CHAPTER 2
STRUCTURAL CHANGES IN THE ENERGY SECTOR UNDER YELTSIN

When Gorbachev came to power, he described that the economy of the Soviet Union was in the state of pre-crisis and needed radical reforms. Gorbachev explained the situation in the following words, "The output of most types of industrial and agricultural goods fell short of the targets set by the 26th congress of the CPSU for the 11th five year plan period. There are serious lags in engineering, the oil and coal industries ... neither have the targets been met for the main indicators of efficiency and the improvement of the people's standard of living. ... In the absence of accelerated economic growth our social programs will remain wishful thinking" (xxvii CPSU Congress 1986: 29-30). To improve the deteriorating situation, Gorbachev announced some worthwhile policies for the betterment of the conditions for the Soviet people viz. raising the pensions of elderly people, ambitious plans of house building etc. At this time he speeded up anti-alcohol program which led to decline in state revenue. Also sudden drop in international oil prices in 1986 led to severe drain on the state budget.

Russia emerged as the most important successor of the erstwhile USSR in the aftermath of August 1991 coup and Yeltsin became the first freely elected leader in his country's 1100 years history. President Yeltsin announced the beginning of a radical policy of transition from a centrally planned economy to a market economy in October 1991. From 1991 to 1992, Yeltsin's program for economic reform was focused on the gradual elimination of price controls and he attempted to create a solid foundation for the transition to a free market economy (Considine and Kerr 2002: 236).
The Russian oil economy had to adjust to the two main problems i.e. the dissolution of the Soviet Union and the objective of establishing a market economy in between 1991-2000.

In the last quarter of 1990 the ‘USSR Presidential Guidelines for the Stabilization of the Economy and Transition to a Market Economy’ indicated the bleak situation in the following words:

“The position of the economy continues to deteriorate. The volume of production is declining. Economic links are being broken. Separatism is on the increase. The consumer market is severely depressed. The budget deficit and the solvency of the government are now at critical levels. Anti-social behavior and crime are increasing. People are finding life more and more difficult and are losing their interest in work and belief in the future.” (Granville 1995: 10)

According to Anders Aslund (Aslund 1995: 6), who was an economic advisor to Russian government from November 1991 until January 1994,

“The defining characteristic of Russia in 1991 was the depth of the collapse of the state, which had occurred in at least four ways, first, and most obviously, the Soviet Union broke up in December 1991. Second, the communist political system fell apart in the fall of 1991. Third, the command economy system founndered in 1990 and 1991. Fourth, state finances faltered as well, as a massive budget deficit of perhaps 30 percent of GDP mounted in 1991”. They had lot of hopes from Boris Yeltsin. Very few were aware of the gravity of Russia’s economic problems and the realities of its political situation.”

Yeltsin was born in a small village in the Ural Mountain. Interestingly, he was an independent child and a leader who was very aggressive and was fond of fights. He was very daring and was not afraid of saying what he believed.
Yeltsin tried to copy the democratic systems of the west. But the conservatives in Parliament, most of whom were bureaucrats and party officials of the old Soviet regime felt that their power and special benefits would be eradicated under such reforms and started opposing them.

Though Yeltsin was elected by the people as President, (with 57% of votes) this did not help his relations with the Parliament. Parliament opposed many of his reforms and policies tooth and nail mainly concerning the establishment of a free-market economy in Russia. Ruslan Khasbulatov, the parliament’s speaker and Aleksander Rustkoi, his Vice-President were Yeltsin’s most formidable opponents. Yeltsin also faced problems because of opposition from many political parties and groups. Some hard-line communist groups loyal to the Soviet system of socialism were dead against him. The confusing constitution of Russia could not explain and help to settle the dispute between Yeltsin and the parliament as who had more power. Moreover, more than half of the members of the Russian parliament opposed Yeltsin’s program of taking Russia towards a free market economy.

A constitutional court was created in July 1991 to interpret and apply the Brezhnev-era constitution to post-soviet Russia. Chief justice Valrey Zorkin acted as a mediator between the warring parliament and President. But the political struggle intensified further as he also started supporting Yeltsin’s opponents.

Yeltsin faced two problems in implementing his strategy, first although the Soviet Union had passed into history; the state had not been transformed overnight into a modern, western, liberal democratic structure well adapted to the extensity, intensity, velocity and impact of contemporary globalism. The controlling force of the communist party was gone, but the enormous
bureaucracies, ministries, agencies, layers of governments at the regional and local levels, and practices of corruption at all levels remained. (Solnick 1998)

The decline in production and the inability to collect taxes from the republics and the regions led to soaring budget deficit as centre had lost effective control over the economy. The problems in the Russian oil industry also got aggravated by the chaotic reorganization of the Soviet Union in 1991 which gave birth to 15 sovereign republics. During the 1990s, the rate of oil recovery of the Russian petroleum industry averaged a very poor 8-9%.

The economic situation in Russia during 1991 (When Yeltsin took over the reins of power) can be described as catastrophic. The Soviet economy was in a bad shape as USSR had ceased to exist. In just one year national income had fallen by more than 11%, Gross Domestic Production by 2.8%, oil and gas production by 11%, pig iron by 17%, and the output of the food industry by more than 10%. The foreign currency position deteriorated sharply. External debt increased to USD 76 billion, and internal foreign currency debt to USD 5.6 billion. Gold and foreign currency reserves fell sharply and for the first time in the entire period of the existence of the Soviet state, the Gold reserves were less than 300 metric tons (289.6 metric tons on January 1992) (Yukaev 1996: 3).

Because of rapid economic decline the situation became so grim during the Yeltsin’s administration that for the first time since World War II the rate of mortality in the Russian Federation exceeded the rate of birth. Russian population which was initially excited by the prospects of restructuring started arguing that Yeltsin’s policy of economic liberalization had a more ruinous effect on the country’s economy than the damage of 4 years of war against Nazi Germany. According to official estimate, the decline in Russia’s GDP
from 1991 to 1994 amounted to a cumulative 38% (Goskomstat 1993: 13-14.)

According to Public opinion studies, the Russian population started perceiving the process of transition as unjust, divisive and disabling (Whitefield and Evans 1994: 38-60).

Table 2.1: GDP Percent Change

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP as a % change of preceding year</th>
<th>Change in %</th>
<th>Index of consumer price as a % of preceding December</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>-</td>
<td>-</td>
<td>?</td>
</tr>
<tr>
<td>1990*</td>
<td>97.6 to 95.0</td>
<td>-2.4 to 5.0</td>
<td>?</td>
</tr>
<tr>
<td>1991</td>
<td>95.0</td>
<td>-5.0</td>
<td>+260</td>
</tr>
<tr>
<td>1992</td>
<td>85.5</td>
<td>-14.5</td>
<td>+2,610</td>
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<tr>
<td>1993</td>
<td>91.3</td>
<td>-8.7</td>
<td>+940</td>
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<tr>
<td>1994</td>
<td>87.3</td>
<td>-12.7</td>
<td>+320</td>
</tr>
<tr>
<td>1995</td>
<td>95.9</td>
<td>-4.1</td>
<td>+230</td>
</tr>
<tr>
<td>1996</td>
<td>96.6</td>
<td>-3.4</td>
<td>+122</td>
</tr>
<tr>
<td>1997</td>
<td>100.9</td>
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<tr>
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<td>95.1</td>
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<td>+137</td>
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<tr>
<td>2000</td>
<td>107.7</td>
<td>+7.7</td>
<td>+120</td>
</tr>
<tr>
<td>2001</td>
<td>105.0</td>
<td>+5.0</td>
<td>+119</td>
</tr>
</tbody>
</table>


The state budget deficit increased 6 times from the planned level for 1991. Practically all goods were in short supply. The ratio of stocks of commodities to the money saving of the population declined sharply. (by 5 times compared to 1985 ). Stocks of goods in retail trade fell to record low levels, 32 days overall, and for meat and fish 10 days, eggs 3 days, butter 21 days, clothing 35 days, footwear and hosiery 29 days. As a result rouble neither had the backing of gold and foreign currency nor of commodity (Yukaev 1996: 4)
From the above mentioned statistics it is clear that Russia inherited many weaknesses of the Soviet economy when it emerged as a successor state of the USSR. Yeltsin took over command from Gorbachev and announced transformation of the command economy to market economy. He announced a policy of shock therapy to complete this process of change; promising the complete abandonment of the command economy and a rapid shift to private property and free market.

It is very important to understand as how the entrepreneurs have made their appearance in a society where state socialism had prevailed for a long time. It is also important to understand as by what means (fair or unfair) large private fortunes were created in Russia and how the state and the society of Russia suffered because of the emergence of this so called ‘New Class’. It is somewhat surprising that party ideologues and government bureaucrats who had for a long time worked under condition of a developed socialist society helped usher in a capitalist bourgeoisie to take shape that too in the shortest possible time (Medvedev 2000: 170-171).

We can trace the beginning of the emergence of legal businesses and large private fortunes in USSR since 1987-1988. A law “On Individual Labor Activity” was adopted in November 1986 by the Supreme Soviet. This law permitted the establishment of thousands of small workshops. According to the law “On Cooperatives” tens of thousands of cooperatives were formed by private individuals, government enterprises and organizations. Through these cooperatives billions of rubles worth of non-liquid assets could be transformed into cash. Foreign trade was also liberalized (the monopoly of the previous government on foreign trade was relaxed) and making it possible to swing commercial transaction through the cooperatives. Many business
tycoons even believe that it was easier for them to work under Gorbachev than under Yeltsin. Making millions was far easier under Gorbachev because of less corruption and state control. According to many present day millionaires, during Gorbachev’s regime the years 1988 and 1989 were most suitable for their progressive business. It was very lucrative for them to mint money by selling commodities including oil abroad for dollars, after purchasing it inside the USSR for rubles. “‘Right connection’ even during the last years of Gorbachev’s regime was the most important aspect of the spectacular growth of many businessmen as there was no serious competition and USD 600 could be turned into USD 60,000 without any entrepreneurial talent (Molodoi Kommunist 1990 no.2 : 39).

Even government assets could be transformed into ready money through the Komsomol organizational structure, and the first commercial banks and stock exchanges were set up through Komsomol structure. The Komsomol (The young Communist League) had been the starting point for young adults and teenagers wishing to make career in the CPSU. It began to engage in business activities with the support and backing from the ruling party with an objective of profit making. The result was that a new term “The Komsomol Economy” came into vogue (Medvedev 2000: 72).

Within the government organizations and in the official structures of the state-owned economy it became possible to engage in activities to put some property into profitable circulation, though it was kept secret. Many managers and directors were given ‘special’ degree of independence, and their enterprises were placed partly on a self-financing basis, instead of depending on government subsidies. In place of several ministries, large Trusts or
Conglomerates were formed. The example of Gazprom is illustrative in this respect.

In 1992-93 there was a sea change in the condition of many business elites. With the liberalization of prices, and the coming of power to the ‘democrats’ too many opportunities emerged for Russian and foreign adventurers. With the demand of dollars rising rapidly, the purchasing power of foreign currency in Russia greatly exceeded its purchasing power in the west. This resulted into big profits for everybody who purchased commodities at the domestic Russian price and resold it at world market price. Many Russian citizens minted money by selling oil and other raw materials in the western market. Russians could make money because of their favorable positions, good connections in the government and their manipulative art and tactics to obtain the necessary licenses and permissions from a corrupt bureaucracy.

Many top ranking Russian officials as well as businessmen made big profits in a short period because of provisions of export privileges. The intricacies of foreign trade did not play a major role in making profits, instead inside information, bribes and “right connections” proved to be more beneficial.

It is well known that oil has been and still remains to be of prime importance in the Russian economy. Oligarchs controlling this massive industry can influence the global oil market. During the Yeltsin period a handful of Russian oligarchs exercised decisive control over the important oil industry of the country.

In the early 1990’s liberal economic reforms were enacted in Russia according to the prescription of the International Monetary Fund. The new economic program clearly took care of interests of the transnational corporation. The Russian economy was to be incorporated into the world system through several
measures, including conversion of Russia into a raw materials resource base of the west. The main objectives of these economic programs were- privatization, liberalization of prices, deregulation and the freedom to export capital out of Russia. The west also aimed to denude Russia of its financial resources besides exploiting it as a raw material appendage (Kagarlitsky 2008: 305-306).

The I M F and the World Bank became the advisors of the new administrative elite of Yeltsin’s government. Vice – Premier Yegor Gaider, the main architect of economic reforms acknowledged that his program for Russia matched the full recommendations coming from the western experts. Even the first document to formulate priorities of the new Russia (Memorandum of 27 February 1992) was addressed to the head of the IMF in Washington and not to the Russian population (Kagarlitsky 2008: 306).

According to some American scholars, the Russian government was acknowledging the west’s leading role as an active participant in the planning of reforms in New Russia and the Western approach reforms found a near total acceptance in the Kremlin (Nelson And Kuzes 1995). It seems the Kremlin was working under pressure because of bleak situation of Russian finances and the country’s inability to pay off the foreign debt. Gaider’s priority was to obtain foreign financial support but this desire was not fulfilled by the west for Russia got only I M F conditions in exchange and no financial support in early 1992 (Reddaway And Glinski 2001: 293).

According to Peter Reddaway and Dimitry Glinsky, “Russia, in the 1990s benefited little from the opportunities and advantages of opening to the international economy because its economic system remained highly corrupt, concentrated, politicized, unaccountable, and opaque. Opening to global financial markets did not attract investment and capital; instead, it facilitated
capital flight. Privatization did not promote entrepreneurship; it encouraged asset stripping, created large and unproductive business holdings, and discouraged foreign direct investment. Shifting to a market economy did not subject Russian businesses and the Russian state to the disciplining constraints of the market; rather, it enabled them to amass wealth without the threat of bankruptcy and spend state funds without balancing the budget largely by attracting foreign investment willing to enter the new Russian stock market and purchase Russian government securities bearing favorable interest rates”, (Reddaway and Glinsky 2001)

Throughout the entire period of Yeltsin’s regime the Russian economy suffered from acute shortage of investments. Equipments were not replaced and proper infrastructure was not developed. Even the cash generating oil industry did not receive sufficient capital investment required for its development. The country’s natural wealth particularly oil was exploited by exporting the capital on a large scale.

It is worthwhile to note that the shortage of investment was not due to lack of funds, the fact was that there was enough money in the country but New Russian property owners and the subsidiaries of foreign companies started sending capital abroad. According to Andrey Kolganov, ”This outflow exceeded all the foreign investments and loans received by Russia during the reform period many times over. During the 1990’s it was estimated at 150 to 250 billion dollar.” (Buzagalin and Kolganov (Eds) 2001: 231)

In the first week of January 1992, Yeltsin took the first steps for the elimination of price controls as per the advice of western experts. These western economists had advised him two pronged approach towards attaining a market economy i.e. Privatization and liberalization of prices. Accordingly, the prices
for most goods and services were liberalized. However important exceptions were made in the cases of energy (all fuels), agricultural (basic food stuffs such as milk bread sugar salt etc), precious metals and freight tariffs etc. While still tightly controlled, the prices for the administered price of coking coal were raised by 700 percent. In a slight concession to avid ‘reformers’ the share of oil, natural gas and coal that could be sold ‘legally’ at free prices was increased to 40 percent in May1992. Prices in the state distribution sector were partially deregulated, but confined to a 25 percent ceiling all markup ratios (Considine and Kerr 2002 237-238).

In the opinion of eminent scholars J. I. Considine and W.A. Kerr, “On 1 January 1992 the average wholesale enterprise price for crude oil was raised to 315 rubles per tonne, a 385 percent increase over 1991 levels. At the same time, wholesale industry prices were ‘unified’ and raise to a single, state controlled level of 350 rubles per tonne, a 400 percent increase. An inconsequential volume of domestic oil prices was cautiously liberated. To summarize the complex repertoire of tentative price reforms. A two-tiered pricing system was introduced under which a fraction of total Russian Federation production—approximately 30 percent—could be sold at the free market prices available on the domestic market. As always, approximately 10 percent of total production was earmarked for exports to the non—CIS nations and sold at the world oil price.” This type of experimental pricing policies in the oil sector proved to be insufficient and gave very poor results (Considine and Kerr 2002: 240).

Domestic oil producers, who were habitual of paying only token charges for centralized assets like free use of land and mineral rights, were subjected to many taxes, levies and duties imposed by local, regional and federal authorities
and governments during 1991-1992. For example, a few of the new and burdensome levies and taxes can be cited as follows:

1. A 26 ECU per tonne export tax was introduced in December 1991, and increased to 44 ECU per tonne in mid-1992;
2. Mandatory currency conversion or surrender requirements were introduced in December, 1991;
3. A 6-16 percent royalty payment for the use of subsoil resources was introduced on 21 February 1992;
4. A 10 percent geology fee (revenue tax) for the use of subsoil resources was introduced on 21 February 1992;
5. An 18 percent excise tax was introduced on 17 September 1992;
6. A 32 percent profits tax was introduced in 1992;
7. A 28 percent value added tax replaced the turnover tax in January, 1992;
8. Deduction to the Federal Oil Investment Fund averaging approximately 28 percent of gross proceeds excluding the excise tax were introduced in 1992; and
9. A host of additional taxes was introduced in 1992, including the road tax, the excess-wage tax, property (assets) taxes, the land tax environmental taxes, and a wide variety of colorful, and diverse 'local' levies (Considine and Kerr 2002: 250-251).

The Russian oil taxation system was also very complex and unfavorable. For most of the decade (1990-2000), approximately 100 federal, regional and local taxes and special payments were levied on oil firms. These taxes were levied on production basis and not on profit basis. The fluctuation in world oil markets really affected the oil producing firms of Russia. Different federal agencies were involved in sharing authority with regional and municipal
government to assess various corporate, excise, vat, export and royalty taxes on oil revenues. This haphazard approach to taxation undermined the inducement effect of federal tax exemption, as regions and localities were under no obligation to reciprocate and were free to levy separate taxes at discretionary rates (Stulberg 2007: 78).

The government was also lacking in formal authority with respect of commercial decision making for the fractured domestic oil industry. Tax and licensing responsibility were divided among several federal agencies, regional authorities and semiprivate agencies. Successive “laws on Oil and Gas” were generally vague and unclear about stipulating “Joint Jurisdiction” between Federal and regional government over the issuance of licenses for leasing exploration and production right from the state. Ultimately, administrators at different levels in the government wielded unlimited, independent and conflicting mandates for granting or withholding concessions for lucrative oil reserves of Russia (Wakefield 1997: 149-163).

As already mentioned, in 1991 and 1992, huge volumes of oil were illicitly exported to take advantage of large gap between domestic and export prices. At this time Vagit Alekperov, who was director of a production association in Kogalym, created his own western-style oil company, Lukoil, out of 3 Siberian production associations, 2 refineries and a trading company. Lukoil was Russia’s first vertically integrated oil company. Alekperov, who took the initiative at a time when the economy was in chaos, set an example, which the Russian government followed under Yeltsin for the rest of the oil industry. The idea was to reassemble the oil-fields and refineries of the far flung Soviet system into a dozen large private companies, building a new, market oriented oil industry. On November 17, 1992, Yeltsin signed a decree establishing the
first 3 vertically integrated oil companies, including Lukoil, and ordered the industry to be restructured (Moser and Oppenheimer 2001)

It is also important to note that Khodorkovsky became an advisor to Vladimir Lopukhin, Gaidar’s minister of fuel and energy during first year of the Yeltsin government. Vladimir Lopukhin had created an informal position, with the rank of deputy minister, putting Khodorkovsky in charge of energy ministry’s “investment fund”. This is common knowledge that this opportunity must have given an excellent insight of the inner working of the oil industry along with highly secretive information about industry to Khodorkovsky. Khodorkovsky must have also come in contact with the oil ‘generals’ (the powerful Soviet era directors of the production associations) (Khodorkovsky, November 19 1992: 7).

In 1992, Khodorkovsky told Thane Gustafson, a specialist in Soviet Russian energy issues, that he was providing credits to the oil industry (Gustafson 1999: 121).

In the oil industry, money was also being transferred by a technique called “transfer pricing”. An extraction company sold oil to another company at an artificial low price, say USD 5 per barrel. The second company then sold it for export abroad at a much higher price, say USD 25 per barrel. The result was that the extraction company, with all the wells, drills, fields and workers, lost money, while the second company made a handsome profit. In this manner the Russian wealth was transferred from one company to the other secretly by offshore shell companies.

In the early 1990s the Russian Government started creating holding companies. These holding companies became corporate energy giants practically overnight
and ranked among major international oil firms. The holding companies were fattened up by the state which awarded them lucrative stakes in the oil field extraction companies. In general, the Russian government gave the holding company at least 51% of the voting shares in the extraction companies, enough to ensure that holding companies got control. The government then planned to sell off its part of the holding companies after 3 years reaping a nice chunk of cash.

The risk for investors in the extraction company was that when the holding company took over, the new bosses could easily siphon off the oil wealth for themselves. The holding company could use transfer pricing, asset stripping and other means to redirect the profits. The shareholders in the oil field extraction company would be robbed. They would have lots of stock certificates, but none of the profits. The situation was ripe for conflict. The holding companies, which had majority of shares in the extraction companies had their own minority shareholders, who could be prickly and rebellious if they saw they were being ripped off.

For example, in the first three quarters of 1999, Yukos forced its three partially owned subsidiaries to sell it approximately 240 million barrels of oil at approximately U.S.D. 1.70 per barrel at a time when the average market price was about U.S.D. 15. Yukos then exported nearly 75% of that oil to world markets. Thus Khodorkovsky’s Yukos managed to siphon off approximately U.S.D. 800 million during a period of just 9 months (Wolosky 2000: 22).

Despite the fact that these practices were illegal under law, virtually all of Russia’s oil oligarchs engage in them.
The hasty privatization of state owned enterprises at very low prices created opportunities for the directors of those firms to acquire large ‘chunks’ of formerly state owned property including oil companies. In reality the plundering was conducted under legal cover. Managers and directors not only received a too generous share of state enterprises, but were granted the Soviet era’ right of “edinonachalie” (one man rule). These lucrative assets, many in the natural resource processing sector, were channeled to the Yeltsin clan at rock bottom prices (Rosefield 2007: 170-171).

Yukos was created as a holding company in 1992, incorporating Yuganskneftegaz, Samaraneftegaz, and refineries (Yukos was offered for sale three years later, in 1995). Yukos’ core was a production association, on the southern bank of the Ob River. A second production association, Samaraneftegaz, was also added to Yukos. Yuganskneftegaz had enormous potential; it was extracting 33 million tons of oil a year in 1993, nearly 15% of all western Siberia’s output. Yuganskneftegaz also had some of the largest reserves in Russia, including the biggest single underdeveloped field, Priobskoye.

Many banks including Uneximbank and Menatep generated lucrative profits by involving ruble-dollar speculation business which was “authorized” by the government. But in the mid 1995, The Russian Central Bank imposed a new exchange rate “corridor”, (a narrow range in which the ruble would be allowed to rise and fall against the dollar) to bring inflation under control. Chubais thought that such control on currency would bring stability in the economy.

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1 Priobskoye field, discovered in 1992, occupies an area of 5466 square kilometres along the Ob River, 100 km west of Nefteyugansk, with about 4.5 billion barrels of oil, Yuganskneftegaz has a license for about 72% of the field, The National Territory, according to a Yukos Press release, October 28, 1999, on passage of production-sharing legislation for the field.
By 1995, it was clear that Yeltsin had become very weak politically and among the Russian public there were probabilities that in the elections of next year (1996), the Communist led by Zyuganov could win the elections by defeating Yeltsin.

In the beginning of 1995 it was feared by many that big industry remained in the hands of the red directors and if their clout and economic power is not controlled timely they could bring back communists to power. During mass privatization, Soviet factory directors, being insiders had been controllers of their factories. The so called “red directors” were still ruling Russia’s giant key industries with excellent influence and control, including in the energy sector (Rosefield 2007: 170-171).

During this critical time Vladimir Potanin (who was a banker and big business magnet) came out with a new scheme. This scheme was called “loans –for–shares”. Under this scheme the financially strapped Russian government would mortgage the states prime industrial assets to a few politically connected and influential insiders of Kremlin for far less than real value.

Yeltsin signed a decree on August 30, 1995 finalizing ‘loan for shares’ scheme. In the original plan international companies were also allowed to participate in the bidding under the scheme. However, Khodorkovsky and K. Kagalovsky, a former Russian representative to the International Monetary Fund and world Bank managed to manipulate the scheme finally in such a manner that foreigners participation was not allowed. This was a well planned effort as the Russian business tycoons knew their limitation and were not so financially sound that they could compete with rich foreign oil companies. For example Khodorkovsky did not want to face a competition for bidding with Chevron or any other foreign company. Anatoly Chubais also formulated a dual process
system - two key system, under this system the first key for the factory would be handed over before the 1996 Presidential election and the main and the second key would only be handed over after the 1996 election. This system was created to see that business magnates ensure victory of Yeltsin in the coming elections.

The business tycoons were allowed to bid on the property / industry of their choice while also being the auctioneers. For example, Menatep Bank was the chief suitor as well as the "organizer" of the auction for Yukos (Hoffman 2002: 314). This was a real conflict of interests joining hands. The business tycoons with tacit understanding with Kremlin picked the companies they wanted. According to Joel Hellman, an economist for the European bank for Reconstruction and Development it was a "State Capture" meaning that businessmen and vested interests turned around and "captured" the government (Transition Report 1999: 115).

On September 25, Yeltsin approved a list of forty four companies that were supposed to be offered under loans for share scheme, but by the second week of October 1995, it was reduced to twenty -nine. In October 17, 1995 version these were further reduced to sixteen. Four companies could not be auctioned as there were no bids for them. Finally twelve companies were auctioned between November and December, 1995 and the maximum number of companies went to the banks that acted as organizers of the auction, their secret shell companies or the affiliates of the enterprises themselves (Hoffman 2002: 314 – 315)

The two oil generals, Alekperov and Bogdanov, also won loan- for shares auctions for parts of their companies, Lukoil and Surgutneftegaz respectively. The Surgut auction was especially a unique example as how intention and
action were different in reality. It was also a unique example as how the ideas of openness and competition propagated by Anatoly Chubais were ignored in practice. Outsiders were warned in advance by the Surgut management not to make a bid for this company and Surgut airport was kept closed that day deliberately to ensure that other bidders could not come to buy the part of the company (Freeland 1995: 3).

In fact the treasury position was so bad that the Russian government was desperate for cash to pay wages and pensions at that time. Incidentally "loans-for-shares" was also the first phase in Yeltsin's election campaign for 1996. In reality this scheme was the umbilical cord between the oligarchs and Kremlin who did not wish communists to be back in power. Under this scheme, Russian government relinquished control of its biggest enterprises (many of them oil companies) through a rigged "loans-for-shares" program (Liberman and Veimetra 1996: 773). The government shares of large enterprises were placed under trust management with oligarch-affiliated financial institutions and banks in exchange for loan to the state. When the government defaulted on these loans, the creditor-trusted acquired the right to auction the collateral stakes. Almost all the auction winners turned out to be affiliate companies of the banks and financial institutions who paid only a nominal amount above auction starting price. Ultimately the oligarchs got control of these key assets at a very low price. Affiliates of Khodorkovsky’s Rosprom-Menatep group acquired Yukos oil company for U.S.D. 159 Million. Yukos was one of the largest oil company in the world with a production of 44.5 million tons (1999) of crude oil worth approximately USD 8 billion (at the price level of year 2000). Similarly affiliates of Boris Berezovsky and Roman Abramovich acquired control of Sibneft for only U.S.D. 100.3 million. In 1999, Sibneft had produced oil worth U.S.D. 3 billion annually and its proven reserves estimated to be equal to Texaco’s. Potanin’s Interros-Neft acquired

Yeltsin’s shock therapeutic policies involving asset – grabbing Ponzi schemes (chain-letter type frauds like the M M M case) (Rosefiled 2007: 171), revenue diversion and capital flight resulted into a super-depressive free fall in production. The oil oligarchs were also involved in massive dilution of capital for quicker gains defrauding the state. In last quarter of 1997, Sibneft issued approximately 44 million new shares of its principal production company, Noyabrskneftegaz, at a below – market price. Those shares were sold to affiliates of Sibneft. Sibneft then transferred these shares to Noyabrskneftegaz, at a below market price. This transaction diluted the equity of existing Noyabrsk stockholder by 75 percent. The transaction also resulted in transfer of USD 400 million in value terms. Ultimately Boris Berezovsky and Roman Abramovich (controllers of Sibneft) later merged the Noyabrsk out of existence by using their new super majority voting power (Wolosky 2000: 22).

Table 2.2 : Business holdings of selected Russian oligarchs

<table>
<thead>
<tr>
<th>Oligarchs</th>
<th>Primary financing Institutions</th>
<th>Primary Industries</th>
<th>Primary subsidiaries</th>
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<tr>
<td>LUKoil</td>
<td>Vagit Alekperov</td>
<td>Imperial Bank, Petrokommertz Bank, Nikoil Investment Co., LuKoil-Garant Pension Fund, LUKoil-Reserve Investment Co., CK-LUK oil Insurance Co.</td>
<td>LUKoil, Arkhangelsk Geology</td>
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<td>Berezovsky and Smolensky</td>
<td>Boris Berezovsky, Alexander Smolensky</td>
<td>SBS/Agro Bank, Agorprom Bank, Zolotoplatin Bank, Obiedinennyi Bank, KOPF Bank, STS Insurance Company, Dorbroe Delo Pension Fund</td>
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<tr>
<td>Group</td>
<td>Founder/Leaders</td>
<td>Companies/Enterprises</td>
<td>Source</td>
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<tr>
<td>Group MOST</td>
<td>Vladimir Gusinsky</td>
<td>MOST-Bank, Insurance Group &quot;Spasski Vorota&quot; Moscow Fuel Company, &quot;Most-Development&quot;</td>
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Similarly, Fridman’s Tyumen Oil Company (TNK) allegedly stole Sidanko’s most valuable assets by manipulating the bankruptcy process.

The oil oligarchs were involved in looting their companies even more directly – by stealing valuable assets eg: equipments, wells etc. In fact, from 1997 to 1998, assets worth a book value of approximately USD 3.5 billion were parted with the oil production companies which were controlled by Yukos. Yukos had forced its subsidiaries to transfer assets to new companies (Wolosky 2000: 23). All this was done under the corrupt and inefficient regime of Yeltsin. This type of illicit activities clearly shows the inability of Russian leaders to control powerful oligarchs and oil barons and also their deep involvement to mint money by unethical practices. On top of that, the oil barons frequently quarreled among themselves and on many occasions settled their differences by using muscle power and involving in murders. On the prevailing situation a totally different view had been given by a prominent Russian sociologist Olga Kyrshtanovskaya, She wrote:

At the core of Russia’s economy is a class of “authorized personnel”, owners of majority property to whom the state has entrusted the task of developing a market. The economy operates in the absence of equal ‘money making’ opportunity for all. The state capitalism of today has itself nurtured these businessmen, giving birth from its own inner recesses to this class of authorized property owners. This was a positive, productive move. First, these government-authorized owners had a personal interest in making a profit (as did the state, personified in its top officials); second, government authorized business was guaranteed against bankruptcy and all sorts of disorder and consequently, brought an element of stability into the chaos of the market; third, this economic elite was a natural obstacle in the path of any “plutocracy”
that might be formed by the nouveaux riches of Russia, for whom the laws had not been written (Izvestia January 10, 1996).

Vadim Kortunov, director of the Humanities Center at the State Academy of Management has given following opinion about Russia’s new class. According to him:

“The new generation of Russian “businessmen” has been formed, for the most part, on the basis of leftovers. Above all these are people incapable of marketing their own intellectual property, incapable of constructive, creative activity. Consequently they are people who have been left on the sidelines by society, in the margins of cultural and spiritual life...

They are either member of the nomenklatura who were in the right place at the right time when their enterprises were privatized, people who found it easy to exchange their “communist convictions” for the psychology of monetarism. Or else they are openly criminal elements who shrewdly grasped that under condition of social, political and legal instability it was more efficient and safer for them to operate by hanging up a commercial sign. Or else they were youthful newcomers who hadn’t absorbed what they were taught in school but, to make up for it, were not burdened with any symptoms of the thinking process...

This generation of “new Russians” is united by such characteristics as moral nihilism, a total inability to engage in spiritual and intellectual activity, a monetarist psychology, and consequently a parasitic mode of existence displaying the flag of “free enterprises”. It is therefore quite logical that the growing prosperity of today’s Russian businessmen takes place against the backdrop of overall decline in production impoverishment of the population,
inflation and the ruination of our country’s economy as a whole (Nezavisimaya Gazeta December 5, 1996).

It is worth while noting that during Yeltsin’s regime; nearly all of Russian oil had come under the control of an exclusive club of new businessmen. There existed an obnoxious nexus between some of the gas oligarchs and Yeltsin; for example: Rem Vyakhirev and Viktor Chernomyrdin. Rem Vyakhirev controlled Gazprom from 1992 until 2001. Chernomyrdin, who was the minister of the Gas Industry, transformed ministry of Gas Industry’s assets involved in production, processing and shipping of natural gas and formed a new state entity- Gazprom in 1989. His designation also changed from minister to CEO of Gazprom. In December 1992, Chernomyrdin was made Prime Minister by Yeltsin. At this time Vyakhirev became the Chairman of the Management Board of Gazprom. In November 1992, Boris Yeltsin converted Gazprom from a wholly state-owned joint company into a private and independent joint stock company (Rutland 1996: 12). Some of the shares of Gazprom were owned by state and some were sold to its (Gazprom) officers and friends later (Rutland 1996: 12). Vyakhirev ran Gazprom as if it was his own company and by 1998 Forbes Magazine declared him as world’s 200 richest men (Transition, June 1997 Forbes Magazine, July 6, 1998: 192). Vyakhirev and Chernomyrdin converted Gazprom’s valuable resources and assets into many hundred new subsidiaries. These subsidiaries gave a lot of benefits to their relatives and close friends.

According to Boris Federov, who served as the outside director of the Gazprom Board, Executives of the Gazprom took away approximately USD 2 billion per year for almost 10 years (Johnson’s Russia list, February 19).
According to Stieglitz, an American economist who had held senior office in the IMF:

"THE [Russian] government was virtually giving away its valuable state assets, yet was unable to provide pensions for the elderly and welfare payments for the poor... [It] was borrowing billions from the IMF, becoming increasingly indebted, while the oligarchs who received such largesse from the government were taking billions out of the country.

The IMF had encouraged the government to open up its capital accounts, allowing a free flow of capital. The policy was supposed to make the country more attractive for foreign investors; but it was a virtually one-way door that facilitated a rush of money out of the country" (Longworth 2006: 311). Yeltsin had little knowledge of foreign countries and was lacking in the exposure to the international environment. The West (mainly USA) had supported Yeltsin for developing a new system in Russia. The USA also promised economic aid package of about USD 4 billion and a 5 year (1991-1995) credit of USD 11 billion towards acceleration of transition of the socialist economy to a capitalist market economy in new Russia (Imam and Romanovsky 2002: 169).

In the area of foreign policy Yeltsin and his team had no plans and no clear ideas. Yeltsin's foreign minister Yuri Kozyrev had been following blindly what USA dictated in the initial years of Yeltsin's regime. Therefore, the foreign policy of Russia in the beginning had a very strong bias in favor of USA with pro-western orientation. Kozyrev also favored close relations with the west on philosophical and practical grounds (Checkel October 16, 1992: 20-21).

Kozyrev had spent most of his life in the USA and western culture and way of life had deeply developed a pro-western orientation in his mind. He had also
opined and believed that the highly industrialized nations of west particularly USA would become the main source of economic assistance for an economically weaker Russia. Kozyrev also stated- “We proceed from the premise that no developed, democratic civil society based on reasonable and rational principles can threaten us”.

By the start of 1992, various Russian foreign policy experts and some members of the parliament had started criticizing foreign policy of Russia. Kozyrev’s critics argued that the Russian government supported western and American policies compromising Russian national interest. Therefore, Russia was no longer behaving as an independent great power (Tolz 1992: 1-9). The statesmen of the world were puzzled and confused as to how foreign policy was formulated in Moscow. The President, ministry of foreign affairs, Parliament, reconstituted Security Council after 1992, and presidential advisors, all functioned in a fractured manner, with unclear delimitations and responsibilities, which did not and could not result in a coordinated policy process (Pravda 1997: 208-226).

Russia was well known for its natural resources. However, huge investment was required for their extraction. Oil and gas remained prime sources of Russia’s currency throughout Yeltsin’s regime. For example: In 1996, 70% of federal budget incomes had originated from the oil and gas sector of the national economy. But in practical terms Yeltsin’s foreign policy did not bring about expected results- as the economic aid, credits and FDI from the USA and the West was not coming as expected. The ultranationalists, militant nationalists and Communists joined forces in a red-brown coalition that forcefully condemned the west for humiliating Russia, reducing it to a second-rate power, ruining its economy and robbing it of its national resources.
Yeltsin finally dismissed Kozyrev in January 1996 and academician Primakov was appointed as new foreign minister in April 1996. Primakov was a pragmatist and was opposed to the one sided tilt of Russian foreign policy towards west (including USA). Primakov was an advocate of believing in striking a balance between the east and west in Russian foreign policy by paying more attention to Asian countries, particularly China and India.

Economic turmoil, political instability, separatist movements, ethnic violence, the eastward expansion of NATO and Russia’s lukewarm support to its policies in Yugoslavia had already weakened Yeltsin on many fronts in the eyes of majority of Russians who had started believing in Russia’s inability to cope effectively with domestic and international issues of crucial importance.

The breakup of the country and disappearance of the unified Soviet economic space pushed Russia towards bankruptcy. During the 1980s the Soviet GDP was estimated by CIA as about half that of the USA. By 1992 the CIA concluded that the Russian GDP had fallen about 10% of the USA. By 1996 oil production in Russia was 47% (Goldman 2008: 56) of the 1987 level. The infighting among the oligarchs for privatizing the various oil fields and pipelines was largely to blame for this sharp decline. The oil prices in the mid 1990s which moved around a low of USD 20 per barrel did not encourage increase in production. According to Marshall Goldman, no Russian oil company increased production during 1990-1999 (Goldman 2008: 56). Much of the industry was privatized in the mid 1990s and almost all the new owners seemed more interested in stripping and sending assets outside the country.

Capital flight from the country as a whole has been estimated at USD 1 billion a month (Goldman 2008: 56). The inflation rate had risen by twenty one times in 1992 and government budget showed serious deficit. Few of the Russian
population who should be paying taxes did so. In 2000 even after a decade of private ownership only 3 million Russians out of 70 million actually paid taxes. It is interesting to note that for 8 years oil production continued to decline. It was about 60% in 1998 of what it had been at its peak earlier. The mismatching of technology with economics and acute shortage of funds in the last days of the Soviet Union, disorganization and so called restructuring and infighting of the oil industry under Yeltsin’s poor administration further aggravated the situation. Even the fields which had been identified by previous exploration plans were not developed despite the fast declining output from existing production fields.

Joint enterprises or joint ventures in working oilfields had been the main routes for foreign investments in Russian oil industry. There had been considerable attempts on part of Yeltsin’s government towards attracting foreign investment in energy sector. Following were the important efforts towards achieving this aim: (Mitchell 1996: 75-76)

a. The Law on Foreign Investment providing the basic rights of establishment and legal protection (July 1991)

b. The Law on Property creating property rights for Russians and foreigners (December 1991)

c. The Federation Treaties of March 1992 stabilizing the relationship between the Federal Russian governments and the republic, oblast and autonomous region governments.

d. The Law on Mineral Resources establishing federal ownership of underground resources, licensing procedures, and some rights of regional governments to revenue sharing (February, 1992)
e. A Bankruptcy Law (March 1993), and the Civil Code (1994) providing basic protection of command enforceability of contracts.

f. The Production Sharing Law substituting contracted production shares for taxation (December 1995)

According to IEA (1995a report), despite all these attempts direct foreign oil industry investments brought in only approximately USD 1.7 billion in the beginning of 1995. These were very small percentage for a petroleum industry which invested about USD 90 billion annually outside the former communist areas. Joint ventures or contracts with some 40 foreign partners supplied about 5% of Russian production in 1995 (Russian Petroleum Investor, June 1995).

These laws can be viewed as few positive steps for the development of a comprehensive framework for foreign investment. But fact remains that the Russian laws as passed during Yeltsin's regime were not attractive to the foreign investors. For example, in case of the Production Sharing Law, there was a need for parliamentary (rather than government) approval of contracts for operations in so-called “strategic” and offshore regions. Also absence of international arbitration in case of disputes and freedom for Russian government to reopen the clauses in case of major changes in circumstances gave an upper hand to Russians.

As declining oil output had caused lot of worries for Russia under Yeltsin's Presidency, Russian government allowed foreign companies eg. BP to acquire equity in the energy ventures of Russia especially as it planned to develop some of the remote Arctic and offshore regions. These remote fields were having very difficult and tough working conditions and needed ultramodern and advanced technology, which Russians lacked. Therefore, Russia as in past, allowed Western companies to develop fields near the islands of Sakhalin and
in the northern Siberia. Accordingly three Production Sharing Agreements (PSA) were signed with foreign companies. This was something positive for foreign companies as Russia was reluctant to sign such agreements earlier. A Production Sharing Agreement is more preferable by oil companies than a regular operating agreement as it allows the oil company to recover all of its cost before it has to share profits with the country of operations.

For development and exploration of the Kharyaga field in Timan-Pechora, one PSA was offered to the French company Total. Rest of the two PSA’s were demarked for development in Sakhalin island. Out of these two, one PSA was signed with Royal Dutch Shell led consortium in June 1994, which agreed to work in Sakhalin 2 offshore oil and gas field. Shell agreed to put up 55% of the equity with Mitsui (which took 25%) and Mitsubishi (which took 20%) as partners. It is interesting to note that there were no Russian partners in Sakhalin 2 project. On the contrary in Sakhalin 1 consortium which was signed in 1995 Sakhalinmorneftegaz was having equity of 11.5% and Rosneft was having the equity of 8.5%. Both these companies also did not have expertise, technological knowledge and Exxon-Mobil would be given a 30% share in the consortium and this company would work as the lead partner for the success of this ambitious project. A Japanese company, SODECO was the other stakeholder with 30% share and one Indian company, ONGC Videsh was given a share of 20% (“ONGC Videsh Limited’s activities in Sakhalin, Asia Pacific”, Online :Web). Russian oil companies led by Mikhail Khodorkovsky’s Yukos opposed the concessions to PSA tooth and nail.

**Yeltsin’s gas diplomacy towards Ukraine:**

In the initial years of Yeltsin’s presidency when energy privatization had just begun the increased prices charged by Russia from Ukraine were more the
result of domestic change in the Russian economy (the domestic price liberalization needed to set economic reform in swing) than of policies specifically aimed at Ukraine. Therefore this can be concluded that Russia’s energy related behavior towards Ukraine has not been always politically motivated, especially in the very initial period i.e. during the first months and years following Ukraine’s independence in 1991.

Russia made it clear to Ukraine by 1993-1994 that Russia was willing to use energy as an instrument for the pursuit of broader policy objective in Ukraine, in particular to make Ukrainians “rethink the wisdom of their sharp break with Russia” (Anieri 1999: 74) During this period and that immediately following it, Russia was able to use energy as a tool of its foreign policy vis-à-vis Ukraine in three main ways, first through the threat of a cut-off in supplies (Anieri 1999:69-98).

Second, through the issue of Ukraine’s large, energy debt, which gave Russia indirect leverage over the Ukrainian economy. By 1994, this debt amounted to $2 billion, which was later converted into Ukrainian state debt toward Russia (Anieri 1999: 74).

Indeed, it could be said that the Russian state, despite complaining loudly about Ukraine’s rapidly growing debt, in reality was happy to use it as and when required, to be exchanged for political or economic concessions, not only in bilateral relations, but also at the level of issues such as control over the Black Sea Fleet, Ukraine’s nuclear weapons program, and mainly for control of its gas transit system.

Third, by supplying energy to Ukraine, with relatively favorable conditions, (Anieri 1999: 74-78). By providing energy resources at lower than world
prices, credits, and barter deals, Russia ensured that Ukraine would remain dependant on it. A diplomatic approach was adopted to use these three ways. In the early September 1993 Massandra summit between presidents Yeltsin and Kravchok, where the fate of the Black Sea Fleet and Ukraine’s nuclear weapons was to be discussed. Just before the summit, gas supplies to Ukraine by Gazprom were curtailed by about 25 percent (Anieri 1999: 77).

Conclusion:

It is an irony that Russia had inherited 75% if the territory of the former Soviet Union, 52% of its population, 76% of the mineral and fuel resources, 90% of the oil production and 80% of its military –industrial complex. Yet, the economy had registered a decline of cover 40% up to the end of 1993 and the trend continued in successive years with slight improvement in the year 1996 (Imam and Romanovsky, 2002: 186). This sort of problems had hampered the real conduct of Russian foreign policy under Yeltsin’s Presidency.

During 1998 President Yeltsin became very sick and was not actively involved in day to day affairs of running the State. At this time the then Foreign Minister Primakov was looking after Russian Foreign Policy and during his tenure as Foreign Minister Russian relations with the CIS and Asian neighbors improved a lot.
Table 2.3: Changes in Industrial output

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<tr>
<th></th>
<th>1999 as % of 1998</th>
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<tr>
<td></td>
<td>Original index</td>
<td>New index</td>
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<td>New index</td>
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<tr>
<td>January</td>
<td>97.6</td>
<td>110.7</td>
<td>114.1</td>
<td>105.3</td>
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<tr>
<td>February</td>
<td>97.0</td>
<td>113.7</td>
<td>116.7</td>
<td>100.8</td>
</tr>
<tr>
<td>March</td>
<td>100.4</td>
<td>109.6</td>
<td>112.3</td>
<td>103.6</td>
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<tr>
<td>April</td>
<td>100.6</td>
<td>105.5</td>
<td>109.5</td>
<td>105.2</td>
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<tr>
<td>May</td>
<td>106.0</td>
<td>110.6</td>
<td>114.2</td>
<td>-</td>
</tr>
<tr>
<td>June</td>
<td>109.0</td>
<td>109.8</td>
<td>112.4</td>
<td>-</td>
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<tr>
<td>July</td>
<td>112.8</td>
<td>108.5</td>
<td>111.9</td>
<td>-</td>
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<tr>
<td>August</td>
<td>116.0</td>
<td>110.2</td>
<td>113.2</td>
<td>-</td>
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<tr>
<td>September</td>
<td>120.2</td>
<td>107.2</td>
<td>110.7</td>
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<tr>
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<tr>
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<td>111.1</td>
<td>102.5</td>
<td>103.9</td>
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Source: Goskomstat – monthly reports provided by internet securities.

Table 2.4: percent change in electricity usage and official GDP, Russia, 1991-98

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<tr>
<td>Electricity usage</td>
<td>-1.3</td>
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<td>-5.1</td>
<td>-8.5</td>
<td>-1.8</td>
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<td>-1.6</td>
<td>-1</td>
<td>+2.2</td>
<td>+3.5</td>
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<tr>
<td>Official GDP</td>
<td>-5</td>
<td>-14.5</td>
<td>-8.7</td>
<td>-12.6</td>
<td>-4.1</td>
<td>-3.4</td>
<td>+0.9</td>
<td>-4.9</td>
<td>+3.2</td>
<td>+7.7</td>
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Figure 2.1: Involvement of Kith and Kin in Gazprom. (Source: Goldman, Marshall, I. (2003), The Piratization of Russia: Russian reform goes awry, London: Routledge: 109.)