. At the same time, Russia announced its intention to conform to Article 8 of the IMF Charter, which requires current account convertibility for the ruble.

In late 1995 the industrialist Soskovets seemed to join forces with the liberal Chubais. They used the energy corporations' tax arrears as an excuse to persuade Yeltsin to strengthen the powers of the Federal Energy Commission, with the aim of forcing the energy companies to freeze and even cut prices (which were already moving up toward world market levels.)<sup>35</sup> The initiative

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<sup>34</sup> Vladimir Chervyakov, "The Russian National Economic Elite in the Political Arena," in Klaus Segbers and Stephan De Spiegeleire (eds.), *Post-Soviet Puzzles*, *op. cit.*, ch. 6.

<sup>35</sup> Rustam Narkizulov, "Velvet revolution in the fuel and energy complex," *Biznes Segodnya*, no. 46 (1995), p. 7.

was lost amidst all the maneuvering prior to the December 1995 parliamentary elections, which resulted in a surprise communist victory. After the election, Chubais was dismissed for his alleged failure to deal with the wage arrears crisis.<sup>36</sup> He was replaced by Vladimir Kadannikov, the former head of the AvtoVAZ auto dinosaur, and an ally of Soskovets. In February 1996 Kadannikov and Soskovets pushed for a hike in import tariffs, but were deflected by the IMF, which made trade liberalization a condition of the \$10 billion Extended Fund Facility granted in March. The Russian government was obliged to abolish export duties on all goods except oil in April 1996, and the duties on oil were finally removed in July 1996. To some extent the move was compensated by an increase in pipeline tariffs and excise duties, which are paid by both domestic and foreign buyers.

Chubais, who headed Yeltsin's reelection team through the spring of 1996, managed to engineer the dismissal of Soskovets through a campaign finance scandal in June 1996, and was appointed presidential chief of staff after Yeltsin's successful reelection. (He has since been named first deputy prime minister.) Kadannikov was replaced in the government by Vladimir Potanin, the 34-year-old head of Oneksimbank, and Aleksei Bolshakov, an industrialist from St. Petersburg, took over Soskovets' slot. Much of the rest of 1996 was taken up with efforts to strengthen tax discipline and battle the yawning budget deficit. In March 1997 a major government reshuffle saw the departure of Potanin and the promotion of Boris Nemtsov to first deputy prime minister. The addition of the reformist governor from Nizhnii Novgorod enabled Chubais to make a fresh assault on the privileges of the energy lobby.

However, the assault was soon dissipated by the outbreak of the "bankers' war" in the summer of 1997. Seven leading bankers joined forces at the Davos economics forum in February 1996 and agreed to bankroll Yeltsin's election campaign. The alliance fell apart in the wake of the privatization of the Svyazinvest telecom company, when Potanin's Oneksimbank won a competitive bid for 25 percent of the company's shares. The banks used the media outlets they control to pour slander and compromising material on their economic rivals. By September, Boris Yeltsin had to call the bankers into the Kremlin and order them to cease their feuding. The affair damaged the credibility of Chubais, who was seen as too closely tied to Potanin's group, and boosted the authority of Chernomyrdin, who had wisely stayed out of the conflict.

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*. . . political battles over the pace and direction of market reform were accompanied by spectacular changes in the distribution of wealth in the Russian economy: there have been big winners and big losers in the market transition.*

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These political battles over the pace and direction of market reform were accompanied by spectacular changes in the distribution of wealth in the Russian economy: there have been big winners and big losers in the market transition. The proceeds of the export industries are divided between the elites who control the extractive industries and those who run the new commercial banks. Perhaps 65 to 75 percent of these elites come out of the ranks of the old nomenklatura. The remainder are new entrepreneurs, with a diverse range of previous careers—from academia to the criminal underworld. Income inequality increased rapidly between 1991

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<sup>36</sup> Shortly after his dismissal, Chubais was brought back into the government to head Yeltsin's reelection campaign. In July 1996 he was appointed presidential chief of staff and in March 1997 he returned to his former post of first deputy prime minister.

and 1993, whether it is measured by industrial sectors, by region, or by social stratum. These so-called “New Russians” are outnumbered by the new poor.

### ***Patterns of Lobbying***

Despite these dramatic shifts in the allocation of wealth and power, the pattern of lobbying has changed less rapidly than the fruits of lobbying. The most important form of lobbying continues to be informal personal contacts between directors and government bureaucrats—a pattern which dates back to the Soviet era. Although the proponents of Russian privatization claim that economic decision-making has been depoliticized as a result of the market reforms, in reality this is far from the case.

The lobbying process is highly opaque, fragmented, and disorganized. Although organized interest groups have been created, such as the Union of Oil Industrialists and the Russian Manufacturers’ Federation, their influence generally has been weak and sporadic.<sup>37</sup> Business groups have contributed to political parties and parliamentary factions, but no clear pro-business party organization has emerged—despite the strenuous efforts of figures such as Arkadii Volskii, the head of the Russian Union of Industrialists and Entrepreneurs.

In April 1995 the cautious Chernomyrdin decided to enter the electoral arena by forming a new political party, Our Home is Russia. (He previously had no party affiliation.) Our Home is Russia was seen as representing the interests of the energy lobby and the financial corporations associated with them, and was soon dubbed “Our Home is Gazprom” (*Nash Dom Gazprom*).<sup>38</sup> Its philosophy is that of professionalism and technical competence, and a disdain for all ideology (either communist or radical-liberal). Although this apolitical ethos seems to reflect the public mood, the party only managed to win 10 percent of the popular vote in the December 1995 Duma elections. It is seen, correctly, as representing the “party of power,” and voters are inclined to use the opportunity provided by elections to register a protest against falling living standards and rising social problems. Our Home is Russia has built up what appears to be a solid network of support among regional governors; what it lacks is a popular, charismatic national leader and a clear message, beyond vague patriotism.

Part of the problem is that wealth creation in Russia is concentrated in a small number of firms employing a negligible proportion of the electorate. It is thought that the 100 biggest companies produce 40 to 50 percent of GDP but employ less than 3 percent of the labor force.<sup>39</sup> This naturally creates difficulties when it comes to building a broad-based political party. The energy lobby and their banker allies are short of voters—but they are not short of money. And in Russia’s nascent, media-driven democracy, money buys votes. The most striking sign of the political influence of business since 1991 has been the process by which the cash-starved media (print and electronic) have been turned into the mouthpieces of business and political “clans.” The ruling elite sees the media as a more malleable instrument for political intervention than political parties, which tend to develop a life of their own (and typically collapse in the hands of feuding leaders).

Many of the leading banks and energy corporations have directly acquired media outlets, which are used shamelessly to attack adversaries and promote the owners’ interests. Gazprom itself has a 30-percent stake in the private TV channel NTV, and controls more than two dozen

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<sup>37</sup> Vladimir Chervyakov and Vladimir Berezovskii, “Corporate Groups of Industrialists and Managers in the Production Sphere,” and “Sectoral Production Capital: Military Industrial Complex and Fuel Complex,” in Klaus Segbers and Stephan De Spiegeleire (eds.), *Post-Soviet Puzzles*, *op. cit.*, ch. 13 and 14.

<sup>38</sup> Laura Belin, “The Chernomyrdin Bloc Surges Forward,” *Transition*, OMRI, August 25, 1995, pp. 21–26.

<sup>39</sup> *The Economist*, July 12, 1997.

regional newspapers and TV stations. LUKoil caused a stir by buying a large stake in *Izvestiya* in 1995. Onexsimbank, headed by Potanin, wrested control of *Izvestiya* from LUKoil in July 1997, and also owns the daily *Komsomolskaya pravda*. Boris Berezovskii's LogoVAZ group has a large stake in Russian Public Television (ORT), the daily *Nezavisimaya gazeta*, and the weekly *Ogonek*. Vladimir Gusinskii, the head of Most Bank, has assembled the most impressive media empire: the NTV television channel; the dailies *Moskovskii komsomolets* and *Segodnya*; and the weekly *Itogi*.

Just as the energy lobby has had only limited success in creating a vehicle to reflect its political interests in national elections, the other economic lobbies have likewise found it difficult to mobilize their constituencies. The potential for such mobilization is there: some 20 percent of the population still works in agriculture and food processing; and it is estimated that another 20 percent works in defense industries or the armed forces. Together with their families, the number of people whose livelihood depends on these old stalwarts of the Soviet economy vastly outnumbers the socio-economic groups that have benefited from the market transition. However, this has not been reflected at the polls. The Agrarian Party won 8 percent of the votes in 1993, but failed to reach the 5 percent minimum required to obtain Duma seats in the 1995 elections. The military lobby has consistently failed to produce a national political party of its own. It seems as if the natural constituencies for these sectors are not voting as a bloc of economic interests, but are being drawn off into the ideologically based parties: the communists (pulling 25–30 percent of the vote) and the nationalists (with 10–15 percent support).<sup>40</sup>

### The Tangled Web of Energy Economics

While the restructuring of the oil sector was under way, oil output slumped dramatically. It dropped 13.5 percent in 1993, 12 percent in 1994, 3 percent in 1995, and 2 percent in 1996.<sup>41</sup> Annual oil output fell from 390 million tons in 1992 to 293 million tons in 1996, which is 45 percent down from its 1987 peak. Gazprom managed to increase its output by 1 percent in 1996, but in the first half of 1997 experienced a 5 percent decline.<sup>42</sup> During the first half of 1997, Russia produced 147 million tons of oil (up 0.4 percent compared to 1996), 87 million tons of refined products (up 2 percent), and 282 billion cubic meters of gas.

This decline in output was in part a response to the slump in demand from Russian customers, who were caught in the general economic recession. High tax rates and the slow pace at which price controls were lifted contributed to the production decline. Another important factor was the slump in investment in infrastructure and new drilling, which drove producers to squeeze more oil out of exhausted wells, driving up costs.

The energy sector is urgently in need of fresh investment. More than half of Russia's 200,000 kilometers of oil and gas pipelines are over 25 years old. As overall investment fell in the Russian economy (from 29 percent of GDP in 1990 to 12 percent in 1995), the energy sector absorbed an increasing share of the available capital—up from 40 percent in 1990 to 56 percent in 1993, but this was still insufficient to stop the industry's decline.<sup>43</sup> Russian industrialists have blamed the investment slump on Russia's chaotic financial system, insisting that it was capital rather than technology that was lacking. Russian factories have the capacity to produce many of the

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<sup>40</sup> Stephen White, Richard Rose, and Ian McAllister, *How Russia Votes*, Chatham, NJ, Chatham House, 1997.

<sup>41</sup> "Oil," *Delovoi mir*, February 7, 1994, p. 12; "CIS in figures," *Delovoi mir*, November 14, 1994, p. 8; "CIS economies in 1995," *Delovoi mir*, March 1, 1996, p. 2. See also Robert E. Ebel, *Energy Choices in Russia*, Washington D.C., Center for Strategic and International Studies, 1994.

<sup>42</sup> *Kommersant Daily*, June 19, 1997, p. 1; July 17, 1997, p. 8.

<sup>43</sup> *Statistical Handbook 1994: States of the Former USSR*, World Bank, p. 496; *Review of the Russian Economy*, Institute of Economy in Transition, vol. 3, no. 1, p. 118; ITAR-TASS, March 9, 1996.



required items, they argue, often at lower cost, but unlike foreign suppliers they cannot offer their customers credit.<sup>44</sup>

With the demise of central planning in 1991 and 1992, production targets were abolished and energy producers were free to operate as profit-seeking entities. However, the market continues to be dominated by oligopolistic producers operating in collusion with the Russian government. The latter backed away from lifting all price controls in 1992, and continued to impose periodic price freezes for energy producers. Oil was selling domestically at less than 5 percent of the world market price in 1991, but rose steadily to 75 percent of the world price by 1996.<sup>45</sup> The low domestic price (and payments arrears) meant that it was much more profitable for oil and gas producers to sell to Western Europe than inside Russia, and the availability of cheap energy made it easy for metals producers to undercut rival suppliers on the global market. Hence the export boom coinciding with domestic recession. Unfortunately, much of the proceeds from these exports were salted away in offshore bank accounts, and are not being recycled back into the Russian energy sector. Capital flight is estimated at \$10–15 billion a year.<sup>46</sup>

Despite this progress toward world price levels, it is still far from the case that market forces are determining decision-making in the energy industry. (It may be naive to imagine that market prices would have free rein, since major producers such as the United States or Saudi Arabia have always sought to influence the market price.) On one side, much of the industry is still run by Soviet-era managers whose approach is that of the engineer, looking for technically advanced and ambitious projects and paying scant attention to questions of cost and economic efficiency. To this engineering mentality has been added a layer of financial managers and trading companies who are looking at the financial bottom line, but are more interested in quick profits than in the long-term development of the industry. The third major set of players are the politicians, local and national, who try to mediate between these economic elites and the disgruntled (but largely passive) workforce.

### ***Facing a Financial Squeeze***

Despite their relative health in comparison to the rest of the economy, most fuel enterprises have been facing a financial squeeze since 1991. Their rising export earnings have been accompanied by an apparent cash squeeze that has seen investment slump and wage arrears mount. The pressure comes from several sides—rising production costs, a lack of investment capital, non-payment by customers, and punitively high taxes.

Production costs have risen sharply since 1991, and the net profit on a ton of exported oil fell from \$31 in 1993 to \$17 in 1996 (with an average final sale price of \$120 a ton).<sup>47</sup> In 1996 it cost \$28.80 to transport a ton of oil from the Tarasov field in West Siberia to the Black Sea port of Novorossiisk, double the 1993 price. The existing oil fields have been in production for 10–20 years, and reserves are now heavily waterlogged or at depths of 5 kilometers or more.<sup>48</sup> Oil spills are frequent due to corroded pipelines, often with severe ecological effects.

Exploratory drilling to develop new fields has dropped off (falling by one third in 1996 alone), due to uncertainties over privatization, high costs, and an acute shortage of working capital caused by customer arrears.<sup>49</sup> Investment in the energy sector as a whole was 104 trillion rubles (\$19

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<sup>44</sup> G. Lyulkin, "Defense plants seek business in the factory," *Rabochaya tribuna*, October 14, 1994, p. 5.

<sup>45</sup> Russian Public Television (ORT), February 9, 1996.

<sup>46</sup> *Kommersant*, no. 40 (1995), pp. 38–39.

<sup>47</sup> Reuters, May 8, 1997.

<sup>48</sup> "There will be no more easy oil," *Rossiiskaya gazeta*, February 8, 1997.

<sup>49</sup> *Finansovye izvestiya*, April 22, 1997.

billion) in 1996, down 16 percent from 1995.<sup>50</sup> Investment has also been deterred by the punitively high interest rates which Russia has experienced over the past several years. For most of the transition period it has been simply impossible for firms to borrow for long-term investment projects. The Central Bank's refinance rate peaked at 212 percent annually in June 1996, before falling to 48 percent by year's end. By mid-1997 real interest rates for bank loans had fallen to about 25 percent. Nevertheless, lending is for two to three months' duration and is used only to meet urgent needs.

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*Total debts owed to energy suppliers rose from 39 trillion to 86 trillion rubles in the course of 1995 and to 320 trillion (\$58 billion) by the end of 1996—a sum equal to two-thirds of their annual sales.*

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### ***Caught in a Chain of Debt***

As Russian GDP has fallen by 40 percent over the past six years, a chain of debt has spread its tentacles throughout the economy. Energy companies are owed the most.<sup>51</sup> Total debts owed to energy suppliers rose from 39 trillion to 86 trillion rubles in the course of 1995 and to 320 trillion (\$58 billion) by the end of 1996—a sum equal to two-thirds of their annual sales.<sup>52</sup> By 1993 only 60 percent of oil and gas deliveries were being paid for: that proportion has remained roughly constant in subsequent years.<sup>53</sup> In April 1994 the government gave fuel companies permission to stop deliveries to non-payers, but in practice they were rarely allowed to do so. The right to cut off delinquent customers was revoked for a long list of clients in October 1995, in the run-up to the Duma elections. (The ban was lifted in August 1996—after the presidential election.) Gazprom in particular is the last link in the chain of debt. By 1997 Gazprom alone was owed 77 trillion rubles (\$14 billion). Only 7 percent of its Russian customers were paying in cash, another 53 percent were paying in securities or barter goods, and 40 percent were not paying at all.<sup>54</sup> There is a brisk secondary market in debt (even in tax debt), and firms have been issuing all sorts of securities of dubious provenance in an effort to finance their operations.

At the same time, oil and gas firms are berated for falling behind with their own payments to the tax authorities and to their workers. At the beginning of 1996, the fuel and energy complex owed 25 trillion rubles (\$4.5 billion) to the federal budget, 9 trillion to the pension fund, and 8 trillion in wages for their workers.<sup>55</sup> While the average firm in Russia was one month late paying its workers' wages, the average delay was two months in the coal and oil industries, and four months in the gas industry.<sup>56</sup> Industry executives complain that taxes take up 56–62 percent of the revenue from gas sales and 53 percent from oil sales, while the energy sector provided 69 percent of receipts to the federal budget in 1996. Gazprom alone paid 23 trillion rubles (\$4.2

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<sup>50</sup> Konstantin Baskaev, "The Russian energy sector moves to center stage in struggle with arrears," *Finansovye izvestiya*, March 13, 1997, p. 1.

<sup>51</sup> *Ibid.*

<sup>52</sup> First Deputy Prime Minister Oleg Soskovets, cited by ITAR-TASS, February 21, 1996; State Tax Service department head Dmitrii Popov, cited by ITAR-TASS, December 2, 1996.

<sup>53</sup> Vladimir Cheryakov and Vladimir Berezovskii, "Sectoral Production Capital: Military Industrial Complex and Fuel Complex," in Klaus Segbers and Stephan De Spiegeleire (eds.), *Post-Soviet Puzzles*, *op. cit.*, ch. 14.

<sup>54</sup> Interfax, July 15, 1997. These data were confirmed by a Price Waterhouse audit.

<sup>55</sup> Konstantin Baskaev, "The Russian energy sector moves to center stage in struggle with arrears," *op. cit.*

<sup>56</sup> ITAR-TASS, January 29, 1996.

billion) in taxes in 1996.<sup>57</sup> Former fuel and energy minister Petr Rodionov complained that the situation has changed 180 degrees since the Brezhnev era: before, the state was pumping money into the energy sector, now it is pumping money out.<sup>58</sup>

### ***Siphoning Revenue***

Critics argue that the incumbent managers have systematically looted the wealth of Russia's energy companies, siphoning off revenues into private offshore bank accounts. There are many opportunities for the managers of nominally public companies to utilize their position for personal gain. The instruments for this leakage of cash have included special tax exemptions; import and export duty waivers; and the creation of independent trading companies, which generate large profits through tax evasion and transfer pricing. The number of firms given permission to export oil soared from 22 to 179, including companies controlled by sports foundations, veterans organizations, and even the Orthodox Church.<sup>59</sup> The Church's trading company, for example, was granted an oil export tax waiver worth \$340 million in 1994 alone. Organized crime became deeply involved in the struggle for lucrative export licenses, and was responsible for the deaths of two directors of a Belgian-Russian joint venture that was exporting oil from the Samara refinery in 1994.<sup>60</sup> In an attempt to impose order, in March 1995 Yeltsin issued a decree abolishing the export privileges enumerated in 59 of his previous decrees.<sup>61</sup>

The chaotic Russian economic system leaves much scope for such maneuvers. Legal regulations are often lacking and are frequently ignored. Auditing practices are primitive, and it is common for firms to hold multiple bank accounts. Receipts are paid into one account while debits are registered in another account, enabling the firm to avoid paying wages and taxes even while sales are expanding. The situation has improved over time as controls have been tightened. The Central Bank estimated that the proportion of export revenues not returning to Russia was 70 percent in 1992, falling to less than 40 percent in 1993, and 12 percent in 1994.<sup>62</sup>

When in March 1997 Yeltsin appointed Boris Nemtsov to be first deputy prime minister alongside Anatolii Chubais, he charged his new minister with tackling the "natural monopolies" (that is, Gazprom and the electricity and railway companies). In April Nemtsov launched an ambitious draft plan to force Gazprom to hive off its subsidiaries and allow competitors access to the national gas grid.<sup>63</sup> Gazprom was also to eliminate cross-subsidies by raising prices for households and cutting fees for industry. Nemtsov accused the "natural monopolies" of price gouging, and persuaded Yeltsin to sign a decree in June ordering Gazprom to cut prices by 40 percent for customers who pay cash.<sup>64</sup> He also got Gazprom to pay off its federal tax arrears. The company handed over 14.5 trillion rubles (\$2.6 billion) in June, but only thanks to bridging loans it obtained from Western banks.<sup>65</sup> Nemtsov was less successful in changing the management structure of the company, and Gazprom rebuffed efforts by Oneksimbank (which had purchased 3 percent of Gazprom shares) to place one of its men on the Gazprom board. Gazprom president Rem Vyakhirev did pledge to revise the company's internal structure, hiving off secondary facilities with perhaps one quarter of its 400,000 employees, and promised that the company would

<sup>57</sup> Interfax, July 1, 1997.

<sup>58</sup> Quoted in "There will be no more easy oil," *Rossiiskaya gazeta*, February 6, 1997.

<sup>59</sup> *Segodnya*, June 22, 1995, p. 4; Rustam Nirzikulov, "Daughter company of Orthodox Church," *Segodnya*, November 15, 1995, p. 4.

<sup>60</sup> S. Leskov, "The secret war of Russia's oil kings," *Izvestiya*, June 11, 1994, p. 4; Stanislav Lunev, "Russian Organized Crime Today," *Prism* (Jamestown Foundation), vol. 3, no. 8 (May 30, 1997).

<sup>61</sup> *Obshchaya gazeta*, March 16, 1995.

<sup>62</sup> Nikolai Vardul, "Tomorrow will come after the New Year," *Kommersant*, no. 40 (1995), pp. 38-39.

<sup>63</sup> For the text, see Interfax, May 4, 1997.

<sup>64</sup> *Izvestiya*, June 20, 1997, p. 2.

<sup>65</sup> Bank of Finland, East European Economies Unit Bulletin, June 19, 1997.

be more transparent in its accounting in order to attract foreign investors.<sup>66</sup> However, he complained that the pressure to cut prices was a sign of “non-market” thinking, arguing that “We are not simply producing and selling gas. We are pursuing a popular, socially-oriented policy whose significance goes beyond narrow economic calculation.”<sup>67</sup>

### All Politics is Local

Despite the lack of strong representative organizations at the national level, industrialists have been quite successful at coordinating their activities at the regional level. However, this cooperation has often focused on carving up state property among the local elites, and has not been able to stop the economic decline. Nevertheless, in most regions of Russia the “industrial party,” in the form of an informal network of local economic elites and their political-bureaucratic allies, effectively runs local politics.<sup>68</sup> Unlike in times past, these elites must be elected to office. Most regional governors were directly appointed by President Yeltsin after 1991, but in 1996 and 1997 they all had to face popular election. Some of these elections were less than free and fair, but incumbents were deposed in about half the races. Apart from looking over their shoulder at local voters, a major task of regional elites is to stay on good terms with Moscow. Only 10 of Russia’s 89 regions are net donors to the federal budget—the others are all dependent on federal transfers to varying degrees. Since there is little in the way of a systematic and transparent regional policy at the national level, federal favors tend to be doled out for political reasons and in response to lobbying efforts. Even the donor regions must play this game since they are dependent on permission from Moscow for tax waivers, access to export markets, and so forth.

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*Generally the oil and gas regions have been pro-Yeltsin  
and pro-reform in the elections and political confrontations  
from 1991 to 1997.*

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The significance of the regional dimension is heightened by the fact that Russia’s energy resources are heavily concentrated in a handful of Russia’s 89 provinces. This is partly a result of geography, and partly a result of deliberate decisions in the 1960s to focus development efforts on the West Siberian oblast of Tyumen. Tyumen alone accounts for more than 90 percent of Russia’s natural gas production and more than two thirds of its oil output, and generates 20–25 percent of Russia’s total export earnings.<sup>69</sup> The Khanty-Mansii Autonomous Okrug (AO), located within Tyumen Oblast, provides about 65 percent of Russia’s oil and the Yamal-Nenets AO (also within Tyumen) another 10 percent, followed by Tatarstan (7 percent), Bashkortostan (5 percent), Samara and Perm (3 percent). Orenburg is a distant second in natural gas production, with 6 percent. As for reserves, 47 percent of gas reserves are in Tyumen (of which 43 percent are in Yamal-Nenets), 18 percent in Taimyr AO (in Krasnoyarsk Krai) and 11 percent in Komi, with new exploration currently underway at Astrakhan. Proven oil reserves are focused in Tyumen (63 percent, of which Khanty-Mansii has 57 percent and Yamal-Nenets 6 percent), Nenets

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<sup>66</sup> “Gazprom will look European,” *Kommersant Daily*, March 26, 1997, p. 1.

<sup>67</sup> Rem Vyakhirev, “I will not give up that easily,” *Nezavisimaya gazeta*, March 25, 1997, p. 2.

<sup>68</sup> Vladimir Mau and Vadim Stupin, “The Political Economy of Russian Regionalism,” *Communist Economies and Economic Transformation*, vol. 9, no. 1 (1997), pp. 5–25.

<sup>69</sup> Vladimir Kolossov et al., “The Situation in Russia’s Fuel and Energy Complex,” in Klaus Segbers and Stephen De Spiegeleirs (eds.), *Post-Soviet Puzzles*, op. cit., vol. 3, ch. 15.

AO (in Arkhangelsk Oblast) has 6 percent, and Tatarstan 6 percent. Sakhalin is an up-and-coming region whose offshore oil fields are estimated to contain 340 million tons of oil.<sup>70</sup>

This regional concentration gives the favored regions economic muscle but also paradoxically makes it easier for the center to control them, since it reduces the number of actors with whom Moscow has to deal. Generally the oil and gas regions have been pro-Yeltsin and pro-reform in the elections and political confrontations from 1991 to 1997. Presumably, this is because these regions have a strong interest in the steady flow of oil and gas to the West, something which is secured by the government's policy of trade liberalization and the preservation of political stability at the national level. The leaders of the ethnic republics of Tatarstan and Bashkortostan have tried to pursue a more independent course and slow the pace of economic reform. Tatarstan president Mintimer Shaimiev backed the August 1991 coup attempt, although he subsequently became an ally of Yeltsin. Of all the 21 ethnic republics (save Chechnya), Tatarstan was the toughest advocate of "sovereignty," holding out until Moscow signed a special bilateral treaty with the republic in February 1994 that granted broad autonomy in economic policy and virtual exemption from federal taxes. Tatarstan has no border with a country outside the Russian Federation and recognizes that complete secession is not a feasible option. The Tatar and Bashkir oil fields reached their peak some years ago and it is not clear whether the regions' economies will be strong enough to sustain their drive for autonomy. The special treatment for Tatarstan fueled resentment among other Russian regions, but Moscow has been using its control of the federal purse strings and national economic policy to keep secessionist tendencies in check.

Some of the toughest contests have been at the subregional level. In Soviet times, autonomous districts (okrugs) were created within oblasts in recognition of the presence of ethnic minorities in those territories. Thus in the north of Tyumen oblast there are the Khanty-Mansii and Yamal-Nenets autonomous okrugs. (It should be noted that less than 10 percent of the population of these regions belongs to the titular nationality: the majority are ethnic Russians.) In the early 1990s these okrugs started claiming the same rights as the oblasts and ethnic republics. The new 1993 federal constitution was ambiguous on their status: one clause gives the okrugs equal status with the oblasts, while another subordinates them to the oblast in which they are located. Nenets AO threatened to secede from Arkhangelsk Oblast, but in April 1994 struck a deal to preserve the constitutional status quo in return for free control over its economy.<sup>71</sup>

Khanty-Mansii and Yamal-Nenets have been locked in an increasingly fierce dispute with the Tyumen oblast for control over oil and gas revenues.<sup>72</sup> The law on underground resources gave okrugs the right to levy fees on the exploitation of oil and gas on their territory, but the two okrugs have tried to assert that their legislation and not oblast laws have priority within their territory. In 1993 Khanty-Mansii separated its budget from Tyumen, and in January 1994 agreed to split oil revenues with the oblast 77 percent to 23 percent. In 1997 the okrug will pay 1.3 trillion rubles (\$225 million) into oblast coffers.<sup>73</sup> However, Tyumen was unhappy with the arrangement, and tried unsuccessfully to get the State Duma to pass a law giving the oblast control over the oil and gas industry infrastructure in the okrugs. Matters came to a head with the 1996 Tyumen gubernatorial elections, which the okrugs threatened to boycott as a sign of their independence. The dispute was examined by the Russian Constitutional Court, which ruled ambiguously in

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<sup>70</sup> Thomas Orszag-Land, "Russia's Far East Bonanza," *Christian Science Monitor*, April 28, 1997.

<sup>71</sup> Vladimir Kolosov et al., "The Situation in Russia's Fuel and Energy Complex," in Klaus Segbers and Stephan De Spiegeleirs (eds.), *Post-Soviet Puzzles*, *op. cit.*, vol 3, ch. 15.

<sup>72</sup> Peter Glatzer, "Elections Deepen Split in Tyumen Oblast," *Institute for East West Studies (IEWS) Russian Regional Report*, April 24, 1997.

<sup>73</sup> Interfax, June 24, 1997.

July 1997, noting that the okrugs have equal rights with the oblast, and have the right to secede, but only if the latter is approved by a special federal law.<sup>74</sup>

A crucial factor preventing these disputes from escalating out of control has been the role of the energy corporations, which have a strong interest in keeping the situation calm. Gazprom is in a position to virtually dictate the revenues it pays to regional governments (and Gazprom reportedly pays Khanty-Mansii more for transporting gas than Yamal-Nenets for producing it.) In addition, the national leadership of the energy complex made their careers in these regions, and have close personal ties with the key decision-makers in places like Tyumen and Tatarstan.

### Foreign Investors: Still Waiting

Foreign capital and technology will be crucial to the future of the Russian oil and gas industry. However, most Russian politicians (and especially those in the Duma) remain suspicious of foreign investors, while Russian business leaders are reluctant to share their potential profits with outsiders. Foreign investors in turn are deterred by continuing political uncertainty, bureaucratic red tape, crime, and corruption.<sup>75</sup> The national leaders of Russia, Germany, and the United States have paid lip-service to the need to promote trade and investment, but that has been insufficient to overcome the internal barriers to foreign investment. It seems as if most Russian political and business elites simply do not want foreign investment if it means giving up control over the development of oil and gas fields (and the ensuing profits).

As a result, the expected “golden rain” of foreign investment has not materialized. Between 1991 and 1997 Russia accumulated a mere \$7.5 billion in foreign direct investment (FDI) compared to the \$32 billion that flowed into Mexico and \$113 billion into China during the same period.<sup>76</sup> The Russian fuel and energy sector is the largest recipient of FDI, receiving about \$2 billion since 1991, but even so most of the major investment programs remain in pre-contract limbo. So far only a few dozen small joint ventures have actually started operations, accounting for 7 percent of oil production and 12.5 percent of exports in 1996.<sup>77</sup> One of the first was Conoco’s \$300 million operation in the Polar Lights field in Arkhangelsk: but that project has been described by one Conoco official as “an unqualified failure” due to the unforeseen 250 percent increase in taxes and tariffs.<sup>78</sup> To a large extent domestic and foreign oil companies still speak different languages, with the Russians being very suspicious of Western motives and refusing to countenance the 20 percent plus rates of return which Westerners expect on their investment in Russia’s risky conditions. Nevertheless, some Western companies are doggedly pursuing the pot of oil at the end of the rainbow.

Elf’s 1992 deal to develop fields in Saratov was delayed by political opposition from regional authorities, and the company is still not pumping oil. Talks with Texaco and Norsk Hydro for development of the giant Timan–Pechora field in the far north (requiring perhaps \$80 billion of investment) have dragged on for four years. In December 1995 the French company Total signed a 33-year production sharing deal to develop the Kharyaga field in the Nenets AO.<sup>79</sup> Exxon and Sodeko hold a 30 percent stake each in Sakhalin I, the first stage of the development plan for the Far Eastern region, with Rosneft and its subsidiary Sakhalinmorneftegaz holding 17 percent and 23 percent respectively. In March 1994 Marathon, Shell, Mitsui, Mitsubishi, and McDermott agreed

<sup>74</sup> Anna Paretskaya, “Constitutional Court Rules on Tyumen Dispute,” *IEWS Russian Regional Report*, July 17, 1997.

<sup>75</sup> *1996 Investment Climate Statement*, Moscow, U.S. Embassy, July 1996; Jonathan Stern, *Oil and Gas in the Former Soviet Union*, London, Chatham House, 1993.

<sup>76</sup> *Interfax-AiF*, July 30, 1997; *International Herald Tribune*, July 14, 1997, p. 15.

<sup>77</sup> *Finansovye izvestiya*, March 27, 1997, p. 1.

<sup>78</sup> Kenneth Watts, cited in a U.S. Embassy report reprinted by Interfax, May 2, 1997. See also Christos Nicandros, “Russian Oil, Western Investment,” *The World Today*, October 1993, pp. 186–89.

<sup>79</sup> Reuters, May 2, 1997.

on a \$10 billion project for the second phase of Sakhalin's development. Work at Sakhalin was held up pending passage of legislation allowing production sharing, while the Gore-Chernomyrdin commission on U.S.-Russian trade and technology cooperation, which was formed in 1993, pressed the Russian government to move the project forward. In June 1996 the Sakhalin I consortium announced it would begin operations, with a \$270 million investment planned for 1997.<sup>80</sup> In May 1997 Yeltsin signed a decree granting the Sakhalin I and Sakhalin II projects the tax breaks (such as import tax exemption) that it would be entitled to under the production sharing law, which at that time was still not operational.<sup>81</sup> At the same time, the Sakhalin oblast дума passed laws exempting the Sakhalin projects from local and regional taxes.<sup>82</sup>

The oil industry needs money not just to open new fields and restore defunct wells, but also to overhaul its refineries, most of which are over 20 years old. By chance, the most modern Soviet refineries were built outside Russia—Mazyr and Novopolotsk in Belarus, and Mazheeikyanskii in Lithuania. Russia also needs to develop its own oil equipment industry. Two thirds of Soviet-era equipment was produced in Azerbaijan, which due to political and economic dislocation has ceased to be a source of supply. Most of the \$4–5 billion of equipment which Russian oil and gas firms purchase each year is imported.<sup>83</sup>

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The funds for Western involvement in the development of Russia's oil and gas industry are available; what is lacking is political will on the Russian side. The U.S. Export-Import Bank has offered Russia \$2 billion, of which \$730 million has been spent on imports of U.S. equipment, while the World Bank has offered a \$500 million loan to the oil industry, plus \$99 million for cleaning up oil spills in the Komi Republic.<sup>84</sup> However, Russian producers and their political allies in the oil regions (and in parliament) are wary of committing themselves to foreign partners, and the federal government lacks the muscle to force them to sign agreements.

The lack of legislation regulating the exploitation of oil and gas resources is also an important deterrent to foreign investors. Russia is a member of the European Energy Charter, signed in December 1994, which stipulates that foreign investors, if allowed in at all, must be given the same terms as national investors. This remains only a paper commitment, however.<sup>85</sup> A bilateral investment treaty was signed with the United States, but still has not been ratified by the Duma. Parliamentary deputies are convinced that Western oil corporations want to loot Russia's natural resources, and are determined to keep them at bay. Western firms would obviously prefer to have their rights protected by law rather than resting on the vagaries of presidential decrees.

It was not until the end of 1995 that Russia adopted a Law on Production Sharing (which allows foreign investors to directly earn back their investment with export revenue), and only in

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<sup>80</sup> Interfax, June 25, 1997.

<sup>81</sup> *Segodnya*, June 19, 1997, p. 1.

<sup>82</sup> Radio Free Europe/Radio Liberty (RFE/RL) *Newsline*, May 29, 1997.

<sup>83</sup> Aleksander Romanikhin, "Western firms benefit from Russian petrodollars," *Pravda-5*, July 11–18, 1997, pp. 1, 5.

<sup>84</sup> Interfax, June 14, 1995.

<sup>85</sup> Anatolii Shatalov, Deputy Minister of Fuel and Energy, "Russian energy sector is still attractive for Western capital," *Finansovye izvestiya*, March 22, 1996, p. 3.

June 1997 did the Duma approve a list of sites eligible for the scheme.<sup>86</sup> The Duma approved just seven locations, instead of the 230 originally proposed by the government.<sup>87</sup> The final version of the law contained several clauses that are detrimental to foreign investors—such as the government retaining the right to amend contracts *ex post*, and the imposition of quotas for the purchase of Russian equipment. One positive step is that joint ventures are given a tax exemption on imported equipment if their base capital is more than 10 million ECU.<sup>88</sup>

A new draft law on foreign investment is being prepared in the Duma. Although the purpose of the bill is ostensibly to encourage foreign direct investment, Svetlana Gvozdeva, deputy chairman of the State Duma Economic Policy Committee, warned: “We are creating a new iron curtain for investors!”<sup>89</sup> The draft proposes restrictions on equipment imports and the repatriation of profits, limits recourse to international arbitration, and includes a list of 73 commodity sectors where foreign investment will either be restricted or prohibited.

### The Geopolitical Dimension

There are considerable geographical and geopolitical challenges that must be overcome if Russia’s energy potential is to be realized. However, these problems, while costly in the short run, are being overcome. Long term, the domestic political and economic struggle for control of the energy sector is a more serious threat to Russian energy development than geographical and geopolitical considerations.<sup>90</sup> The fact that most of the energy deposits lie east of the Urals provides a strong incentive for Russia to sell these resources to the energy-dependent economies of East Asia, although this will require the development of a new export infrastructure to carry them across Siberia.

#### *Russia and the “Near Abroad”: The Energy Factor*

Most of Russia’s oil and gas fields lie in remote and inhospitable locations, the easy deposits having been exploited over the past 80 years. Developing remote fields presents considerable technological and human challenges; and the fuel then has to be pumped out across thousands of kilometers. Most of the export routes laid down during the Soviet period traversed non-Russian republics: oil and gas pipelines to Europe cross Belarus and Ukraine, while much oil must be loaded at ports in the now independent Baltic countries. Only 15 percent (35 million tons) of Russia’s oil exports are shipped from Russian port terminals.<sup>91</sup> The two main pipelines out of the Caspian Sea basin currently traverse war zones in the secessionist regions of Chechnya, Abkhazia (in Georgia), and Nagorno-Karabakh (in Azerbaijan). Russian involvement in the development of the Caspian Sea fields involves complex negotiations with the other four littoral states and a host of international corporations.<sup>92</sup>

However, it is important not to exaggerate these geographical challenges. First, one must remember that elsewhere in the world it is not unusual to find oil and gas fields located across

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<sup>86</sup> Konstantin Levin, “President to decide how to share production,” *Kommersant Daily*, December 7, 1995, p. 1; Interfax, June 23, 1997. Five of the seven sites are oil and gas fields—Samotlor and Krasnoleninsk in Khanty-Mansii, Romashkin in Tatarstan, North Sakhalin, and Prirazlomnoe in the Barents Sea.

<sup>87</sup> Reuters, June 13, 1997.

<sup>88</sup> *Finansovye izvestiya*, no. 47 (1995), p. 1.

<sup>89</sup> *Trud*, May 17, 1997, p. 2.

<sup>90</sup> As laid out in the policy document prepared by the Council on Foreign and Defense Policy, “Will the Union be reborn?” *Nezavisimaya gazeta*, May 23, 1996.

<sup>91</sup> Valerii Ilin, “Those who lost in the Baltic seek a northern route,” *Delovoi mir*, April 30, 1997, p. 1.

<sup>92</sup> As the forthcoming paper by Rajan Menon in this series discusses Caspian Sea developments, this important issue will not be discussed in this paper. See Rajan Menon, “Traacherous Terrain: The Political and Security Business of Energy Developments in the Caspian Sea Zone,” *NBR Analysis*, v. 9, n. 1, forthcoming (January 1998).



political fault lines. Russia's testy relations with the Baltics and Ukraine are much more stable and predictable than the explosive geopolitics of zones like the Caucasus and the Persian Gulf, which repeatedly erupt into armed conflict.

Second, like many economic questions, Russia's geographical challenges boil down to problems of time and money. New pipelines can be laid, and new port terminals built, although this will take a few years and hundreds of millions of dollars. Whether Moscow will press ahead with such projects depends upon a mixture of political and economic considerations. Russia's motive is not simply to guarantee the cheap and secure shipment of energy to global markets. There are elements in Russia which are also keen to use the energy factor to reestablish a sphere of influence in the former Soviet republics (the "near abroad", in Russian terminology).

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*The fact that pipelines cross other countries has advantages as well as disadvantages for Russia, since it creates a pattern of mutual dependency.*

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The fact that pipelines cross other countries has advantages as well as disadvantages for Russia, since it creates a pattern of mutual dependency. Russia's Western neighbors are all heavily dependent on energy imports, and need the revenue from energy transshipments just as much as Russia needs to use the existing export infrastructure. Most of the CIS countries are deeply in debt to Russia for past energy deliveries, despite the fact that Russia charges them less than the world price. (The average oil price paid by CIS clients in 1996 was \$80 a ton compared to \$120 for other customers.<sup>93</sup>) CIS country debts for energy supplies alone rose from 1.6 trillion rubles at the beginning of 1993 to 13.9 trillion rubles (\$3 billion) by August 1995, of which 11.8 trillion was for gas, 1.8 trillion for electricity, and 330 billion for oil.<sup>94</sup> By February 1996 Gazprom was owed \$1.1 billion by Ukraine, \$910 million by Belarus, and \$333 million by Moldova.<sup>95</sup>

Russia can try to use this dependency to win political and economic concessions from those countries. For example, Gazprom has repeatedly pressed the ex-Soviet republics to pay off their gas debts with equity in energy installations. Ukraine has rebuffed this suggestion, although Moldova and Kyrgyzstan have taken up the offer. In December 1996 Belarusian president Alyaksandr Lukashenka agreed to allow LUKoil and YUKOS to take majority ownership in the Mazyr and Novopolotsk refineries.<sup>96</sup> Given the mutuality of the dependency, however, Russia's ability to use the energy weapon is limited.<sup>97</sup> Gazprom periodically threatens to cut off supplies to Kazakstan or Ukraine, but such threats are not really credible because a complete shutdown would cause a political scandal, and would harm Russian firms that are dependent on trade with these countries. Thus Kazakstan has pressed ahead with its program to privatize its metals and energy industries to Western firms despite vociferous Russian objections.<sup>98</sup>

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<sup>93</sup> ITAR-TASS, November 10, 1996.

<sup>94</sup> *Russian Economic Trends*, vol. 4, no. 4 (February 1996), Working Center for Economic Reform, Government of the Russian Federation, table 77.

<sup>95</sup> *Delovoi vtornik*, February 20, 1996, p. 1; Interfax, March 19, 1996.

<sup>96</sup> Denis Kirillov, "Russian oilmen favor economic integration with Belarus," *Finansovye izvestiya*, April 8, 1997, p. 2.

<sup>97</sup> Interview with Andranik Migranian in *Argumenty i fakty*, June 23, 1997, p. 3.

<sup>98</sup> *Rossiiskaya gazeta*, September 26, 1995, p. 1; Vladimir Kiselev, "They will not get down on their knees anymore," *Obshchaya gazeta*, May 22-28, 1997.

### ***Fractured Decision-Making***

Complicating Russia's ability to wield the energy "weapon" in the CIS is the fact that Russia cannot be treated as a unified "rational actor" in this sphere of foreign policy. Different corporations, different government agencies, and different individuals within those corporations and agencies are all wont to pursue policies that advance their own interests. The line between political and economic interests is totally blurred. Gazprom, ostensibly a profit-seeking company, clearly has its own domestic and foreign political agendas; while Boris Berezovskii, the deputy secretary of the Security Council charged with untying the Gordian knot of Chechnya, is a businessman (the richest in Russia according to *Forbes* magazine). Coordination of Russian foreign policy with regard to these issues has been weak, although the government has had some successes in enforcing a single policy (in stubbornly pushing ahead with trade liberalization and the introduction of the "ruble corridor," for example).

Thus some of the fiercest "under the carpet" arguments have taken place over Russian policy toward the near abroad. The energy lobby pushed for the Russian state to take over responsibility for all CIS debts, past, present, and future, and generally favored cutting back on deliveries to CIS countries unable to pay for them. However, people like former First Deputy Prime Minister Oleg Soskovets, a product of the metallurgy lobby, believed that it was important to preserve Russia's market share in the CIS, even if it meant selling energy to them at less than world prices (and selling to customers who could not pay), both for political reasons and because many Russian manufacturing plants were dependent on supplies from Ukraine and Kazakstan (and vice versa).

Russia generally seems content with the shaky status quo that has emerged in its relations with Ukraine, despite the drawn out dispute over the fate of the Black Sea fleet. At least once each year, typically in January, the two countries exchange sharp words over their energy trade.<sup>99</sup> Russia complains about Ukraine's payments arrears, Ukraine complains that the transit fees paid by Russia are below international standards. But the oil and gas deliveries continue. Ukraine actually owes very little to Russia for oil deliveries, since the deliveries are closely monitored and the tap is turned off for nonpayment.

Natural gas is a different picture. It is more difficult to control, since it cannot be turned on and off (without causing explosions). However, it is curious that although the Gazprom president periodically complains that local Ukrainian utilities are stealing gas, Gazprom has not made any effort to install meter technology or separate the export pipeline from the Ukrainian grid. There is probably a method to their apparent madness. Certainly it is not in Gazprom's short-term interest to disrupt the status quo; both Gazprom and the Russian government desperately need the monthly revenues from gas sales in Europe. In 1997 Ukraine will obtain free of charge 30 billion of the 53 billion cubic meters of gas it will import from Russia in return for transporting 110 billion cubic meters of gas from Russia to Europe.<sup>100</sup>

Many Ukrainians, especially the nationalist wing in parliament, repeatedly advance schemes to reduce Ukraine's dependency on Russian energy—by buying gas from Turkmenistan and building a new port at Odessa in order to ship Caspian oil from Georgian ports once it comes on stream. The most bizarre example of this line of thinking is a proposal to build a *south-north* pipeline across Turkey to bring Persian Gulf oil to the Black Sea (bizarre because Turkey is also pressing ahead with a plan to build a *north-south* pipeline to ferry Caspian Sea oil to the Mediterranean!). These alternative routes are going to be much more expensive than Russian oil and

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<sup>99</sup> Ustina Markus, "Energy crisis spurs Ukraine and Belarus to seek help abroad," *Transition*, OMRI, vol. 2, no. 9 (May 3, 1996), pp. 14–19.

<sup>100</sup> Interfax, July 1, 1997; *Delovoi mir*, July 11–14, 1997, p. 2.

gas, and if Ukraine has problems paying its Russian suppliers, how can it hope to pay for more costly supplies?<sup>101</sup> Turkmen gas is not really an alternative to Russian supplies, since it is shipped through the Gazprom network. The alternative supply argument only really makes sense if one expects Russia to exert crude political blackmail, threatening to cut off supplies unless exorbitant prices are paid, or if one expects civil disorder in Russia and hence a breakdown in supplies. These are possible, but unlikely, developments: it is doubtful whether Ukraine is rich enough to insure itself against such risks.

### ***Russian Efforts to Diversify Export Routes***

While Moscow seems happy to maintain its existing relationship with Ukraine, it is also keen to diversify its export routes: hence the new gas pipeline from the Yamal region to Germany across Belarus, which began construction in 1996 (the first new pipeline to be built in 15 years). For all the claims of Slavic brotherhood and the seemingly annual ritual signing of treaties of friendship and closer union between Russia and Belarus, relations between Moscow and Minsk are far from idyllic. Many Russian leaders correctly see Alyaksandr Lukashenka as a deranged and unreliable ally, and do not want to put too many eggs into the Belarus basket. Belarus' ailing and unreformed economy is chronically unable to pay its energy bills. By mid-1997 the Belarusian debt to Gazprom had reached \$200 million.<sup>102</sup> On two previous occasions Russia wiped out Minsk's debts by canceling other claims Belarus had on Russia for use of military installations and the like. It is improbable that this "zero variant" can be used a third time.

Further north, Surgutneftegaz won permission to build three new oil-handling facilities in the Leningrad Oblast, on the shores of the Gulf of Finland, which are intended to reduce their reliance on the costly ports in the Baltic republics. The new Primorsk port has 45 million ton capacity and could generate fees of \$1.5 billion a year.<sup>103</sup> LUKoil is building another terminal in the Arctic port of Murmansk, and for that reason turned down an offer from Lithuania to help finance the reconstruction of the Klaipeda terminal in return for a 10 percent equity share.<sup>104</sup> YUKOS, however, has said that it is interested in the Klaipeda project.

In the south, the interdependence of oil and politics is vividly illustrated by the Chechen case. Chechnya has its own modest oil field and more importantly sits astride the main export route from Azerbaijan. Many—including Aleksandr Lebed—believe that the Chechen war was started in December 1994 by financial interests keen to get a piece of the oil action bubbling up in Azerbaijan. Moscow could, however, build a new oil pipeline bypassing Chechnya. (Just as in 1997 a new 80 kilometer railway was built linking Dagestan with Rostov without crossing Chechen territory.) Moscow wants to ship oil across Chechnya for political reasons: the Kremlin still has not given up on the idea of keeping Chechnya within the Russian Federation.<sup>105</sup>

In the Far East, the geography generally works to Russia's advantage. Although distances are long and the terrain difficult, Russia is adjacent to Japan and China—two of the largest markets for energy in the next century. Relations with China are warm and the demarcation of the mutual border is nearly complete—despite the patriotic rhetoric of Yevgennii Nazdratenko, the governor of Primorskii Krai, protesting the "concessions" to China. Russo-Japanese relations also seem to be improving. South Korea, which now has no political quarrels with Russia, is also keen to

<sup>101</sup> Turkmenistan has announced that it will halt deliveries to Ukraine, since Kiev already owes \$1.08 billion to Turkmenistan for gas deliveries dating back to 1993. Interfax, May 7, 1997.

<sup>102</sup> Russian Public Television (ORT), July 18, 1997.

<sup>103</sup> See Valerii Ilin, "Those who lost in the Baltic seek a northern route," *op. cit.*; Agence France Press, March 22, 1997.

<sup>104</sup> *OMRI Daily Digest*, October 1, 1996.

<sup>105</sup> Aleksei Chichkin, "Oil and the Chechen War," *Vek*, February 16–22, 1996, p. 7; Igor Rotar, "Will Caspian Oil Flow Over the 'Northern Variant?'" *Prism* (Jamestown Foundation), vol. 3, no. 12, part 3 (July 25, 1997).

invest in Siberian energy projects, such as a gas pipeline from Irkutsk. Russia already exports electricity to the giant Erdamet copper smelter in Mongolia.

### **The Shape of Things to Come**

It would be foolish to try to predict the course of Russian development over the next ten years. On the surface, Russian politics seem to be in turmoil. Ministers and favored courtiers come and go with bewildering speed, and accusations of corruption fly back and forth in the captive media, while serious structural problems (from the status of Chechnya to military reform) go unresolved.

Dive down beneath the choppy surface waves, however, and the waters appear to be calmer. Yeltsin and Chernomyrdin anchor the system at the national level, and regional leaders seem to run a tight ship at the provincial level. No serious challengers to the current political regime are in sight. The communist opposition is confused, trapped in nostalgia, and bewildered by the changes; the mass of the population is disillusioned and apathetic; and the military has been disabled both as an interest group and as a possible threat to democracy.

Political and economic power seems to reside fairly firmly in the hands of a financial-industrial oligarchy: a few dozen corporations and a few hundred key individuals. They squabble between themselves, but don't try to use the army or to mobilize the population to put their rivals completely out of business. If this analysis is correct, then "more of the same" is the dull but reliable prediction for the next decade. One can expect incremental improvements from the status quo—a gradual rise in GDP, a slow revival of investment, the opening of some projects to foreign investors.

It is hard to tell whether this cautious scenario is good news or bad news for Russia, and for the West. It is good news for the Russian elite, but not so good news for the Russian people, since a rise in general living standards is not to be expected in the near future. A revival of oil and gas production would benefit the workers in those sectors, but it would be several years before the positive effects (in the form of increased orders for industrial machinery) would percolate through to other regions of the country. The scenario is good news for the United States to the extent that it downplays the likelihood of a communist-nationalist takeover. The oil and gas industry will need Western capital and technology—but the particular political and economic characteristics of the new Russia will dictate the environment within which these transfers take place.

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The current situation of "stable instability" is highly advantageous for speculative capital, which has learned to make money out of risk. It is more frustrating for industrialists, who want to minimize uncertainty. West European corporations, like Italian Agip and German Ruhrgas, are hoping that their long-standing political and economic ties with the core Chernomyrdin group in the Russian elite will carry them through the current uncertainty. The international oil business will never be risk free, and one cannot be too choosy about one's partners. For international energy companies, the situation is probably manageable if the risk in Russia is limited to such

factors as the width of Yeltsin's coronary artery and which minister is caught frolicking in a steam bath. The variables which one has to monitor are fairly restricted in number and in scope. The IMF, World Bank, and international credit rating agencies keep a close eye on Russia's monetary and fiscal policy, and Moscow's enthusiasm to join the WTO means that backsliding in foreign trade liberalization is unlikely. The perturbations that accompany political faction fighting may appear alarming on a day-to-day basis, but the general vector of slow but steady change in society and in the economy is fairly predictable.

At the same time, one cannot rule out the possibility of unpredictable developments. The death of Yeltsin, an ecological disaster, or the outbreak of fighting in the North Caucasus could break the consensus among the political elite in Moscow and trigger destabilizing tendencies. It is easier to imagine worst-case scenarios than to come up with plausible optimistic forecasts in which the doors are thrown open to foreign investors and oil gushes forth from the Klondike of the East. n

## APPENDIX

### Anatomy of the Russian Oil Industry

Name of Firm	Producer Subsidiaries*	Number of Refineries	Number of Major Joint Ventures (examples)
<b>LUKoil</b>	Astrakhan Langespas Kaliningrad Kogalym Nizhnevolzhsk Perm Urain	Perm Volgograd	18 (Tengiz, Azeri)
<b>Surgut</b>	Surgut	Kirishi	1
<b>Yukos</b>	Samara Yugansk	Kuibyshev Novokuibyshev Syzran	8 (Priobskoe)
<b>Tatneft</b>	Tatneft	Nizhnekamsk	5
<b>Sidanco</b>	Chernogor Kondpetroleum Saratov Udmurt Varegan	Angarsk Khabarovsk Saratov	8 (White Nights)
<b>Tyumen (TNK)</b>	Nizhnevartovsk Tyumen	Ryazan	5 (Samotlor)
<b>Sibneft</b>	Noyabrsk	Omsk	1
<b>Bashkiriya Petroleum</b>	Bashneft	Kaustik Novoufa Salavat Ufa Ufaneftekhim	1
<b>Slavneft</b>	Megion	Mazyr (Bel) Yaroslavl (2)	2
<b>Rosneft</b>	Dagneft Kalmneft Krasnodar Purn Sakhalinmor Stavropol Term	Tuapse Komsomolsk Krasnodar Moscow (2)	11 (Polar Lights, Sakhalin I,II,III)
<b>Eastern</b>	Tomsk	Tomsk Achinsk	4
<b>Onako</b>	Orenburg	Orenburg Orsk	3
<b>KomiTEK</b>	Komi	Ukhta	12

\* The full name usually includes the suffix “neftegaz”, hence “Purn” is “Purneftegaz”, etc.

Source: Ministry of Fuel and Energy.