TURUN KAUPPAKORKEAKOULU
Turku School of Economics and Business Administration

RUSSIAN OIL SECTOR TODAY AND TOMORROW – THE IMPLICATIONS OF THE CASE OAO YUKOS

Peeter Vahtra

Electronic Publications of
Pan-European Institute, 2/2004

http://www.tukkk.fi/pei/

TABLE OF CONTENTS

1 INTRODUCTION

Russia has recently re-emerged as one of the most significant player in world oil markets presenting unchallenged numbers of growth for the year ended. The favorable oil prices in world markets have boosted the growth of Russian economy for several years in a row and the end is not foreseeable – or is it? Although the conduct of market economy and partial economical liberalization are strengthening their roots in Russia, the admirable economic growth has been shaded by increasing concerns on the institutional inefficiencies and authoritarian rule over the economy. The glooming oil sector of Russia is currently involved in one of its most internationally recognized crisis spreading around its leading actor, OAO Yukos Oil Company. During the past year, this most controversial of Russian enterprise majors, alleged with charges by governmental agencies and tax ministry, has witnessed several upheavals inside and around itself. A widespread speculation on the reasons and beneath-laying political causes of the events are being presented in all forums, coupled with mounting concerns over ownership rights and eventually the shape of the whole oil business in Russia. This discussion paper aims at going deeper into the effects of the events by bringing together the existing information and adding the consideration on the present and future state of the industry in light of case Yukos. The attention will thus be given to the characteristics of Russian oil economy in light of the controversial Yukos case and its effects to the sector, leaving the further speculations of the reasons behind the charges of Yukos' individual shareholders untouched upon possibilities.

While the arrest of Khodorkovsky has been granted a great deal of attention, there are simultaneously other significant forces at work on the background enjoying the lack of big publicity and preparing new conditions for the oil sector in form of higher taxes, closer scrutiny and less governmental lobbying power appointed to the oil giants. The re-division of power in Russian oil economy is likely to been seen in the near future, with the most probable outcome of reduction of the profit margins and lobbying power of oil companies and increasing flow of the companies' excess profits to the state coffers.

In all its controversy, what characterizes the Yukos case, is that it includes several issues crucial for the future of the whole Russian oil industry. The crisis is in fact concentrating on the very issues under heavy debate currently in Russian oil sector. Whichever the outcomes of the twisted Yukos saga, the beneath-laying issues remain topical for time to come. Major changes are inevitably to take place in the sector along with probable shift in power over the industry procedures. In this paper, following the overview of current indicators and recent development of Russian oil sector, the main characteristics of the Yukos inquiry are briefly discussed with subsequent analysis on the industry-wide controversial issues they felicitously address.

2 AN OVERVIEW OF RUSSIAN OIL INDUSTRY

2.1 The Main Indicators

Through the impressive growth of recent years, Russia has emerged as a key player in world energy markets. After a steady rise in oil production during the last few years, according the latest data, the country now ranks first in oil export terms in worldwide comparison and the second only to Saudi-Arabia in oil production, with only a marginal difference. As of the end of 2002, Russia possesses some 5,7 per cent of world's proven reserves, amounting to 60.0 billion barrels, ranking the 7th in worldwide comparison. (BP 2003a) From domestic viewpoint, the oil sector forms some 15% of the Russian GDP with oil-related taxes accounting for up to one quarter of the federal budget receipts (Khartukov & Starostina 2003). Russian proved reserves are dominantly located in West Siberia region, which accommodates some 72% of the country's total, followed by Volga-Urals and Timan-Pechora regions with 14% and 7% share of total reserves, respectively (BP 2003b).

Although Russia and the US, for example, are estimated to possess similar endowments, the US has exhausted far greater portion of its endowments. The rising world market prices for oil and oil products accompanied with remarkable devaluation of Russian rouble have boosted the Russian economy since the 1998 economic crisis with the national economy experiencing rapid growth ever since.

Table 1: Spot Crude Oil Prices, 1998-2002.

Year	Brent, $/bbl
1998	13.11
1999	18.25
2000	28.98
2001	24.77
2002	25.19
2003	29.55

Source: BP 2003a, Petroleum Argus

The oil production is currently in a phase of rapid growth (Table 2) and the trend is likely to continue in the near future. The Russian oil managers are even presenting the estimations of the production reaching as much as 10 million bpd by the year 2010. The fact is, however, that the major production expansions of this scale are heavily dependent on the development of Russia's export markets. (Ebel 2003) In comparison to US, EU or China, the domestic consumption of Russia is minimal, with the country producing 10,7% of world's oil production but consuming only some 3,5% (BP 2003a).

Table 2: Russian Oil Production 1995-2003, mbpd

1995	1996	1997	1998	1999	2000	2001	2002	2003
6,1	6,0	6,1	6,0	6,1	6,5	7,0	7,7	8,4

Source: BP 2003b, Petroleum Argus

2.2 The Oil Export System

At present, Russian economy is critically depending upon oil export revenues. During the past few years, crude oil exports accounted for some one third of Russian export revenues. For the oil companies, these oil exports form the only reliable source of cash that is needed to meet the basic financial needs. Thus, no matter what the circumstances, Russia would export as much oil as possible. (Khartukov & Starostina 2003) Although the exports are planned to be considerably raised further, the plans are facing increasing constraints in form of limited pipeline infrastructure and available export facilities.

The crude pipeline export monopoly is held by government-owned company, Transneft. Russian crude pipeline system covers over 48 000 km, with almost ¾ of the pipelines being older than 30 years. The investment demands for reconstruction and technical upgrades amount roughly to some $ 1 billion per year. The overall capacity of the pipeline network is 600 mt/year. In 2002, some 374,4 mt of crude oil was transferred through the system, accounting for 91,8% of Russian crude production in that year. (BP 2003b) In 2003, the exports through Transneft pipeline system totaled 149,8 million tonnes.

Table 3: Main Exporters through the Transneft Pipeline System in 2003, '000 tonnes

Lukoil	Surgutneftegaz	Yukos	TNK-BP	Sibneft	Tatneft
25698,5	18278,7	26840,7	16267,8	11356,9	9332,4

Source: Argus Petroleum

Main export constraints are connected to physical bottlenecks of the pipeline system and concerned governmental bureaucracy. With the oil transportation infrastructure operating at its capacity limits, the main bottlenecks are located in Western parts of Russia and western republics close to the main export points. Crude shipment is further limited by domestic delivery requirements connected to export quotas and allocation. (BP 2003b) Since the foreign hard currency markets are more lucrative target for oil companies as the domestic ones, the governmental delivery quotas are set to ensure the supply to domestic markets. (Considine & Kerr 2002)

Currently in the west, the Druzhba pipeline is the main export route for Russian oil with the capacity of up to 1,3 mbd. Through the Druzhba pipeline, crude is delivered to Central and Eastern Europe and former Yugoslavia. Further expansion is planned, to connect the Druzhba with Adria pipeline running to the Croatian Adriatic port of Omisalj, a scheme through which the Russian crude could be shipped straight to the port of Mediterranean Sea. This would allow great cost savings and allow more efficient and economically feasible shipments beyond. However, the pipeline is not expected to become operational before mid-2004. (Khartukov & Starostina 2003)

Main pipeline projects outlined by Transneft include the Phase 2 of Baltic Pipeline System, reversal of Adria pipeline and expansion of Novorossiysk pipeline. Enhancing the throughput of Baltic Pipeline System and the efficiency of Russian Baltic Sea port of Primorsk will give considerable boost to Russian oil exports, simultaneously shifting the emphasis from somewhat troubled Black Sea port of Novorossiysk (due to the complexity of shippings through the narrow Turkish Bosporous strait) to the Baltic Sea. However, also the Primorsk exports have faced recent troubles in form of increased transportation costs caused by the stricter rules of maritime transportation and harsh weather conditions on the Baltic Sea. Although several additional large-scale pipeline projects for improving Russian export capacity and debottlenecking the existing routes, even under the most favourable scenarios, these projects would only be long-term solutions because of the gigantic and time-consuming nature of the pipeline construction projects.

3 THE YEAR OF IMPRESSIVE GROWTH

During the past year, Russia has further strengthened its position as one of the world's leading oil producing and exporting countries. Apart from OPEC, Russia has maintained its production growth and collected the gains from continuously high world market oil prices, despite the propositions of OPEC to cut the production in order to maintain the price levels at more suitable levels for the organization. In 2003, Russia's oil and oil condensate production rose by 11 percent to 8,43 million bpd, along with 9 percent export growth to non-CIS countries, amounting to 149,82 million tons and some 13,4 percent export growth to the CIS countries to 37,5 million tons. Moreover, during the last two months of 2003, oil production in Russia reached its new heights amounting to 8,82 mbpd. Comparably high world market prices for oil have thus fuelled the country's economic growth, however simultaneously causing concerns of the country being far too reliable on the oil price levels. Measured in proven oil reserves, Russia holds the 7^{th} position in the world, with its leading companies holding the reserves comparable to those of world's biggest oil conglomerates, ExxonMobil and ChevronTexaco.

In Russian international economic relations, the oil companies play a vital role, accounting for some 30% of country's exports. The main target for Russian oil remains the EU, at present accounting for some 50 percent of Russian oil exports, with the EU enlargement in May bringing about further increase in this share. To some extent, the one-sided export structure of Russia causes concerns of its future position in international markets as a mere raw-material supplier, inhibiting the development of the country's industrial structure and other fields of economy. At present, some 75 percent out of Russia's 100 biggest exporters operate in oil or gas business. For time being, only the heavy industry sector has some real potential of challenging the dominant export position of natural resource based conglomerates. Still, in many parts Russian superiority as and increasing importance as oil and gas provider has been seen as the main vehicle for developing the co-operation with and bringing the country closer to European Union. In a short term, it can thus be argued the Russian economy mainly to benefit from the superiority of the oil and gas sector in its economy, while in long term perspective, alternative economic sectors have to be developed in order to sustain the country’s economic competitiveness.

The oil production growth is estimated to slow down somewhat during the course of 2004; according to International Energy Agency the growth would be around 600 000 barrels per day against 800 000 bpd in 2003. The initial estimations of Russian Energy Ministry were way more pessimistic, anticipating the growth of only some 2,5 percent, which would bring the oil production in Russia to some 8,65 mbpd in 2004. However, the revisited estimations from Energy Ministry were announced in late January, quoting the growth of some 6-8 percent. However, the optimistic growth scenarios, heavily dependent on world oil price level, may well be curbed during the course of the year.

The reserves in main production regions are already close to depletion and the export pipeline capacity remains a critical bottleneck. Some improvement can however be expected, addressed mainly to enhanced capacity of Baltic Pipeline System. The preliminary estimations by state pipeline monopoly, Transneft, indicate a 14,5 percent rise in crude exports via its pipeline system. The growth slowdown would understandably indicate good news for OPEC, addressing increasing concerns of the world oil price level. At the moment, as the production is constantly rising in many non-OPEC countries, the demand for OPEC oil is projected to fall by some 700 000 bpd in 2004, being at 25,5 mbpd. Even further slowdown in demand for OPEC oil is considered possible during the latter half of 2004.

4 AN OVERVIEW OF THE MAIN ACTORS

The organizational and competitive patterns in Russian oil industry have gone through several alterations during the passed few years and further changes are already foreseeable. The competitive positions have inevitably been affected by the upheavals around the biggest of the individual actors, OAO Yukos, giving the challengers a vantage in the competitive race. The overall trend during the last few years indicates strong growth tendencies in practically all companies in Russian oil sector, with trouble-beaten Yukos still holding the leading position accompanied with Sibneft, both in growth numbers and current estimations. With overall production growth of the sector of some 11 percent in 2003 and estimated growth up to 8 percent this year, individual actors' growth projections range from "modest" 5-6 percent of Lukoil to ambitious goal of 20 percent of Sibneft. In following, indicators on latest development (see Table 4) and an overview of the market position of five biggest actors in Russian oil sector are provided, along with additional considerations based on these developments.

Table 4: Production and Exports of the Five Biggest Producers in 2003

	Proven Oil Reserves 31.12.2002, mmbls	*Production 2003*,mtons*	*Production Growth '02-'03, percent*	*Exports 2003, mtons*	*Export Growth '02-'03, percent*
Yukos	*13 734*	*81*	*16,7*	*49,5*	*37,5*
Lukoil	*15 258*	*81,5*	*4,2*	*37,5*	*9,6*
TNK-BP	*8 374*	*55,75***	*14,5*	*n.a.*	*n.a.*
Sibneft	*4 575*	*31,45*	*19,6*	*12,46*	*24,55*
Surgutneftegaz	*6 600***	*49,2***	*11,8***	*n.a.*	*n.a.*

*preliminary figures

** year 2002/ '01-'02

Source: Companies' web sites, author's calculations

4.1 Yukos

In market capitalization terms, Yukos is currently the number on company in Russia. Measured in proved oil reserves, Yukos ranks second after Lukoil in Russia with the reserves of 13,734 billion barrels as of the end of 2002, a figure being comparable with that of the world’s leading majors, ExxonMobil and ChevronTexaco. The annulled merger with smaller rival Sibneft would have resulted in creation of world’s leading oil company by proven reserves. Yukos proven gas reserves amount to 220 million cubic feet as of the end of 2002. Most of the company’s reserves are located in Western Siberia, especially the main oil field of Priobskoye, which is considered one of the Russia’s largest. Not included in this figure are the upstream acquisitions in 2001 and 2002, consisting of controlling stakes in gas producing companies Arcticgas, Urengoil and Rospan International.

In production terms, Yukos took the leading position in Russia in 2003 by overtaking its main rival, Lukoil. During the last years, Yukos has reported production growth challenged by very few Russian oil companies, or even world’s leading consortium for that matter. The oil production of Yukos amounted some 81 million tons in 2003, which is approximately 20% of all the Russian production, bringing it to par with Lukoil and indicating over 16% production growth compared to 2002. Three main upstream operations of Yukos include Samaraneftegas in Western Russia and Yuganskneftegas and Tomskneft in Siberia.

In marketing activities’ sector, Yukos operates over 1200 filling stations in Russia, one of the largest station chains in the country. The company exports some 50 percent of its crude oil with the main target markets being the EU and CIS countries. The main export routes are the Baltic and Black Sea ports and Druzhba pipeline running across the Southwest Russia and CEE countries.

Yukos is executing an aggressive internationalization strategy, with exports to over 40 countries worldwide. During the first nine months of 2003, the company’s combined exports of oil and oil products amounted to 45,8 million tons, indicating over 30% increase compared to the corresponding period of 2002. During the first half of 2003, oil products’ exports grew to 8,0 million tons, up by 66% compared to the first six months of the previous year.

Despite the ongoing upheavals around the company, Yukos recently presented its ever-strongest quarterly results for third quarter of 2003, with net profits up by impressive 56 percent compared to corresponding period of 2002. The comparably low oil lifting and refining costs further add to the company's competitive position in economic terms; compared to its main rival Lukoil, Yukos is currently possessing significantly more efficient resources with oil well exhaustion rates and the age of the wells considerable lower than these of Lukoil. However, the tax payments in 3rd quarter 2003 were only at the rate of 7 percent, compared to the statutory 24 percent, causing further concerns over additional pressures from tax ministry. As of recent, Yukos has announced considering abolishing its tax optimization schemes thus complying with the tax officials' demands.

4.2 Lukoil

In terms of proven oil reserves, Lukoil continues to hold the number one position in Russia and ranks second in worldwide comparison with the proven reserves of 15,257.8 billion barrels. During the past year, Lukoil had to give up its leading position to scandal-troubled Yukos, who overtook Lukoil in production terms during the last months of 2003. According to the latest estimations, Lukoil's total share in Russian oil production will somewhat equal that of Yukos, both being equivalent to some 19% of the market share. While the production of both companies amounted to 81 million tons, the production growth of Lukoil has been far from that of its biggest competitor, amounting to just over 4%, compared to 16,7% of Yukos. Lukoil's refining production amounted to 42 million tons, up by some 0,4 tons from the last year.

Lukoil operates over 4000 filling stations in Russia and CIS, with the sales through its own retail network rising to 2,4 million tons last year and the total amount of oil products sold through oil distributors rising to 14,2 million tons. In the end of January 2004 Lukoil signed the deal with US oil major, ConocoPhillips, to buy 795 gas stations in US, by which Lukoil doubles the size of its retail chain in the country. In the view of the purchase, the company hopes to boost up its exports to US in order to make full use of the extended retail chain and a refinery in its possession. Along with the projections of increasing exports through Baltic ports, Lukoil still pushes for the construction of Murmansk pipeline system, remarkably enhancing the exports from Western Siberia to

US. Further support for Lukoil’s extended retail chain will be provided through rental refining capacities in Europe, nearby either the Northwestern or Mediterranean ports.

According to preliminary statements, Lukoil’s exports were up by 9,6% in 2003 compared to that of 2002. Including the CIS countries the volume of exports rose to 37,5 million tons with oil refined oil exports amounting to 13,6 million tons. The domestic crude oil sales were decreased by 1,5 million tons simultaneously increasing its exports and domestic refining throughput. According to the statements given by the company in the beginning of 2004, Lukoil is considering eventually giving up the domestic crude sales thus concentrating heavily on the growth in international oil markets and domestic oil products.

4.3 TNK-BP

In the beginning of 2003, thus far the biggest single foreign investment in Russian economy was witnessed when British Petroleum bought a 50% stake in Tyumen Oil Company (TNK), in a $ 7 billion deal. The creation of the joint venture was officially completed by the end of August 2003. Newborn TNK-BP is holding third position in Russian oil sector both in terms of production and proven oil reserves. In 2003, TNK posted significantly high production growth figure of 14,5% compared to previous year, outperformed only by Yukos and Sibneft in production growth terms.

As of recent, TNK-BP has emerged as the potential buyer of Latvia’s Ventspils oil terminal, which is being prepared for sale probably already during the first months of the current year. TNK-BP has already overtaken problem-ridden Yukos as the main exporter of oil through the terminal and is believed to be in talks concerning the takeover of the terminal which operating profits have collapsed after Russian Transneft stopped its crude exports to the port in the beginning of 2002. Further, the plans have been discussed, for TNK-BP taking part of constructing and operating the 4 mtons/ year oil terminal at Vistino bay on the Baltic Sea near St. Petersburg. These two projects also show some features of interconnectedness, since the involvement of TNK-BP in Vistino project can be further used for increasing the pressure on Venspils Nafta. Whichever the results of negotiations, however, TNK-BP is evidently strengthening its position on export markets by attempts of gaining the foothold on the Baltic Sea with fairly good projections. Succeeding in the projects would significantly improve the company's position as a major exporter of Russian crude and would enable the increasingly efficient use of consortium's extensive retail and marketing network in Europe.

4.4 Surgutneftegaz

Surgutneftegaz is currently holding the fourth position in Russian oil sector. The company has traditionally kept in good relations with Russian state, thus considered as the most "politically correct" private oil company. The company's production amounted to 54 million tons last year. In the end of December 2003, Surgutneftegaz along with state-owned Gazprom and Rosneft, formed an alliance to develop the huge untapped oil and gas reserves of Eastern Siberia, thus indicating the growing state interest and participation in oil business. The area is of strategic importance for both Yukos and TNK-BP, the latter of which owns a license to the huge Kovytka field in Eastern Siberia. When developing the planned gas link to China, TNK-BP now has to co-ordinate its projects with state-backed consortium, the procedure is not likely to emerge as smooth as planned. As of Yukos, the temporary operating license it held to develop the Talakan field in East Siberia was passed to Surgutneftegaz in November and thus the newly-formed consortium can be considered the most likely receiver of the permanent license for Talakan field when auctioned in 2004.

As of the beginning year, Surgutneftegaz is planning to slow down its output growth after presenting the 9,8 percent year-on-year growth for 2003. The possible drop in output is addressed to the pipeline capacity constraints.

4.5 Sibneft

During the past years, Sibneft has presented unchallenged production growth figures among Russian oil companies. In reserves and production terms, Sibneft ranks fifth in Russia with its oil production amounting to 31,45 million tons in 2003. During the past two years, Sibneft's production has been growing at pace of 20 percent/year, and the company plans to maintain growth for 2004. Sibneft has been able to maintain the impressive growth rates possessing resources relatively unexploited, compared to bigger actors in Russian oil sector, such as Lukoil, with several wells in its possession close to exhaustion. Whereas regarded as one of the most dynamic and "Westernized" Russian oil companies, Sibneft is selling around 60 percent of its crude oil to domestic market with considerably lower prices than its main competitors.

Sibneft exports some 35 percent of its crude output and around one quarter of its oil products, mainly through the Black Sea ports of Novorossiysk and Tuapse. Due to development of Baltic Pipeline system, the importance of Primorsk port in the company's exports is continuously growing.

As a result of the planned merger transactions with Yukos, 92 percent of Sibneft's shares were transferred to Yukos shareholders in exchange to $3 billion in cash and 26,01 percent of shares in the merged company. After the last-minute announcement of Sibneft's core shareholders to pull out from the deal, an agreement on reversal transactions and annulation terms have been sought. Until the reversal transaction is carried out, Yukos technically owns 92 percent of the company. Most probably, Sibneft is looking for the quickest way to separate itself from the deal seen as a burden to its operations under the present course of events.

Since the divorce from Yukos merger was announced, the possibility of selling a stake in the company to foreign owner has been analyzed. Latest news indicate the interest of French major TotalFinaElf in acquiring the stake in Sibneft; however any transactions are extremely unlikely to be carried out before the dust has settled around the Yukos case and the March Presidential elections. However, for time to come, if Kremlin allows any deals of foreign takeovers, Sibneft is proposed to be the most likely target for the acquisition regarding its size on one hand and the competitive resource basis, on the other.

5 INTERNATIONALIZATION PATTERNS OF RUSSIAN OIL MAJORS – SOME RECENT SCHEMES

The oil giants have for years been the main vehicles of internationalization in Russian enterprise field. However, although undoubtedly classified as the most international actors in Russian enterprise sector and accounting for the lion's share of the country's exports, the scale and scope of Russian oil companies' international activities remains far from that of their Western counterparts. In terms of crude oil reserves and production, at least Yukos and Lukoil (and to some extent, Sibneft) are already at par with the Western oil majors; however Russian actors are still seriously lacking the global reach characteristic to Western companies. Measured by international asset base, Lukoil is by far the leader in the process of establishing international presence, whereas the other companies have thus far mainly concentrated on developing the international production sites and export networks. What is further characteristic for Russian oil companies' asset base abroad is that in several cases they comprise of the assets still at their development phases or uncertain of their profit-creating potential.

However, the direction seems to be right with some recent international acquisitions by Russian oil companies. The biggest step was taken by Lukoil, which won a tender in late January for exploration and development of a major gas block in Saudi Arabia. The block in question is a smaller part of the huge initiative launched few years ago, to develop an area totaling 120000 sq. km by inclusion of international oil and gas majors. Although the Saudi oil sector remains closed for outside participants, the gas project thus gives Lukoil significant foothold in the country holding the world's largest oil reserves.

In December 2003, a Slovakian pipeline operator Transpetrol, 49% owned by Yukos, signed a joint venture deal with Austrian OMV, for the construction and operation of crude oil pipeline between Bratislava and OMV's Schwechat refinery, to be supplied by Russian crude. Yukos hereby strengthened its holdings of oil transportation infrastructure in Slovakia by extending the network towards the Western markets. The value of Yukos' stake in Slovakian Transpetrol will further increase during the current year, when Druzhba-Adria pipeline (in part to be operated by Transpetrol) is bound to be opened offering the direct route for deliveries of Russian crude to the Croatian port of Omisalij on the Mediterranean. These deliveries will considerably enhance the economy of shipping Russian oil to US, now mainly delivered through the Black Sea port of Novorossiysk and the Primorsk port on the Baltic Sea.

Another set of competitive actions will be witnessed in the case of Latvian port of Ventspils, with the Ventspils Nafta company most probably emerging as a subject for privatization during the first months of the year. Operational profits of the state-owned company collapsed last year when Russian Transneft ended the deliveries of crude to the port due to the dispute resulting from the dispute over privatization patterns of Ventspils Nafta. To make the port operational, Latvian government has very few changes but to sell the controlling interest to a Russian supplier, most probable of which is considered TNK-BP, lately overtaken trouble-ridden Yukos as the main supplier to the port. The dispute over the strategically important export facility will probably go on, added to the fact that the Ventspils port would emerge as a serious competitor to Transneft’s high-profile project of Primorsk. Since Transneft controls the pipeline infrastructure connecting the resource sites with the port no contract is likely to be signed without the approval of Russian pipeline monopoly.

As of actors of smaller scale, the regional oil company of Tatarstan, Tatneft, has claimed winning the tender over Turkish biggest refining company, Tupras. If realized, the acquisition of 65,76 percent share in Tupras would give serious lift to Transneft’s profile ensuring its crude a stable export markets.

6 BACKGROUND FOR THE CRISIS AND RECENT EVENTS AROUND YUKOS

As of current the biggest oil company in Russia, and internationally the most recognized one, Yukos has gained widespread international attention due to the high profile probe around its shareholders, recently extended to cover as well its productive activities. Deprival of licenses and company assets, a wave of charges against and arrests of its principal shareholders added to tax evasion charges laid on the company itself, rise increasing concern over the economic and political environment as well as the respect of ownership rights in Russia. The effects of the crisis undoubtedly emerge widespread and not only Yukos, but Kremlin as well is in the middle of the biggest and most sensitive economic policy upheaval since the 1998 economic crisis. This section aims to provide some insights into the events around Yukos and discuss their potential long-term effects on Russian economy and oil industry. In following sections, several critical issues regarding to the shape of Russian oil sector, brought up by Yukos case, are addressed, providing an analysis on the most topical issues in the industry at the moment.

The Yukos crisis publicly began in June 2003, with the charges against and arrest of Platon Lebedev, one of the principal shareholders of Gibraltar-based Group Menatep Ltd, a commercial institution that possesses the 61,01% of the shares of OAO Yukos oil company through Isle of Man–based Yukos Universal Ltd and its Cyprus-based subsidiary Hulley Enterprises Ltd. Lebedev faced charges on embezzlement of state property during the controversial privatization schemes of mid-90s, and has been held in prison since last June.

Along with the arrest of Mr. Lebedev, state prosecutors initiated further investigations into Yukos offices and questioned the main shareholders of the group, presenting the possible charges of tax evasions and stealing of state property by individuals connected to Yukos. The scope of the scandal around the company widened rapidly and eventually led to arrest of Yukos CEO and principal owner (through Group Menatep), Mikhail Khodorkovsky in November 2003 and his subsequent resignation from his CEO post in Yukos. Mr. Khodorkovsky is facing several charges ranging from fraud to tax evasions and the attempts of the lawyers to release him against the bails have constantly been rejected by the Moscow court. According to the current information, Khodorkovsky is due to be hold under custody until March 25th, only two days after Russian Presidential elections.

Additionally ate the time of arrest, some 40% of the OAO Yukos shares held by the core shareholders of Group Menatep were frozen, an unexpected measure even in supposed-to-be free market economic regime of Russia. The stock markets reacted to the event with a sharp fall and trading on Yukos' shares was suspended for a short while. As a result of the events, the rating agencies have constantly lowered both international and domestic credit rating of the company.

Additional charges are laid against OAO Yukos oil company, of tax evasion amounting to $ 3,27 billion in 2000. The amount of tax arrears is, according to the company, based on the inclusion of the revenues of several independent companies, fully reporting these sums to tax authorities. Moreover, according to Yukos' official statement, the total tax burden with the claimed arrear added, would have yielded some 84% of company's revenues in 2000, thus far exceeding the profits for this period.

The crisis around the company eventually led to the cancellation of a biggest deal in Russian corporate history when the merger between Yukos and its smaller rival Sibneft, officially announced in April 2003, was halted in late November. The merger already well in process would have yielded the biggest Russian corporation by market capitalization and world's fourth largest private oil company with number one position measured by proven oil reserves. During the preparation of the deal, Yukos gained control of 92% of the shares of Sibneft, in exchange to 26,01% of the shares in the merged company and $ 3 billion in money terms. Thus, at present 92% of Sibneft shares are owned by Yukos and while preliminary talks have been held, on the repurchasing of the shares, the Yukos shareholders are looking for interest to be paid for this $ 3 billion "loan" offered to Sibneft for the time period in question. The deal was halted on behalf of Sibneft's shareholders presenting additional requirements on changing the agreed managerial and corporate structure of YukosSibneft, a proposal considered as unacceptable by Yukos' shareholders. According to the latest information, the agreement is eventually reached between Sibneft and Yukos shareholders on the final divorce of the company. Although the issue is still to be discussed in Yukos Board of

Directors, the Russian law gives the core shareholders the possibility to go through with the arrangements even without the acceptance by the board. Since its would be virtually impossible for Yukos to achieve control over Sibneft's whole asset base and operational activities in form of hostile takeover measures, the only realistic solution for the deal would be the total divorce of the two companies. The explanations for Sibneft's decision to pull out at the last minute have been given no satisfactory official explanation, however the connections to governmental recommendations are widely been drawn. In present course of events, a world-class oil giant controlled by Yukos shareholders and management was not likely the first preference of Kremlin, resulted in Sibneft pulling out form the deal.

Whichever the case, it seems to be Sibneft who pulls out from the Yukos deal as a winner as neither the initially agreed $1 billion penalty payment for breaking the merger agreement, nor the claimed interest by Yukos shareholders on the $3 billion "loan" granted to Sibneft shareholders, are going to be paid.

The events around Yukos have indisputably weakened the position of the company both in domestic and global markets. Besides the individual charges against the Yukos shareholders, (by now raised against 12 individuals) on fraud, tax evasion and stealing of state property, the battle has now moved on to the heart of Yukos' business activities, the physical asset base. A license to develop one of the largest oil and gas deposit of Talakan, considered as one of the largest in Siberia, which was temporarily held by Yukos-controlled Lenaneftegaz, has been granted to Yukos rival, Surgutneftegaz instead when the licensing period expired. Very recently, additional charges against Lenaneftegaz were raised by regional authorities resulting in freezing of 50 percent of the shares in the subsidiary. As of recent, the state prosecutors have initiated an investigation into the privatization deals of company's production and refining assets. The probe deals with claimed illegal acquiring of shares in Yukos subsidiary Eastern Oil, including Yukos' main production site in Eastern Siberia, Tomskneft, responsible for some 12% of company's total output and Achinsk refinery delivering some 1/6 of Yukos' total product output.

The troubles around Yukos have further declined its possibilities to acquire the control over strategically significant Latvian oil port of Ventspils, for which Yukos had thus far been considered as a most probable purchaser. Already, TNK-BP consortium has overtaken Yukos as the areas main oil exporter and is further proceeding with negotiations for acquiring the port. The blessing for the deal, however, has to come from Russian pipeline monopoly Transneft, controlling the pipeline network in the area. Since the Ventspils terminal would be competing with Transneft's productive Primorsk port, the deal cannot be expected to proceed without drawbacks, especially what comes to Yukos as a possible candidate to buy the Ventspils terminal.

To continue the list, in Lithuania the consideration has been expressed by the Parliament, to buy back the controlling stake of Yukos in Mazeikiu Nafta oil refinery, an asset of great value for Yukos acquired in 2001. In 2003, some 10% of the company's refined oil was produced in Mazeikiu factory. However, the Lithuania is currently most likely lacking the liquid funds for repurchase.

In addition, the Yukos oil trade to U.S. in form of high-profile shipments has collapsed since along with the deepening crisis. The oil exports by Yukos have been viewed as building closer ties between the company and potential U.S. business partners. Before his arrest, one of the main governmental and industrial lobbying targets of the Yukos CEO, Khodorkovsky, was the building of an oil pipeline from Western Siberia to deepwater port of Murmansk on Barents Sea in order to significantly boost the oil shipments by super-tankers to U.S.

As a whole, the widespread crisis around Yukos has addressed several economical and political issues topical under the present conditions of Russian oil industry indicating the unpredictable environment in the sector. In the following sections, these issues are discussed with and insights given to their development prospects. It is to be kept in mind however, that although the likely projections on the sector development can be drawn from the present reality and current course of events, very few factual assessments of the future events in the sector can be given.

7 RUSSIAN OIL SECTOR TAXATION

Along with the Yukos case, the issue of oil sector taxes has once again emerged as a hot topic in Russia; the related decisions will be nothing but of crucial importance for the further development of the oil sector. Finding the eligible balance between reasonably taxing the excess profits of oil companies however simultaneously ensuring the sustainable profit margins for the companies operating under still highly uncertain market conditions, will be the key question for the future of the industry and its development.

Although the energy and oil sectors account for significant share of Russia's GDP, exports and federal budget, the resentment is increasing that the government is left out from the real profit sharing in the industry while the oil giants are taking advantage of the tax legislation loopholes to pay the taxes far below the standard tax rates applied in the industry. By registering companies in one of the Russian tax havens of Kalmykia, Mordovia or Chukotka, the standard 24 percent profit tax could efficiently be minimized. This loophole has in practice being closed from the beginning of this year as a result of governmental tax offensive. Further amendments to the tax legislation are sought for, to prevent the companies of applying the tax optimization practices. In 2002, Yukos, Sibneft and TNK-BP are reported to have paid the taxes of some 13-15 percent only, thus considerably less compared to the standard rate of 24 percent. The debate continues between the companies and tax authorities whether the schemes were legal at the time or not.

From the beginning of February 2004, the oil export taxes were raised after the short period of lower tax rates that took effect in December 2003. Taxes were raised from $31,2 per ton to $33,9 per ton as a result of continuously high world oil prices. The oil production tax was kept at 90 percent of that of crude exports, thus raised at the level of $30,4 per ton.

In addition to the increases in export taxation, governmental plans have been put forward for introducing a tiered mineral taxation system, with the lower rates of taxation for more depleted fields. In the beginning of February 2004, Russian Energy Ministry is reported being submitted amendments to oil sector tax laws aimed at introduction of differentiated production taxes for oil fields. The current taxation regime is suggested to be left in place only in cases that the wells are either close to their depletion, the wells are producing only modest amounts of oil or are situated in remote locations in relation to pipeline networks. For other cases, the production taxes would be raised considerably, yielding the government an extra $6 billion in taxes a year. According to the plans, production taxes are bound to increase $7,5 billion with profit taxes lowered by $1,5 billion. Worst hit by these changes would be the more efficient companies owning the youngest fields, such as Yukos and Sibneft. In the beginning of 2002, effective lobbying by Yukos inside Kremlin resulted in preservation of current flat tax for the industry, an outcome unlikely to be witnessed now. By implementing the withhold of additional $6 billion in form of tax increases, the profit margins in the industry would drop to the level of around 11-12 percent, according to estimates by Troika Dialog analyst service. Since the proposition by Energy Ministry seems quite radical, strongly contrasting the preliminary proposals by Finance Ministry of raising the taxes by some $1- $1,5 billion, it is likely for the government to reject this proposition in its current scale. This is not to say however that some increase in taxes will not be witnessed in very near future.

Contrary to the proposition by the Energy Ministry, Russian Economics Minister German Gref recently announced the increase of tax burden to amount some $2-3 billion, given the oil export prices above $25 p/bbl. The additional revenues would likely to originate from higher export taxes, still leaving open the possibility of additionally raising the production taxes. From companies' viewpoint, the export duty -scenario would be preferable to the higher production taxes with the former scheme taxing off only the windfall profits while the latter would have considerable effect on companies' profits even in the case of lower oil prices.

According to President Putin, the 50-50 split of excess oil profit between the government and oil companies would be reasonable, causing the drop of oil sector profits from around 25-30% to some 10-15%. Analysts claim the lowest possible acceptable profit rate for oil industry to be some 12% for the capital to stay in the country. However, since the conditions between different locations vary in their ability to yield profits (the age and exhaustion rate of the wells, etc.), one practice will never fit all the companies. Although the amendments proposed by the Energy Ministry seem to somewhat address this variance in resource conditions, the suggestion in its current form would again disproportionably penalize the more efficient companies.

Thus the main question concerning the oil sector economic rents should be “how” not “how much”. The attitude of taking as much as possible without killing the companies could not be a sustainable solution for the matter. In addition, if the rent laid to oil sector becomes too high causing the profit margins to fall considerably, the extraction activities will inevitably be harmed. Thus the vicious circle is to be avoided – eventually the higher the economic rents on oil industry the less the amount of oil in the market. Although the oil companies’ profit margins remain notably higher in Russia than in Western countries, the difference in economic organization between the countries and their risk levels must be bared in mind. In Russian oil sector, the trading of licenses is still highly dependent on the authoritarian level of the economy, compared to the free trading regimes of reserves and licenses on the Western markets.

The development of free market for licenses and reserves along with the accession to and transparency of the Transneft monopoly would significantly improve the conditions on Russian oil sector, remarkably enhancing the market capitalization. By introducing the free markets, according to industry analysts, the capital worth of Russian oil companies would increase up to 3 times in case of the biggest players, bringing Yukos already at par with the world’s leading oil majors in market capitalization terms. Recent statements and assertions of Russian politicians clearly express the view that the oil sector is bound to yield the government the profits manifold compared to the ones at present. The discussion is heating up, on the increasing profit margins and so-called excess profits of the oil majors, and various estimations have been given on the potential of additional rents oil sector could yield in form of raised taxes.

8 PROPERTY RIGHTS AND PRIVATIZATION

The issues brought up first and foremost in connection with Yukos crisis was the possibility of reviewing the privatization in 1990s and related mounting concerns over the subject of property rights in Russia. Whereas the procedures in Yukos case included several features of an arbitrary rule of power, the concerns of re-nationalization of privatized assets seem to have faded.

In light of the recent turmoil in Russian oil sector and the attacks against Yukos and Group Menatep shareholders, the question inevitably arises whether the case is individual in nature or should every businessman and company in Russia involved in privatization deals on mid-1990s be afraid of governmental attacks? During the time of privatizations of large industrial companies in the beginning and mid-1990s, hardly any individual involved in the deals would get the clean records from the processes in light of present legislation. The subject of undoing the privatization of the 1990s has been brought to daylight once again along with the Yukos crisis but however hardly any commenting party seems to believe in this possibility. The economic turmoil resulting from re-nationalizing of even a few of the private conglomerates would be unimaginable and nobody knows it better than the Kremlin authorities. The recent comments from president Putin and the ministries indicate the tendency of moving towards economically more liberal regime, a view backed with recent amendment of currency regulation law even giving an increasing freedom for individuals to move the capital out of the country.

As of the Yukos attack, the ownership patterns of the company clearly underlie the recent events. The company was controlled by a very small group of owners of Group Menatep bank, which under the leadership of Khodorkovsky gained control over Yukos in the privatization deals of 1995. Given the growing importance and size of Yukos in Russian economy, the issue became extremely sensitive given the increasing lobbying power of Yukos group both inside Kremlin and internationally. When adding the aims of Khodorkovsky as a principal shareholder, to transfer the assets under foreign ownership through the high-profile negotiations with ExxonMobil, the line seemed to have been crossed. Going deeper into the privatization deals of mid-90’s have yielded the charges against several Group Menatep shareholders already and this group of oligarchs are certainly not the only one in Russia who's past can be used against them upon the will.

However arbitrary the use of power by Kremlin in Yukos case, the similar events to follow are unlikely to occur, in authors opinion. Procedures used in curbing the ambitions of Group Menatep and Khodorkovsky, are in no means in line with free market economy practices but however to some extent rational in the overall irrational context of Russian market economy. By attacking the Group Menatep, several goals were achieved: the political lobbying power of Khodorkovsky team was eliminated along with sending a clear message to other actors potentially interested in interfering the economic policy decision making. Altogether, charges are laid over ten Group Menatep shareholders and there aren't many optional endings to this manhunt. Charged with tax evasions, stealing of state property and fraud, the Group Menatep shareholders will eventually be pushed out from the picture and, in preferred case, be forced to sell up their stakes in Yukos. As of recent, the last Group Menatep shareholder in Yukos management team, Mikhail Brudno, appearing on Interpol wanted list, was released from his managerial duties in the company. According to the official statement by Yukos, good shareholder practices are thereby followed with separating the ownership and managerial interests in the company.

According to the statements by Yukos CEO, Simon Kukes, the agreement with tax ministry is to be found during the couple of months, and the charges are hoped to be settled in that part. Whatever the outcome of negotiations, considering the tax optimization schemes actively used by Yukos, there will most probably be ways for government to take back what it feels belonging to itself, be it in form of tax or other claims. Also in this matter, further confrontations are unlikely to appear between the companies and tax authorities since new tax regulations, most likely put into effect during the next few months, will eventually prevent such use of preferred regions or tax havens in companies tax optimization procedures.

In the end of 2003, additional larger-scale investigations were started to go through the questionable privatization deals of 1995-1996, taken into action by a group of authorities from both lower and upper houses of Russian Duma. Official explanation to governmental actions initiated at the eve of the presidential elections of March 2004 refers to widespread public resentment towards the oligarch regime and stealing of national property, a factor that can undoubtedly be used to win large-scale support for the procedures. According to state authorities, the investigations won't most likely to lead to more than few charges, the targets of which can however only be guessed. Since the years 1995-1996 yielded the privatization of companies such as Yukos, Lukoil, Sibneft, Surgutneftegaz, Sidanco and Norilsk Nickel, Kremlin has a powerful weapon in its power to gain the public support and fuel Putin's presidential campaign. Few days after the news broke down, of the investigation by tax authorities, Lukoil announced giving up its tax planning schemes and complying with the demands of the tax authorities.

Whatever the results from the privatization investigations, the policy of Putin and the new State Duma is still hardly to be characterized by nationalization tendencies, but seems more likely to move towards some form of command market economy, indicating the attempts of Kremlin to gain more control over the crucial sectors of the economy. Although the fact still remains, that under current legislation, practically no privatization deal in 1990's would get clean records, widespread legislative actions against the violators of that time will hardly be witnessed. It should be however acknowledged, the Kremlin's possession of these powerful means to be used if considered necessary.

9 PRODUCTION LICENSES AND TRANSPORTATION

One of the most crucial questions raised by the Yukos probe is that of the oil production licenses and ownership of oil assets. In following, a brief introduction is given to the licensing economy of Russian oil with some assessments of the latest practices.

According to Russian law, the subsoil resources belong to the state, which in turn grants licenses for their exploitation by competitive tenders. The control for licensing system and the taxation of proceeds is shared by the federal and regional governments. Once licensed, the oil resources extracted are the property of the companies producing them. As the recent case of Yukos has shown, federal government has the executive power in the matter on its will, considerably challenging the position of the companies operating the licenses.

Additionally, further amendments to the law on subsoil resources have been proposed for the resources in land to remain the property of the state until sold, with the mining and producing companies being granted concessions by the state on the basis of exploration and mining costs and added profit margin. The oil companies have vigorously campaigned against such amendments claiming this legislation to significantly increase the potential of arbitrary measures by authorities.

What characterizes Russian oil sector at present seems to be the development towards so-called licensing economy with significant amount of decision-making power laid on the administrational machinery and Russian authorities. The revocation of its licenses by state authorities, a probable threat facing Yukos at the moment, serves as an example of who is in charge in the economy. The Talakan oil field license previously held by Yukos has been granted to pro-governmental Surgutneftegaz; the rule of the game seems to be that the companies supporting the government are being rewarded quite generously for their actions and the stakes are constantly getting higher. Support and respect for governmental procedures has further been given by Lukoil, which has taken into consideration the authorities' viewpoints both in its upstream ventures and tax policy decisions. What Lukoil needs at the moment are definitely the new licenses, with its main production fields located in Western Siberia close to exhaustion.

If significant changes in the licensing practices were sought for, to remove the use of arbitrary measures, the only sustainable solution would be the introduction of free market for licenses and subsoil oil reserves. In addition of bringing considerable transparency to the industry, the introduction of free market would assess the urgent need for enhancing the market capitalization of Russian companies. Although comparable to their Western counterparts in reserves and production terms, Russian companies are still considerably lagging behind in their capitalization with the market value being a fraction of that of their international competitors. Currently, the market capitalization of world's leading oil group, ExxonMobil is some 10 times bigger than that of the Russian number one company, Yukos, whose market capitalization is to estimated to amount some $30 billion.

Thus, in this matter only the introduction of free market conditions for exploration and production activities would offer an economically efficient solution. Under the conditions of current boost in oil economy, the alternative deplorers of licenses are not hard to find thus ensuring the effective use of resources even if deprived from the original holder for time to come.

Along with the growing dependence of Russian oil sector on its exports, another crucial question is that of the export quotas, of which the decisions are laid at governmental level with the oil pipeline monopoly of Transneft controlling all of the crude oil export routes, many of which are in addition already operating at their capacity limits. Several projects have been suggested by leading oil companies, for constructing their own pipelines at profitable outlets, but thus far no amendments on the policy of state control of export outlets is foreseeable. Giving up its primary regulation means in the industry is unlikely to appear on the governmental agenda for time to come. At present, export allocations are quarterly distributed by Russia's government commission on access to export pipelines, based on the actual supplies to the system in previous quarter. The commission thus is able to boost the quotas for producers supplying more than planned with cutting them for companies with supplies below the target. According to official announcement of Transneft, the pipeline exports will be raised by 14,5 percent in 2004 mainly through the expansion of Baltic pipeline system boosting the exports through the Primorsk port on the Baltic Sea.

10 FUTURE OF WESTERN OIL COMPANIES IN RUSSIAN OIL SECTOR

The Yukos case has made clear the attitude of Russian government towards large-scale foreign ownership of Russian oil assets. The negotiations on selling the majority stake in YukosSibneft to ExxonMobil were ended along with the deepening crisis around the company. Following breakdown of the YukosSibneft merger itself left again some room for speculations on foreign takeover of now independent companies, but very few practical signs of actual potential of these transactions to realize have been witnessed.

Not surprisingly, it has became obvious that large-scale selling the oil assets to foreigners will get no further approval of Kremlin authorities. According to some estimations there could still be room for one minor deal of selling a stake of Russian oil company to foreign actors; this possibility however would require complicated negotiations with governmental authorities even in the best case. Most likely, the inward internationalization of Russian oil economy will take other forms in near future and the Western oil companies interested in gaining the foothold in the country will be obliged to look for other alternatives than direct ownership of assets. Nobody denies the urgent need of investment capital in Russian oil sector and there will most likely be no chance Russian government will reject its entry in form of joint ventures, for instance. The question only arises, to what extent are the Western actors willing to bend under Kremlin’s will and invest their capital without getting permanent control over the oil assets.

The future presence of Western oil companies in Russia will further be heavily dependent on Russian companies’ willingness to co-operate through different joint-venture schemes. Since the reality however calls for huge investments even the biggest of Russian majors are not capable of funding, the presence of Western partners will continue to be inevitable. What is more, the Western majors searching for additional resources for their production won’t have much better options even when working under the strict terms and supervision of Kremlin. It has to be remembered, that Russia however possesses the biggest accessible oil reserves in the world, a value of which remains immense no matter how strict the rules of operation. It is neither in interests of

Russian state, breaching the contracts with Western counterparts thereby seriously wounding its main source of income and vehicle for growth.

Moreover, the continuous and further increasing presence of international oil majors in Russian oil sector acts as one the best factor of confidence; these companies are familiar with operating under harsh conditions both physically and politically and Russia should not be an exception. The concrete example can be found from the huge exploration and oil and gas infrastructure project on the Sakhalin Island, now operating its third stage.

What comes to highly speculated issue of acquisition of a stake in Russian oil company by a major Western actor, there are in practice very few options for this type of transaction. It is evident that both Yukos and Lukoil both are inevitably too significant of players in the sector for allowing their acquisition by foreigners. Additionally, Lukoil is evidently respecting the opinion of Kremlin having pulled out from discussions with ConocoPhillips over potential transaction of selling a stake in Russian major and is instead developing joint venture projects in the north of Russia with the US oil giant. Among the other Russian majors, Sibneft seems to appear as the only possibly relevant target for foreign buyout. The company possesses comparably unexploited oil assets and being smaller in size, has the possibility of getting the Kremlin blessing for the deal under favorable circumstances. Moreover, the ownership structure of only a few core shareholders would be optimal for a buy-out if terms were agreed on. However, the fact remains that no deal will be witnessed at least before the dust has settled around the Presidential elections of March and even then the Kremlin backing for such a deal is a big question mark at its best.

11 FUTURE OF RUSSIAN OIL?

The question of the future of Russian oil sector has been a hot topic ever since the Yukos crisis broke down months ago. A wide range of opinions have been presented and even the worst case – pictures been painted on full re-nationalization of oil assets according to governmental will. In following, some recent facts and relevant considerations will be presented, on the future rule and structure of Russian oil sector as well as its role in the country's economy.

Under continuously favorable world market conditions, Russian oil sector is experiencing unchallenged growth in production and export terms. Along with unstable situation in Middle-East, Russia has become the most attractive oil supplier worldwide, providing the world's biggest oil resources available for foreign participants. Fuelling the growth, Russian oil majors led by Yukos, Lukoil and TNK-BP are presenting impressing numbers of growth along with implementation of increasingly Westernized management practices and patterns of organizational development.

In light of the recent events, one can thus only attempt to draw further conclusions on the development patterns of Russian oil sector. At the moment, the most probable outcome seems to be the survival and strengthened position of few oil majors in the sector, playing according to the rules of government. As of the contradictory Yukos case, the company has very few realistic changes to fight back the authorities, being efficiently stripped from its weapons and even its assets. The tax evasion charges, as such, won't bring down the company, with increasingly solid financial base, however, the continuing probe over its assets and license deprival will serve as effective measures to harm the core activities of the company. At current state of license economy in Russian oil sector, very few means are left for the individual companies to fight the authoritarian decision-making, be it justified or not.

It is however realistic to assume more sophisticated practices of governmental control to be implemented in the sector. The revisited tax legislation will most probably bring some enhanced transparency to the oil sector policies. Although cutting the windfall profits of oil companies, use of tax loopholes currently causing troubles for many companies, will be prohibited by law thus decreasing the scale of arbitrary use of power in the matter.

The nationalization of private property, and review of privatization of 1990s, would undoubtedly be one of the shortest ways to yield the destruction of current Russian economy. However tight the control of state over the oil sector, the Kremlin is well aware of the fact the sector being the very basis of Russian economy at present. The means however are there for government to gain unchallenged control over the oil economy and further amendments are being carried out for this purpose. In accordance with the governmental affirmations of respecting the outcomes of the privatization of last decade, statements have constantly put forward about increasing the role and control of government in the oil sector. Under the present circumstances, no realistic alternative for the government tightening its grip over the industry can be presented, whether one likes it or not. The industry and its actors are growing more powerful than ever and for curbing their ambitions, measures are taken, of which the Yukos show trial serves as the most visible example. Since the message is now delivered for time being, no reasons for repeating such actions are at sight, nor can they be afforded. The means more sophisticated are available for increasing the control over the industry and its individual actors.

Whereas the growing oil sector is boosting the overall economic growth of the country, concerns have increasingly been expressed on the future of the other sectors of economy. Along with the growth in oil sector, very few economic branches have witnessed remarkable growth during the past years. Only the heavy machinery industry can be said to hold the potential for international competitiveness, with the vulnerable SME sector still heavily on the path of formulation. No recent analysis have presented the evidence of decreasing importance of the oil sector for the country’s economy (e.g. Sutela 2004, Kaitila 2003, Rautava 2002).With Russia remaining heavily dependent of the volatile world prices of oil and other raw materials, the federal revenues are understandably affected by these fluctuations, offering an unstable basis for economic development. As the oil and commodity sector being the main source of revenues, the investment activities are largely targeted on this sector. With growing investments into raw material extraction and the refining activities, the importance of other economic sectors inevitably decreases and causes a distortion in the country’s economic structure.

(Kaitila 2003). Despite the differing underlying conditions, some commonalities can be recognized between Russia and the oil states of Asia and Latin America with the alarming troubles arising from the dual economy structure and so-called Dutch Disease. A country equipped with such huge strategic resources in one sector controlled by few elite groups, inevitably experiences the growing inflow of money into that sector. This results in huge wealth accumulation connected with high inflation and rising costs, a situation where high domestic costs virtually kill the competitiveness of practically all non-oil exports. (Sutela 2004) Although the economic structure and resource base of Russia (fortunately) differs from that of traditional oil states, the implementation of policies enhancing the use of Russia’s other resources and well-educated labor, are of vital importance for the healthier development of the country in the long run.

Further concerns are connected with the actual condition and development of Russian oil assets. Whereas possessing huge resources, a significant part of Russian oil industry assets are inherited from the Soviet era and of urgent need for restructuring. Although accounting for the lion’s share in the country, the oil sector investments have widely been targeted to the exploration and production enhancement activities with increasing claims from the authorities of neglecting the sustainable long-term development of the assets. In several cases, the wells are used to their exhaustion seeking for high short-term profits. The issue of sustainability in production is firmly connected to the ownership economies and licensing procedures of governmental agencies. One has once again to recall the very nature of the oil business in Russia, based on the license economy with the actual productive assets belonging not to producers but to the state. Under the regime of this nature, the aims of individual actors can often be questioned; under what conditions one is targeting for the long-term sustainable production or practicing an opportunistic strategy of profit making? Additionally, the recent course of events has definitely not increased the confidence in government’s sustainable licensing policy. Since it is more than unrealistic to present the thoughts of free oil license and reserves market in Russia even in the long-term, several questions of the future efficiency of the industry are left open.

12 LIST OF REFERENCES

BP (2003a) *Statistical Review of World Energy*. June 2003.

BP (2003b) *TNK-BP Databook. <http://www.bp.com>*

Considine, Jennifer I. & Kerr, William (2002) *Russian Oil Economy*. Edward Elgar Publishing Limited, Cheltenham, UK.

Ebel, Robert (2003) Untapped Potential The Future of Russia's Oil Industry. *Harvard International Review*, Vol. 25, No: 1, 26-31.

Kaitila, Ville (2003) *An Assessment of Russia's Growth Prospects in 2003-2010*. ETLA Discussion Papers No. 869.

Khartukov, Eugene & Starostina, Ellen (2003) Russia's New Pipelines Will Debottleneck Exports, Production. *Oil & Gas Journal*, Vol. 38, No: 1001, 62-73.

Petroleum Argus *FSU Energy, Weekly Reports.*

Rautava, Jouko (2002) *The Role of Oil Prices and the Real Exchange Rate in Russia's Economy*. BOFIT Discussion Papers No. 3.

Sutela, Pekka (2003) *The Russian Market Economy*. Kikimora Publications, Helsinki.

Troika Dialog *Russia Market Daily.* <http://www.troika.ru>

The following Internet sources were used for repeated quotations:

<http://www.yukos.com>

<http://www.lukoil.com>

<http://www.surgutneftegaz.ru>

<http://www.tnk-bp.com>

<http://www.sibneft.com>

<http://www.moscowtimes.com>

<http://www.rosbaltnews.com>