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U.S. – Russia Economic Relationship: Implications of the Yukos Affair”

The Yukos affair represented a turning point for post-soviet Russia. Ever since acceding to the presidency, Vladimir Putin has worked to concentrate power in his hands and in those of the clan of former KGB officers who are his close supporters. He has eliminated federalism in violation of the Russian constitution, subordinated the legislative branch of government and the courts and imposed control over national television and the press.

With the arrest of the head of Yukos, Mikhail Khodorkovsky, however, he also acted to assure that the nation’s oligarchs would support only political candidates backed by the regime. His goal was to place the nation’s wealth in the service of his own political faction, choking off political opposition and completing the transformation of Russia into a controlled society with a permanent political leadership.

Khodorkovsky would hardly qualify as an international cause celebre if his arrest were an isolated incident, unrelated to the political struggles within Russia. Like the other Russian oligarchs, he amassed a fortune in the Yeltsin years on the strength of insider information and corrupt ties. There is no better example of how this worked than the methods through which he obtained the controlling packet of shares in the Yukos Oil Company, which controlled 2 per cent of the world’s oil reserves. Khodorkovsky’s bank, Menatep, was put in charge of the auction of the Yukos shares. It then acted to eliminate all competitive bidding and Khodorkovsky purchased the company for \$159 million, \$9 million above the starting price. In 2003, the value of Yukos was estimated at \$15 billion.

Unlike the other oligarchs, however, Khodorkovsky understood that the Russian rules of bandit capitalism were unacceptable internationally and he took steps to transform Yukos into a modern Western corporation, declaring his income and introducing Western standards of accounting and corporate governance. He also began to exercise the rights of a Western businessman, including the right to finance opposition political parties.

In the end, it was this that sealed his fate. The Russian bureaucracy depends on businessmen’s violations of the law, in particular tax avoidance, in order to facilitate a steady flow of bribes and to assure that they live in fear and so are amenable to political control. Khodorkovsky had broken with that system and his example had to be suppressed for the system to survive.

In August, the Swiss Supreme Court rejected a request for legal assistance from the Russian authorities in the Yukos case on the grounds that the case was politically motivated. According to the decision, the case against Yukos had “a political and discriminatory character... underlined by the infringement of human rights and of the right to defense.”

Nonetheless, the Yukos affair casts a long shadow over Russian economic and political life. The post-Yukos system uses economic relations for political purposes and obliges Russians and Westerners that seek profitable economic relations in Russia to pay a price in political principles and self respect.

In the post-Yukos system, no individual doing business in Russia is completely secure. Khodorkovsky was not only Russia's richest citizen. He was also the head of its most enlightened company. It was a measure of Yukos's success that on the eve of Khodorkovsky's arrest, the company was on the brink of attracting as much as \$25 billion in foreign investment from Exxon-Mobil for a 40 per cent stake in the company. Given the rise in oil prices, Yukos could not have gone bankrupt for purely economic reasons. Even after losing Yuganskneftegaz, its principal production unit, Yukos made good on a tax bill of \$23 billion by the end of 2005. The company's remaining units included oil fields capable of pumping 500,000 barrels a day of crude and Russia's biggest refinery. According to the terms of one restructuring plan, Yukos promised to liquidate \$18.2 billion in outstanding debts within 18 months. But the creditors rejected all offers and chose to dismantle the company, demonstrating that special interests were determined to destroy Yukos and distribute its assets among themselves. In the end, the principal beneficiaries were state run energy concerns run by Putin's closest cronies.

The aftermath of the Yukos case also makes it highly unlikely that Putin and his cronies will ever willingly surrender power. Yuganskneftegaz was sold to a previously unknown Baikal Finance Group at about half its likely real value. The state oil company Rosneft then purchased Baikal Finance. Yukos had filed for bankruptcy in Texas and won an American injunction barring Gazprom and its Western financiers from participating in the auction. It was apparently out of a desire to avoid legal complications that the Baikal Finance Group emerged to bid for Yuganskneftegaz. The sale, in fact, duplicated the tactics used by Yeltsin era oligarchs during privatization. It was also illegal because in tax settlement cases, non-core assets must be disposed of first. Yuganskneftegaz was the core of Yukos.

Under these circumstances, any transfer of power is risky for the present Russian leadership. Those who organized the illegal dismembering of Yukos could be subject to the same treatment that they imposed. This is an important reason why fair elections in Russia are unlikely to occur. In this, the Russian authorities can only be gratified by the Western reaction. The success of Rosneft's London IPO suggests that the bulk of Western investors are not interested in the ethical and legal issues presented by the destruction of Yukos and the treatment of the Yukos investors.

Finally, the aftermath of the Yukos case convinced the Russian leadership that they can use coercive tactics with foreigners freely. Royal Dutch Shell ceded control of the Sakhalin-2 oil and gas project to Gazprom under conditions in which it was widely believed to have been shortchanged by \$5 billion after the Russian government threatened Shell with the termination of operating licenses over alleged environmental violations. The Western attitude is so supine that Shell president Jeroen van der Veer actually thanked Putin when the ordeal was over in December, 2006. The Russians also cut off supplies to the Mazeikiu Nafta refinery in Lithuania. The refinery was the biggest Yukos asset outside of Russia and it was sold to a Polish company

despite efforts by the Russian government to acquire it. After that, the company began to experience problems with oil supplies. Finally, a Russian pipeline official informed them that they might never get supplies and there was nothing anyone could do about it.

Russia has cut off gas supplies to Ukraine and used the threat of a cutoff to get a higher price from Belarus in the middle of winter while continuing to use discriminatory pricing in the case of other customers in accordance with political allegiance. Turkey receives 75 per cent of its gas from Russia and, under these circumstances, is acutely aware of the need not to offend Russia. Russian officials have openly stated that Hungary's energy dependence on Russia precludes an "anti-Russian foreign policy."

Under these circumstances, it is important for the United States to develop a strategy for countering attempts by Russia to ignore the law and use economic relationships as a means of imposing political conformity. The U.S. was instrumental in the extension of membership in the G-7, which became the G-8 even though Russia's internal practices did not conform with that organization's principles. Similarly, Russia is a candidate for membership in the WTO and consideration is being given to rescinding the Jackson-Vanik amendment. All of these steps are inconsistent with Russia's present practices. Accordingly, Russia should be removed from the G-8 and action on WTO membership and the Jackson-Vanik amendment should be postponed until such time as it is justified by Russia's actions.

Western companies should seek to act cooperatively in the face of Russian pressure and violation of contracts and not allow themselves to be played off against each other to the ultimate detriment of everyone. There should be a means to investigate attempts by the Russian authorities to pressure Western companies to give up their contractual rights as well as measures to support affected Western companies in the event of abuses. At the same time, the U.S. and the European Union should develop a strategy to prevent Russia from using energy as a political weapon, including measures to protect against the consequences of any abrupt and politically motivated cutoff of supplies, coupled with the establishment of standards of transparency, competition and reciprocity.

Finally, the U.S. should be very wary of attempts by Russian companies to acquire U.S. assets with strategic significance both in light of the fact that Russia is determined to prevent such acquisition when it comes to their own strategic assets and because, in the aftermath of the Yukos case, no Russian company can be regarded as truly independent of the Russian state.