

Speech given at the IECA Conference in Vienna in 2007

Ladies and Gentlemen,

On April 23, 2007, an event took place in Russia which made headline news throughout the world. Programmes on television were interrupted with news flashes; newspapers ran headlines; news broadcasts led with the news: Boris Yeltsin, first elected President of the Russian Federation, had died at the age of 76.

In Putin's Russia, however, contrary to tradition, there were no news flashes, no interrupted programmes. The Russian people remained in ignorance of the death of their former president until the news broadcasts on state television aired that evening; even then, Yeltsin's death was relegated to third item. The day of mourning that was eventually announced for the former President was a grudging concession by the current occupant of the Kremlin to the man who had given him his power. The Oil Tsar would have preferred to forget Yeltsin altogether. Just as he would prefer to forget perestroika and the whole period of democracy and privatisation that Yeltsin had engineered. Putin is the heir to Brezhnev, to Khrushchev, to Stalin; he would prefer to forget the aberrations of Gorbachev and Yeltsin. He made that all very clear in an address to his party, United Russia in 2003: the collapse of the Soviet Union, he told them, was the greatest tragedy ever to befall Russia.

Vladimir Vladimirovich Putin had spent much of his life in the shadows. During Soviet times he was stationed in East Germany, in Dresden, a KGB operative working with the Stassi. With the collapse of the Soviet Union, he returned to St Petersburg – a place he still prefers to call Leningrad – and joined the new local administration there. From the very start, he demonstrated what would prove to be his greatest skill: his ability to put others in his debt. And to identify those who would advance his career. He became known as something of a fixer - somebody who could be entrusted with delicate matters and who would come up with a solution.

Putin moved to Moscow in 1996, just after the presidential election that had returned Yeltsin for his second term. His first job was again to fix a problem: to clear up the aftermath of the election.

It had not been particularly edifying. For many months prior, it had seemed certain that Yeltsin would fail to be re-elected, and instead the country would return to communism under the leadership of Gennady Zyuganov. At one point in 1995, opinion polls showed that Zyuganov enjoyed the support of 34% of the population; the support for Yeltsin was just 4%.

It is worth pausing here for the moment, for the actions Yeltsin took to prevent communism returning to Russia in 1995 still have their repercussions today. The main cause of public discontent with Yeltsin can be summed up in one word: money. Inflation was a staggering 600%. The tax system was a relic from Soviet times, where taxation was applied on a sliding scale between 0% and 100%, depending on the whims of the tax authorities. Pensioners were not being paid. Western goods, thought so desirable in communist times, were now on display in shops – but nobody had the money to buy them. In factories, people were paid – if they were paid at all – with products that nobody wanted and nobody could sell. Yeltsin needed money – and he needed it quickly.

Like the communists before him, Yeltsin relied heavily on the energy industry to bring in hard foreign dollars - in fact Russia depended on the energy industry for 30% of its income. The problem for Yeltsin was that the energy sector, rather than earning him money, was actually draining the economy. Yeltsin had tried to address the situation in 1992, when he issued a presidential decree that created a number of vertically integrated energy companies from the fragmented Soviet units. These new corporations included LUKoil, Yukos, Gazprom and Rosneft. The management of these companies, however, was still in the hands of men steeped in the Soviet tradition, with no background in or experience of a free market economy. All they were concerned with was their own pockets. The companies paid no wages, paid no taxes, and slipped to a level of inefficiency that was appalling. To give you some idea of how dire the situation was: Yukos, which was, at the time, under the leadership of the former manager of Yuganskneftegas, owed more than \$3 billion in back taxes.

The situation wasn't helped by the half-hearted approach to privatisation that marked much of the nineties. There was still a desire to protect the citizens of Russia from too much free-market competition, and so the domestic price for oil was set artificially low. In fact, people buying oil on the domestic market could sell it for profits up to 3000% on the international market. It is hardly surprising that this situation encouraged an expanding black market in oil. In Yugansk – the small town

that is totally dependent on Yuganskneftegas for its living – there were, at one time, no less than 35 private trading companies selling black-market oil; and all were in the hands of the mafia and the Red Soviet directors.

If Yeltsin was to stop the communists returning he needed money. And he needed it fast. He turned to the bankers. They were prepared to make a loan of \$ 1.8 billion to Yeltsin in exchange for the government shares in the ailing industries as collateral. If the government later found it impossible to repay the loan – actually it was more a matter of when rather than if – the banks would have the right to sell off the shares in privately organised auctions.

In a paper on Yukos he prepared for Harvard Business School, Malcolm S. Salter states: “Loans for shares solved three tricky political problems for Yeltsin’s team. First, it enabled the state to get these large assets – which were piling up debt, draining the state budget, and being run into the ground – off its books quickly... Second, in a time of nationalistic uproar and budget deficits, the programme provided a way for the state to get a quick cash infusion from domestic sources – that is, without having to give up ownership of the country’s prime assets to foreigners. And third, loans for shares served to get these companies out of the hands of the old soviet directors and under the management of Russia’s most accomplished businessmen, where they were more likely to be successfully restructured.”

With the support of the oligarchs now assured, Yeltsin started his election campaign in earnest. He was supported in this by two of the bankers – Berezovsky and Gusinsky, both of whom were head of major media empires. They ensured, in the coming months, that Yeltsin was constantly on the news; Zyuganov rarely enjoyed a mention.

After the election was ensured, the government defaulted in repaying the loans to the seven bankers, who then auctioned off the shares they held, frequently purchasing them themselves. This was certainly the case with the shares of Yukos, which had been acquired as collateral for a loan of \$ 150 million from Mikhail Khodorkovsky’s Menatep Bank. Although at one point Khodorkovsky had almost decided not to bid for Yukos shares. It was, Khodorkovsky had discovered, anything but a going enterprise; it was mismanaged, underperforming, saddled with an enormous tax burden, a hotchpotch of individual units, all run by directors hoping to make some money for themselves, and a disenchanting workforce that had lost any real hope of ever being paid their salaries either on time or in full. Its production had plummeted since 1992 and its lifting costs were the highest in the whole oil industry worldwide. And to add to all this, Yuganskneftegas, the principle source of crude for

Yukos was virtually bankrupt and was, to all intents and purposes, firmly in the grips of the mafia.

Ultimately, Khodorkovsky was persuaded to acquire Yukos by his business partners, Ledbedev, Brudno, Nevzlin and Dubov. Menatep purchased 43% of Yukos shares for \$ 250 million (plus the original loan); in addition, the bank had accepted non-regulatory debts totalling \$3.5 billion.

And so, when Putin arrived at the Kremlin, he discovered how important the power of the oligarchs had become. He learned how the media could be used to sway voters. He understood the need for a strong power-base. And as he went about his job of clearing up the mess, many people fell into his debt.

But most importantly, he earned Yeltsin's trust. In 1998, he was rewarded by being appointed head of the FSB – the secret service successor to the KGB. Later, in 1999, he was appointed Prime Minister, but still retained his position as head of the FSB. As we would learn later, this would provide him with the power-base he needed as President.

By this time, Yeltsin was becoming increasingly unpredictable – and many saw him as a figure of fun. People in the Kremlin felt it essential to name a successor – all too many were worried that his heart condition (he had had a quintuple bypass in 1996) would strike him down, and it was important that somebody should assume control at least until the following election. It was Berezovsky who was given the job of finding the suitable candidate. Berezovsky enjoyed his reputation as the *eminence gris*, the power behind the throne. And it was he who came up with the name of Putin. At the end of last century, Berezovsky and Putin were close allies and it is certainly probable that Berezovsky believed that this would put him in an unassailable position if Putin were ever to become President.

On the eve of the new millennium, Boris Yeltsin appeared on national television and announced his resignation. He appointed Vladimir Putin as his successor and Interim President.

It is just seven and a half years since that historic announcement. But in that time, the face of Russia has been drastically changed. The media empires of Berezovsky and Gusinsky have been acquired by parties close to the Kremlin – notably Gazprom – and media freedom is at an all-time low. The most successful company in Russia – Yukos – has been destroyed in what Andrey Illarionov, former chief economic advisor to President Putin, has called the “swindle of the year.” Mikhail Khodorkovsky is locked up in a cell in Siberia. The FSB is accused of killing Olga Politskovaya, the journalist who was so critical of Putin, and Litvinenko, who had placed the blame for an explosion in an apartment block in

Moscow and the theatre kidnapping at the feet of Putin. Political opposition has been silenced or obstructed – even the voice of such a public figure as Gary Kasparov. And only just two weeks ago, Putin announced that nuclear weapons would be trained on European targets if the US proceeds with its plan to install a radar tracking station in the Czech Republic.

“The collapse of the Soviet Union was the greatest tragedy ever to befall Russia.”

I do not apologise for spending so much time on the historic background to the current situation in Russia. I believe it is essential if we are to fully understand the duplicity of Putin and his unbridled ambition to recreate a dictatorship in Russia on the ashes of democracy.

There is, however, one piece of history that I have failed to mention thus far: in 1998, Vladimir Putin gained a doctorate in economics. This was not an honorary title such as those routinely given to high-placed government figures. Putin had to earn his doctorate. His thesis dealt with state control of natural resources. In it, he argues that a country's natural resources are best managed by its government, so that profits are enjoyed by the whole population and not by a small group of 'greedy investors'. It would, he concluded, be in the country's best interest to create a nationalised energy system comparable to that of Saudi Arabia or Norway. Since he became President in 2000, Putin has been actively working to put his policies outlined in that thesis into practice. By whatever means he has at his disposal. At the start of Putin's presidency, however, there was little indication of the course he would be taking. The relationships between business and the Kremlin which had been so vital to Yeltsin during this time as President initially continued. But it soon became obvious that Putin was now seeking to distance himself from the former President.

Putin was, of course, fortunate. The economic difficulties that had plagued much of the nineties now seemed a thing of the past. The oil companies – with Yukos, Sibneft and LUKoil in the lead - were increasing production profits but also their production to levels unknown since the mid-eighties. But for Putin there was really only one company that counted – one company that stood apart from the rest and which, he was often heard to say, should act as an example for all Russia.

Gazprom.

I was warned that there would be people from Gazprom in the audience today, and I hope they will accept my apologies for what I am now about to say: the only example Gazprom set at the end of the nineties was for total non-transparency of operations, gross inefficiency, a stubborn unwillingness to pay taxes, and a wide-

spread reputation for corruption. Indeed, an investigation into supposed corruption at Gazprom was initiated towards the end of the nineties; it was suspended at the direct request of Vladimir Putin.

During my many visits to Russia, I tried to find out why President Putin was such a staunch supporter of Gazprom. Most people were as bemused as I was. Only Mikhail Khodorkovsky gave me anything approaching a satisfactory answer. Gazprom was, he told me, the embodiment of the great Soviet institutions. This made it attractive to Putin. But there was another thing – something Putin particularly admired. It had power. Power that Putin could use for his own ends. With the idea that power is good, more power is better, Putin began to look for ways to redesign the Russian energy industry into something more in line with his own ideas. With this in mind – and against the background of his continued determination to eradicate the power base that had supported Yeltsin – he began looking for a suitable prey, one he could use to set an example that would be understood by the rest of the industry.

He turned his sights on Yukos.

At that time, Yukos was the Golden Goose of Russian business. At the beginning of 2003, it overtook LUKoil as the largest producer of oil in Russia, pumping some 1.4 million barrels per day – more than the production of Qatar. It was making enormous profits. It was diligently paying its taxes in close consultation with and under audits by the tax authorities. It was introducing new levels of expertise into an industry that, in many areas, was still floundering under antiquated techniques that were a left over from Soviet times. It was the first Russian company to publish quarterly reports in accordance with GAAP principles. It had declared its shareholder structure - the first Russian company to do that. It was employing more than 120,000 people. And it had negotiated a merger with Sibneft – the oil company belonging to Roman Abramovich – and the resulting company, YukosSibneft, was destined to become the fourth largest privately-owned oil company in the world. We have all followed the events that have led to the total destruction of this once great company. We have watched as the tax bill mounted – reaching a staggering \$ 26 billion. And we have seen how the assets have been auctioned off, each greedily gobbled up by either Gazprom or Rosneft, for prices that bear no relationship to the true market value of the various units. Even today, however, there are still questions being asked. And the question asked most is: why Yukos?

An analyst at Hermitage Investment put it very simply: "If Yukos had not existed, it would have been necessary to invent it."

I believe Yukos was singled out for destruction for four reasons. First, its very success had made it an inviting target. All too often, Gazprom was compared with Yukos, and Gazprom was constantly found wanting. Putin's vision of a nationalised oil industry could not allow the continued existence of Yukos, a company feted in the West as the most successful company in Russia, and moreover a company that was owned by shareholders and not the state. The example Putin wished to set – both for domestic companies and foreign companies operating in Russia – was that no company was safe. Success did not provide protection. Putin was the master – and people had better get used to it.

Second, the plans Khodorkovsky had to sell YukosSibneft to either Chevron or Exxon, plans that were well on the way to conclusion, only waiting for a final price to be set. Imagine how Putin must have felt about this - Russian oil in the hands of the US. There was simply no way Putin could allow this to happen, for it would mean that he had lost control of his own back garden. Russia would, in Putin's mind, have become nothing more than a puppet of the enemy he had fought so long. For a Soviet such as Putin, this was simply unthinkable.

Third, the personal enmity that existed between Putin and his close advisor Igor Sechin and Mikhail Khodorkovsky. Putin was jealous – extremely jealous – of the wealth Khodorkovsky had acquired. Nobody had a right to \$ 18 billion. This may seem strange, but many have given accounts of how Putin is obsessed with the wealth of others.

And fourth, the political ambitions of Khodorkovsky. This was, initially, the reason most people mentioned, but I did not fully subscribe to it at the time. In all my meetings with Khodorkovsky I did not get the impression that he had political ambitions beyond the strong determination to create a civil society within Russia. And he certainly never hinted at the coup that was exposed in June 2003 – a coup which would have seen Khodorkovsky named Prime Minister, with the Duma becoming a fully legislative body. It was later learned that the secret dossier suggesting this had been written and leaked by the FSB following orders given by Igor Sechin. Another supposed coup plot revealed in 2004: just 10 days before the presidential elections, Putin sacked his Prime Minister Kasyanov. The FSB claimed that Leonid Nevzlin, Khodokorvsky's long-time ally, had taken out a contract on Putin, and Kasyanov would then have assumed his place as President. Putin supposedly foiled the plot by having Kasyanov replaced with somebody loyal to the FSB.

Politics undoubtedly played a role in the destruction of Yukos – but it was the politics of the Oil Tsar and not of Khodorkovsky that lay at the root of the attack.

It soon became clear that any opposition was useless: Yukos was facing crippling tax bills that rose to an astronomical \$ 27 billion and it became increasingly obvious that Yukos was being forced into bankruptcy. And the first signal was the decision to auction off Yuganskneftegaz. Yukos fought this decision, based on the legal code which clearly states that, in the event of tax debts, core assets may not be sold until the very last. Needless to say, the court found it unnecessary to apply this article to Yukos.

Gazprom had been tipped as the certain winner of that auction, the more so since it had lined up a consortium of Western banks to finance the deal. But when Yukos sought bankruptcy in a US court, the Western banks - notably Deutsche Bank - got cold feet and withdrew their finance. It was left to Baikal, a post-box company with its head-offices in a grocery shop in a far off town in Siberia, to buy Yuganskneftegaz - which it then promptly sold to Rosneft.

It was later revealed that Rosneft had obtained the money for the purchase from the central Russian bank. So the irony was that the taxpayers had provided the money to buy Yugansk which was being sold to recover tax debts!

As we now know, all Yukos assets have now been auctioned. The story is over. But there is one final twist to the tale. The receipts from all the auctions have been more than the debts which Yukos had. Under Russian law, the remaining money must be paid to the shareholders. But the tax authorities have announced that new tax bills can be expected. There is no doubt that there will be no money left for the shareholders.

Initially, people had thought that the Yukos affair would prove a one-off event. They were soon to discover otherwise. For Putin then turned his eyes on foreign companies operating in Russia.

Shell was the first victim. It had signed an agreement with the Russian government for the development of Sakhalin. Under that agreement, Shell would first recover its investment and operational expenses and then share the profits thereafter with the Russian government. Putin thought that this was not right. And when Shell reported that the initial costs had risen by \$ 15 billion, Putin had had enough.

Enter Oleg Mitvol, deputy head of Russia's Federal Resource agency. He began a highly-publicised campaign against Shell, citing environmental irregularities. The pressure on Shell increased and finally, under the threat of the withdrawal of licences, Shell was forced to cave it and hand over a controlling interest in the project to Gazprom.

For many people, Oleg Mitvol appeared from nowhere. Certainly he had no links to the Kremlin – at least, so it seemed. But scratch beneath the surface of any high-level official active in the oil industry, and you are sure to find traces of Kremlin links. Mitvol is a wealthy man. And his wealth is derived from media interests. In fact, he is now the owner of newspapers that previously belonged to Berevoksky's empire - the empire that he had been forced to sell to Gazprom in a deal brokered by his former assistant, Roman Abramovich. So how did these assets suddenly fall into the hands of this little known bureaucrat?

Let's say – your guess is as good as mine.

Not all acquisitions by State-favoured companies were hostile. One took place in relative peace – and with little media attention. Around the same time, Roman Abramovich quietly sold Sibneft – after Yukos Russia's most successful independent oil company – to Gazpromneft. At the time of the Yukos attack, many people thought Abramovich was Our Man in the Kremlin. During one of the meetings between Sibneft and Yukos about the dissolution of their merger agreement, Yuri Belin, who was handling the negotiations for Yukos refused to agree to a Sibneft proposal. He was told that it would be better if he agreed, otherwise Roman would be forced to talk to Putin... Unlike Khodorkovsky, Abramovich preferred to take the money and run. And at the same time fuelling speculation that he was acting as the Tsar's personal banker.

Consolidation was taking place - with Rosneft, under the chairmanship of Deputy Prime Minister Igor Sechin - that's right, the guy who masterminded the Yukos attack - now claiming the position as number one oil company in Russia, and Gazprom, under Russia's other deputy prime minister, Dmitri Medvedev, consolidating its interests in and grip on Russian gas reserves. And that latter is now enshrined in Russian law. Two years ago, a law was passed which gave Gazprom gas monopoly status.

But we are by no means at the end of the story. TNK-BP is awaiting a decision on its licences to Kovykta. Mitvol is once again heading the attack – all centred on the production of gas. Under its licence, TNK must produce 9 billion cubic metres per year; it is only able to sell 2.5 billion cubic metres. Its plans for a gas pipeline to China have been consistently obstructed by Gazprom. Without that pipeline or access to Gazprom's network, there is simply no market for the remaining gas. The only alternative would be to flare off 6.5 billion cubic metres of gas per year. Is this what Mitvol really wants? And so the State is moving in on TNK-BP because a favoured state company is refusing to allow it to meet its legal obligations to the State.

Initially the decision was due on June 1, but was postponed for two weeks: many people suggested this was to avoid conflict at the G 8 summit. Last Friday, another postponement was announced; some are suggesting this is because of a meeting currently being held in Vienna. A more likely explanation is that a further delay will give the Kremlin more time to persuade the three Russian billionaire partners of TNK-BP to sell their shares as the Kremlin feels appropriate. So what is the current situation in Russia ?

Since Putin became president, the state's share of oil production has risen from 28% in 2000 to over 50% today. And that is not including TNK. Nor has this been achieved by legal or respected business means. Khodorkovsky fell victim to the Kremlin, and his courage should have earned him more than the mealy-mouthed whispers of sympathy he received. I wonder whether people will be more vocal in support of Mikhail Gutseriev, the billionaire owner of Russneft, who has recently been charged with 'large-scale tax evasion' and undertaking illegal activities as part of a 'criminal group' – the very same charges levelled against Khodorkovsky. Rosneft can look forward to acquiring more assets in the not too distant future. In the world of Russian gas, Putin's vision has been achieved: Gazprom now reigns supreme. Thanks to the increasing generosity of European banks, Gazprom has been able to go on a merger spending spree – cementing its position in Russia and Europe – while neglecting exploitation and further development of its immense gas reserves. Even today, Gazprom is still unable to satisfy the domestic market's need for gas.

Now some here may simply shrug their shoulders and dismiss all this as domestic politics. But it is my contention and conviction that the current situation in Russia should give Europe considerable cause for concern. We have already had two minor indications of the power now residing with Gazprom: at the beginning of both 2006 and 2007, Gazprom used its power to throw the switch in an attempt to bring two Russian neighbours into line. In each case, however, supplies of gas to Europe were also curtailed. A similar show of power has taken place in Lithuania. Russia wanted to buy the Mazeikiail oil refinery, but the Lithuanian government were unwise enough to sell it to a group of Polish investors. As soon as the deal was announced, Russia suddenly discovered a leak in the oil pipeline supplying Lithuania and was forced to shut it down for maintenance. In true Soviet tradition, that maintenance work is still continuing – 14 months later.

*Gazprom and Tsar Putin are fully aware of the strategic value of the gas and oil supply network. In 2005, the United States announced a plan to build a pipeline that would bypass Russia by bringing Southern Asian gas to Europe via a pipeline under the Caspian Sea. Putin's response was to persuade the presidents of Turkmenistan and Kazakhstan to send their gas through a pipeline being built along the Caspian Sea coast en route to Western markets via Russian and Russian-controlled territories. The US proposal has been consigned to the history books. And just in case some oil or gas manages to avoid passing through Russia, Gazprom has since acquired a controlling share in the European gas and oil hub in Brunnstein, here in Austria, indisputably the most important energy hub in continental Europe for gas and oil arriving in Europe from Asia and the Middle East.

Lenin once said – at least in a paraphrased version – that capitalists would be perfectly prepared to finance the rope with which to hang themselves. This is certainly true of many Europeans today. While EU politicians – notably Merkel and Blair – are warning about Europe becoming increasingly dependent for its energy needs on a Russia that is rapidly retreating into Cold War mode, European banks are clamouring to finance the very projects that are putting Europe at Russia's mercy. And Russia needs more than money. It is still desperately short of expertise in the oil and gas industry, and this can only be obtained from Western companies. But they must never entertain the illusion that they will under the Oil Tsar, ever profit from their enterprises. They will be reduced to suppliers – and they will be paid what the Kremlin thinks appropriate.

Today, more than at any time since the demise of the Soviet Union, there is growing tension between Russia and the rest of Western World. Diplomatic links with Great Britain are at an all-time low, following the Litvinenko affair. Russia is becoming increasingly irritable with the US plans for a satellite shield in Europe. It may not be long before Russia uses its strategic position in energy to bring Europe into line. Imagine the damage that could be done if Gazprom were to turn off supply.

People try to persuade us that it will never come to that. That Russia is genuinely moving towards managed democracy – and we must give it time and understanding and support.

I just wish I could believe them.