To Be Handled with Care:
The Oil Sector in Post-Soviet Russia

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Thesis instructor:
Prof. Dr. J.G. (Coby) van der Linde
Professor of Geopolitics and Energy Management
Faculty of Arts
University of Groningen

Student:
N.F.G. (Nicolaas) Ravesloot
Student number: s1424335
E-mail: N.F.G.Ravesloot@student.rug.nl
Address: Jan-Pieter Heijestraat 115-2
1054 MD Amsterdam
Telephone: (+31) 6 42801831
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Faculty of Arts, University of Groningen
### List of Acronyms and Abbreviations

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<th>Definition</th>
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<tr>
<td>bbl/d</td>
<td>Barrels per day</td>
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<tr>
<td>BP</td>
<td>British Petroleum</td>
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<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
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<tr>
<td>E&amp;P</td>
<td>Exploration &amp; Production</td>
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<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
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<tr>
<td>FSB</td>
<td>Federal Security Service</td>
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<td>FSR</td>
<td>Former Soviet Republics</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>HC</td>
<td>Host-Country</td>
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<tr>
<td>IEA</td>
<td>International Energy Agency</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IOC</td>
<td>International Oil Company</td>
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<tr>
<td>JV</td>
<td>Joint Venture</td>
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<tr>
<td>KGB</td>
<td>Committee for State Security</td>
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<tr>
<td>LNG</td>
<td>Liquified Natural Gas</td>
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<tr>
<td>MNC</td>
<td>Multinational Oil Company</td>
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<tr>
<td>NATO</td>
<td>North-Atlantic Treaty Organisation</td>
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<tr>
<td>NOC</td>
<td>National Oil Company</td>
</tr>
<tr>
<td>OB</td>
<td>Obsolescing Bargain</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
</tr>
<tr>
<td>OPEC</td>
<td>Organisation of the Petroleum Exporting Countries</td>
</tr>
<tr>
<td>PSA</td>
<td>Product Sharing Agreement</td>
</tr>
<tr>
<td>SEIC</td>
<td>Sakhalin Energy Investment Corporation</td>
</tr>
<tr>
<td>SU</td>
<td>Soviet Union</td>
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<tr>
<td>US</td>
<td>United States of America</td>
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<tr>
<td>USD</td>
<td>United States Dollars</td>
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<tr>
<td>USSR</td>
<td>Union of Soviet Socialist Republics</td>
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<td>WB</td>
<td>World Bank</td>
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Acknowledgements

The idea for this thesis stemmed from a course I took on the Politics of Oil in spring 2009 in Groningen. I was instantly fascinated by the highly interesting subject matter and the enthusiasm with which Prof. van der Linde lectured our classes. The course interested me in particular due to the intertwinement of political and economic factors that shape the different segments of the oil and gas value chain.

The inspiration to write about state-private sector relationships in the oil sector was derived from my internship at the Dutch Embassy in Beijing where I became intrigued by the high level of involvement of the state in shaping the business environment in which foreign companies operate in. As a result, I decided to write about these same relationships, but in the oil sector. The idea to write about Russia was largely influenced by the high-profile renegotiations of the Sakhalin-1 PSA, a subject that intrigued me from the onset.

This thesis would be incomplete without the guidance of Prof. van der Linde, who has helped me refine my understanding of Russia and who has consistently stimulated my intellect throughout the process. Beyond doubt what challenged me the most was the task of adding value to a subject that Prof. van der Linde knows so much about! I am also grateful to my parents for their patience and support during my lengthy studies. Finally, I would like to thank Edmund Wellenstein and Thijs Duyzings for their helpful insights during the writing of this thesis.

Nicolaas Ravesloot

Amsterdam 30th September 2010
1. Introduction

“In the petroleum industry, the major corporations are in the process of being transformed, with or without nationalization, from independent and dominant actors into junior partners of host governments, and they are virtually helpless to prevent it.”

In the middle of 2007, after a period of eight years of sustained production, the output of crude oil produced by the Russian Federation peaked and started to decline. This fall in output came at a critical point in time. As the oil supply tightened and global demand continued to grow, oil prices were moving towards historical highs. Whilst many states increased their oil output to reap the benefits of the rising oil price, Russia endured a slowdown in production growth beginning in 2004 that would eventually lead to a negative growth as of mid-2007. Barely a year afterwards, the global economy, hit by a financial crisis originating from the United State’s (US) housing market, entered the worst recession since the Great Depression. Around the same time, the price of Russian (Ural) oils plunged from a monthly average of $130/barrel at its peak in July 2008, to around $45/barrel in December that same year. With oil and gas revenue accounting for half of all of Moscow’s federal budget revenue, Russia had a worrying prospect ahead of them. For, a low oil price meant a considerable strain on public finances, export revenues and the state’s ability to purchase imports. As a result, for the first time in nearly a decade, in 2009 Russia ran a budget deficit, amounting to 6.3-6.4% of its Gross Domestic Product (GDP).

In his analysis, Matthew Sagers identifies four drivers that played a role in the production decrease that affected the Russian oil sector in the period leading up to the decline in 2007: transportation, economics, geology and politics. Transportation referred to the local bottlenecks in the domestic pipeline system and the outlook on inadequate future export capacity. The economic factors were centred upon “the rising costs of all inputs and the unfavorable effects of rouble appreciation”. Geology related to the nigh end of Russian ‘easy oil’ and, by consequence, the declining quality of oil fields, predominantly in the meteorologically and geologically unattractive West-Siberia. Politics, finally, heavily influenced the diminishing production rates through two factors: On the one hand, an onerous

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1 C. Lipson, Standing guard: protecting foreign capital in the nineteenth and twentieth centuries (Berkeley 1985) p.112.
5 P. Hanson, ‘Oil and the economic crisis in Russia’, Russian Analytical Digest, 54 (2009) p.2.
6 Ibidem.
9 Ibidem p.514.
tax regime was faulted for having given oil companies precious little incentive to increase production. On the other hand, the expansion of state control in the petrochemical sector had reduced efficiency and created an unstable environment for private companies operating in the extractive industry. This transition was remarkable, as Russia, till late 2003, had been the only major exporter in the world with a predominantly private oil industry.

The month of October in 2003 marked the materialization of the Kremlin’s policy of reassertion of the oil sector. In that month, Mikhail Khodorkovsky, head of the Yukos Company, a Russian oil company, was arrested on charges of fraud. Shares of his company, at one time responsible for 20% of Russia’s oil production were immediately confiscated by the state and were later auctioned off. Khodorkovsky, who was estimated at one point to have a net worth of some $15 billion, was sentenced to nine years in jail. This series of events was widely considered to be a declaration of war against the so-called ‘oligarchs’ – extremely wealthy Russian entrepreneurs and former members of the communist-era ‘Nomenklatura’, who had taken under their control the bulk of the post-Soviet economy, including the all important oil sector. As an illustration, in 2001 Russian oligarchs accounted for 72% of all Russian sales in the oil industry. In response to the Yukos affair, the most prominent of the oligarchs fled the country for fear of fraud and tax charges. Others accepted the demands of the state and relinquished their stakes in the oil sector.

Simultaneous to these developments, International Oil Companies (IOCs) operating in Russia also saw their rights and operations in the sector increasingly challenged. Investments and contracts between the state and oil companies were slowly but surely unwound to increase the grip of the Russian Federation on its subsoil energy assets. In January 2004, the Russian government decided to re-auction ExxonMobil and ChevronTexaco’s development rights to the Far-Eastern field of Sakhalin-3. A year later, foreign-owned companies were forbidden by Moscow from bidding in auctions for permits to develop several big oilfields, with the reason given that the deposits were deemed ‘strategic’. In 2005, Royal Dutch Shell was persuaded to relinquish its majority stake in Sakhalin 2 to Gazprom, due to the threat of a lawsuit founded on environmental regulations. French oil major, Total, shared a similar experience when Rosneft annulled a $3 billion partnership in the Vankor oilfield. Oil major British Petroleum (BP) also found itself marginalised over the past years as its Russian partner Tyumen Oil Company (TNK) slowly but surely expanded its controlling stake in the Joint-Venture (JV)

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13 A. Barnes, ‘Industrial property in Russia’ p.54.
project in Kovytka.\textsuperscript{15} That the Russian state was involved in the affair became obvious when, following a raid in March 2008 by the Federal Security Service (FSB) on TNK-BP’s offices in Moscow, BP was forced to suspend 148 of its foreign staff because of visa complications.\textsuperscript{16} This series of events all demonstrated that Moscow was set upon forcefully reasserting and expanding state control in the oil industry.\textsuperscript{17}

So what drove Russia’s behaviour towards private and foreign investment in the oil sector? For a state that is so highly dependent on energy revenues and that has so much to offer, as far as the development and production of its resources are concerned, Russia’s policy seems difficult to explain. Especially as evidence suggests that state control does not benefit performance in the oil sector.\textsuperscript{18} The ‘obsolescing bargain theory’ (OB-theory), originally devised by the late Raymond Vernon (1913-1999), offers a possible explanation for the case at hand. The theory is based upon changes in relative power between foreign firms (in the extractive industries) and host governments.\textsuperscript{19} The model depicts the relationship between multinationals and host countries as a cyclical pattern hinged upon gradual shifts in relative bargaining power. What typically begins as a relatively simple win-win partnership evolves into a much more strained and complex relationship as the state becomes gradually less dependent on the skills and assets of foreign companies.\textsuperscript{20}

Faced with a delicate trade-off between national welfare objectives and economic sovereignty, foreign direct investment remains a highly politicised and national issue for states, especially concerning investments in what is arguably the most politicized extractive industry - the oil sector.\textsuperscript{21} Partnerships between Multinational Corporations (MNCs) and host-countries are characterised by an inherent tension over the control of the economic rents produced by the sale of natural resources.\textsuperscript{22} Although these tensions between both parties arise partly from economic and profit-related issues, their importance and outcome are largely the result of politics.\textsuperscript{23} But how does the behaviour of the Russian government towards the IOCs compare to its policy towards the oligarchs? Was it driven by the same factors?

This paper aims to analyse and understand Russia’s behaviour towards international oil companies and the oligarchs from the beginning of post-Soviet Russia till the end of Putin’s last term. The main research question is as follows: “To what extent can the obsolescing

\textsuperscript{15} http://www.heritage.org/research/Research/RussiaandEurasia/bg2333.cfm consulted on 5th September 2010.
\textsuperscript{16} BP and the Russian Bear, Corporate Europe Observatory and PLATFORM, January 2009.
\textsuperscript{17} F. Hill, Energy Empire: Oil, Gas, and Russia’s Revival, London: Foreign Policy Centre, 2004 p.31.
\textsuperscript{19} R. Vernon. Sovereignty at bay (New York 1974) p.28.
\textsuperscript{20} J. Richards and L. Pratt, Prairie capitalism power and influence in the New West (New York 1979) p.9.
Recent years have brought back a phenomenon that has been uncommon since the 1970s: forced nationalizations of major foreign-owned oil and gas assets in states including Bolivia, Ecuador, Venezuela and Russia. The primary purpose of this paper is to create a thorough and objective understanding of this resurgent phenomenon and its occurrence in the oil sector in Russia. This paper only examines the oil sector because the natural gas sector was not privatised following the fall of communism and because its output remained relatively steady compared to the oil sector. The state’s behaviour towards IOCs and Russian private investors is analysed using a blend of International Relations and economic theory.

This thesis has the following structure. The first chapter is composed of two parts - a theoretical analysis and a methodological background. The first part elaborates on, and debates, the theoretical framework provided by Vernon and other contributing authors in the same field. Dating from the early ‘70s, it does not come as a surprise that Vernon’s theoretical framework has been revised by a number of scholars to incorporate additional variables. This paper also seeks to extend the model by incorporating elements of Graham Allison’s rational actor model. As such, we seek to understand what a rational policy would be towards investors in Russia. Furthermore, we assess any theoretical limitations that arise due to the choice of the theories. The methodological section establishes the variables that will be used to analyse the cases and outlines the research method.

The second chapter seeks an answer to the following question: “What were the drivers behind Russia’s privatization policy in 1991-1999 and was this policy rational?” This chapter has the following outline. First, we sketch the oil sector prior to – and after the fall of the Soviet Union. Using the predictions of the OB-model as a starting point, this allows us to assess the needs of the sector. Second, we analyse the extent to which the IOCs and the oligarchs were able to amend to these needs. Third, we analyse the economic and political context Yeltsin operated in. This gives us insight into the goals and priorities of the government, shaped by this economic and political context. Finally, we discuss the outcomes in the period between 1991 and 1999 and evaluate the rationality of the government’s policy using a scorecard.

The third chapter takes an identical approach to the 1999-1999 period. The main research question here is: “What were the drivers behind Russia’s re-nationalization policy in 2000-2008 and was this policy rational?” The last chapter, finally, concludes this thesis by summing up its findings. In addition, it establishes the explanatory ability of the theory concerning the case. It

will do so by answering the main research question of this paper. Since the OB-theory predicts a
cyclical bargain process, it may even be possible to state a number of predictions concerning the
future relationship between the Russian Federation, private investors and IOCs.
2. The OB-Model: Has it Outlived its Relevance?

2.1. Introduction
The sharing of oil and gas revenue is a highly contested area involving a multitude of actors, extensive bargaining and diverging interests, influenced by political as well as by economic considerations. The obsolescing bargain theory focuses on this bargaining aspect and offers an explanatory framework to understand the forces and elements inherent to bargaining processes between the developing state and multinational corporations in both the extractive and non-extractive industries.

This paper adds to the body of literature pertaining to the theory of the obsolescing bargain. Naturally, as with all theories, certain assumptions, choices and simplifications are made in order to narrow down the scope of the theoretical framework. This chapter has the following outline. The first section outlines the main assumptions and literature concerning the OB-theory. Critique concerning the theory and past extensions of the paradigm by scholars are reviewed in this section. The second part argues that the OB-theory is particularly well suited to explaining the dynamics in the Russian oil sector between Russia, IOCs and the Russian oil companies run by the oligarchs. It does so by summing the core characteristics of the oil sector and by demonstrating its ‘structural vulnerability’ to the obsolescing bargain. The third part sets out the analytical framework that will be applied in this paper. Based on the core concepts of the OB-model, this framework consists of the potential driving factors involved in the decision by the state privatise oil assets, and hereafter, to re-appropriate these assets. The final section elaborates on the methodology adopted by this paper.

2.2. Relations between MNCs and the State
The policy of states towards MNC was originally first analysed by Kindleberger in 1965, when he conceptualized the Host Country (HC)-MNC relationship with regard to Foreign Direct Investment (FDI) as a ‘bilateral monopoly’. With this he considered there to be only one buyer (the MNC) and one seller (the state) of a foreign investment project. He argued that the precise terms of a HC-MNC arrangement would be a function of the relative strength of the two parties. Complementing Kindleberger’s research, it was Vernon who coined the term ‘obsolescing bargain’ back in the early 1970’s in his book Sovereignty at Bay- a scholarly response to the rash of nationalizations that beset extractive investments in the late 1960s.

Like Kindleberger’s earlier work, Vernon’s work focussed on the interaction between two key actors: the state and the multinational company. He viewed the state as a strong economic

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player, capable of using international capital to advance its own interests. These interests were assumed to be broad, including political, economic and social cultural goals. As a way to achieve these goals, natural resources, localized within the territory of the state, were exploited to generate revenue. Consequently, the state held the power to control the access to that particular resource. The state could do this by manipulating two important factors: The terms upon which MNCs would have access to resources and/or markets, and the rules of operation with which MNCs needed to comply when operating within a specific national territory. In Vernon’s original form, the obsolescing bargain applied only to developing states. This delineation was consistent to the wave of expropriations of MNCs in predominantly developing countries around that period. Interestingly, in that same period, developed countries, including Canada and Australia, were also enforcing more restrictive policies towards FDI. As a result, subsequent authors later extended the theory to this group of states.

The MNC was portrayed by Vernon as an equally prominent actor in the international political economy. Earmarked by their sheer size and power, Vernon defined them as ‘enterprises with manufacturing subsidiaries in at least six different countries’. Later, Dunning adopted a broader definition: “an enterprise that engages in Foreign Direct Investment and that owns or controls value-added activities in more than one country”. Albeit far from homogenous, multinationals were believed to be linked by one common objective: a drive for profit and market access. Unlike the developing state, according to Vernon, the MNC had variable degrees of expertise when it comes to negotiating and was therefore capable of securing a beneficial bargain upon displacing its production activities to a host country. Hence, by reason of their sheer size, if allowed to displace their activities to a HC, MNCs were able to incorporate parts of a state’s national economies within their own organizational boundaries. This, however, inevitably impeded on the HC’s most worthy possession – its sovereignty.

These tensions are deemed by this paper to be inevitable, though the magnitude and frequency hereof is admitted to be variable. At the base of this antagonism lie the oft differing, and sometimes even irreconcilable, interests of the HC and MNC. For example, whereas the raison d’être of a MNC is typically maximizing profit and shareholder value, the state is bent upon optimizing the material welfare of its domestic population. Accordingly, continuous

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30 V. Vivoda, The return of the obsolescing bargain and the decline of big oil: A study of bargaining in the contemporary oil industry (Saarbrücken 2008) p.41.
31 B. Jenkins, ‘Re-examining the “obsolescing bargain” p.142.
33 J. Dunning, Multinational enterprises and the global economy (Reading 1992) p.3.
bargaining is necessary in order to resolve conflict and move towards cooperative, win-win situations.

Although the relationships between state and firms may be conflicting at first sight, empirical evidence has shown that state and firms are often interdependent. States need firms to generate wealth and provide employment, whilst MNCs need states to provide them the infrastructural basis for their continued existence. This infrastructural basis can vary between resources and a physical infrastructure to the legal protection of private property. It is this perpetually vacillating balance between cooperation and conflict that defines the relationship between HC and MNC.

2.3. OB-theory Literature Review

The previous section has briefly touched upon the high complexity of MNC-HC relations. Both parties find themselves engaged in a reoccurring bargaining process with each other. The extent, to which each one can implement their own preferred course of action, is determined by their relative bargaining power. In an ideal world, MNCs would pursue their objectives without any form of hindrance by a HC, whereas, states would strive to capture as much as possible of the value created from production in their territory. It is this stark contrast in objectives that leads to the bargaining position that both HC and MNC find themselves in.

The concept of the obsolescing bargain refers to the vulnerability of firms with large fixed investments to find the initial terms of their operating agreements modified, or renegotiated, once their operations are in place and have proved successful. Host-countries, eager to exploit their natural resources, invite foreign companies to invest on their territory and for them to use their technology to extract raw materials. Since the host country does not possess the capital, management, marketing skills and technological know-how necessary to successfully extract the resources, the foreign companies find themselves in a strong bargaining position. Yet, due to the high risk (e.g. political, investment, contractual risk) and uncertainty, associated with such an extremely large fixed investment, an inducement in some form (such as tax-breaks) is needed to persuade the company to invest. Thus, the foreign firm invests in the country so long as prerequisites are set out that make the endeavour at least as appealing as any alternative economic activity in terms of the return on investment involved. Since the HCs often do not possess the capacity to reap the benefits of their subsoil riches, they are not able to independently extract the resources. As such, without any other feasible options, the host countries offer high rates-of-return and accept unequal terms to attract private operators.

From the multinationals point of view, demanding highly profitable terms before investing in a country makes economic sense. In the extractive industry, for example, investments are not only extremely capital intensive and require vast funding, but also entail a great deal of uncertainty and risk. In addition, multinationals are in the position to demand highly profitable terms, since only they (as well as service companies) possess the adequate technology and know how to extract the specific resource. What’s more, they have an advantage over domestic companies due to their ability to produce more efficiently. This bargaining advantage is further amplified by the premise that the state cannot develop its resources on its own. For, had it been endowed with a competent domestic industry it presumably would have extracted these resources already. Nevertheless, the HC is still in the position to let the IOCs compete among themselves for a development contract.

For companies in extractive sectors though, the bargaining advantage stops there. Since natural resources are bound by geography, a firm cannot choose where a non-renewable resource is located- it can only choose to develop or not. Moreover, once an MNC has decided to invest in infrastructure, relocate management and establish offices in a particular country to carry out a certain project, it finds itself with fixed sunk costs. As a result, the MNC has an incentive to carry out the project to avoid losing these sunk and upfront costs and to turn the project into a profitable venture.

According to the OB-theory, once the initial uncertainty surrounding the investment disappears and the firm starts to make profits, the host country starts to question the distribution of benefits from the original contract. This, in effect, instigates a “hostage effect”. Since the assets of the MNC are tied to a particular site till depletion, the relative

bargaining power shifts in favour of the host country. With the MNC having no financially sound exit-strategy, the host government imposes more conditions on the MNC, ranging from a stricter fiscal regime to - in its most extreme form - the entire expropriation of the multinational’s assets. Thus, the bargain deteriorates, or obsolesces - giving the theory its name. Consequently, the company is faced with the choice of compliance with the host country’s new conditions - or opposition. The former option guarantees continued revenue from the extraction site (albeit at a lower profit margin than initially foreseen). The latter, entails a risk of losing one’s assets without any adequate compensation and foregoing all future revenues whatsoever.

Naturally, this view assumes that conflict, and not cooperation, is inherent to the relationships between MNC and state. Vernon’s model states that the goals of both parties are assumed to be conflicting in the pre-bargaining phase. Yet, as both parties initiate negotiations, the bargaining process transforms the relationship into a win-win situation, founded on the desire of both entities to achieve absolute gains. How the subsequent relative gains are dispersed later on, all depends on the outcome of the negotiations and the shifts in power. From an economic rationale perspective, the final outcome should favour the party with the stronger resources, higher issue salience, weaker constraints and greater coercive power. This paper adopts the view that relationships between international concerns and host-countries in the area of oil and gas are inherently conflicting, zero-sum games. This assumption, as elaborated on in section 2.5, rests upon the high politicization of the energy sector, and the lucrative windfall profits associated with oil and gas extraction.

Before turning to its limitations, it is important to appreciate the importance of time to the theory. The obsolescing bargain process is inherently dynamic, because the balance of power between state and private sector in such contracts varies in terms of the international market in energy, of the location of technological hegemony and of the extent of sunk investments. What’s more, time can have a substantial impact on a number of other areas. Firstly, the perception of the host-country is likely to change over time, particularly when the project is financially more successful than first expected by both parties. This sentiment can be amplified by domestic discontent against foreign firms that are perceived to be taking an excessively large share of the pie. Secondly, simultaneous to the exploits of the MNC, economic spin-offs and technological transfers create a favourable environment for (inter)national competitors to

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enter the market. This erodes the possible monopoly position of the MNC and weakens their bargaining position substantially. Finally, over time, economic, social and political forces all contribute to changes in the goals and priorities of the host country, as well as the interest of MNCs themselves and the dynamics occurring in the industry itself.\(^{46}\)

**2.4. Critique of the Obsolescing Bargain Model**

The OB model, and the various revised versions here of, have not escaped criticism in the past. This section seeks not to debunk the core assumptions of the model, but to raise the reader’s awareness to the limitations of the OB theory. Fundamentally, the OB-theory is considered outdated by a number of scholars. In fact, a great deal of variation has been found to exist in the way bargains obsolesce, and if they do so at all.

Building on Vernon’s prior work a number of authors have revised the model over the past years. While Vernon assumed that the host-country was a developing nation and that the multinationals were Western companies operating in the extractive industry, the model was subsequently revised by Moran to accommodate manufacturing companies and Organization for Economic Co-operation and Development (OECD) countries as HCs.\(^{47}\) He concluded that the likelihood of an obsolescing bargain is considered smaller because the displaced capital infrastructure tends to be smaller and more mobile, and unwanted technological transfers easier to prevent. Furthermore, if the MNC can supply the HC with a continuous supply of new investments, the bargain need not obsolesce.

Kobrin later claimed that, in contrast to resource-based industries, obsolescence is by nature not structurally inherent to manufacturing, particularly in high technology sectors.\(^{48}\) He also drew attention to the declining number of sector-wide expropriations since the mid-1970s.\(^{49}\) In developing countries, for example, from 1981 to 1982 only 11 cases of expropriations were identified, as opposed to 83 cases in 1975 alone.\(^{50}\) Dunning agreed with Kobrin on this point and stated that the relations between MNC and states changed in the 1970s from being “predominantly adversarial and confrontational, to being non-adversarial and cooperative” throughout the 1980s and 1990s.\(^{51}\) Kobrin’s argumentation hinges on the broad shift in development strategies that followed the debt crisis of the 1980s, the so-called ‘neo-liberal’ development paradigm. This perspective discredited the dominance of host-country-

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\(^{49}\) S. J. Kobrin, ‘Expropriations as an attempt to ‘control foreign firms in LDCs.p.329-348.


MNC clashes over the conditions of inward FDI. Instead, it argued that international led structural adjustment programmes added significant clout to the cooperative power of MNCs and other actors. By producing a legislative and institutional framework in which MNCs and HCs operate, multilateral institutions like the International Monetary Fund (IMF) or World Bank (WB) facilitated cooperation. In addition, he suggested that technological innovation continues to play an important role in the dependence of host countries on MNCs. Even Vernon himself was not entirely oblivious to the increasingly cooperative nature of the relationship between MNCs and states. In 1998 he underlined that: “The atmosphere in which the conflicts between foreign-owned enterprises and host governments are conducted, it appears, has lost some of its menace, but the substance of the conflicts remains largely unaltered”.

Grosse and Behrman found that MNCs can also control their own obsolescing fate by forming strategic alliances with local firms, diversifying activities (and risks) outside the host country, establishing multiple sites to diminish the probability of asset hostage-taking and offering more benefits to the host government. Moreover, the authors identified two dimensions that shape the expected outcomes of negotiations between a firm and a government. First, the relative resources available to each entity: resources for the MNC include unique technology, benefits for local employment and access to foreign markets. Host country resources are centred on the control over the host country market and factors of production such as raw materials and inexpensive labour. Second, the relative stakes of the situation to each entity. For the host country this can include the availability of other firms to carry out a certain project, or the importance of the situation to governments interests. As far as the MNC is concerned, these stakes involve the availability of other sources of supply or other markets.

In a case study of Mexico, Bennet and Sharpe found that the bargaining power of the host-country is strongest at the time of entrance of the MNC. Contrary to Vernon’s initial assumption, the authors concluded that once the MNCs had become integrated into the host-economy and had built up strong relationships with local upstream and downstream firms, their bargaining power tended to increase rather than obsolesce. A forced exit from the market would then be detrimental to the host-country’s economy. Albeit in agreement with Vernon’s initial assumption that host-country-MNC bargains obsolesce over time, Vachani differentiated between static bargaining success (the outcome of a single negotiation) and dynamic

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56 Idem, p.103.
57 D.C. Bennett and Sharpe, K.E., ‘Agenda setting and bargaining power: the Mexican state versus transnational automobile corporations’, *World Politics* 32 (1979) 1, p.68.
bargaining success (the long run trend in outcomes over several negotiations). Moreover, he presented evidence for a positive correlation between the MNCs’ technology intensity, size of investment and its ability to prevent the bargain from obsolescing.58

Interestingly, even in natural-resource extractive industries, evidence was found that contested the OB-theory. Moran established that a number of MNCs had been able to protect their bargains.59 In a study on Kennecott, a mining company, he found that developing domestic and transnational alliances is beneficial to a MNC’s bargaining position. When Kennecott was finally expropriated by the Chilean government in 1971, it received full compensation for its losses. Rival firm Anaconda, on the other hand, which had not developed any alliances, was nationalized without compensation.

Jenkins also determines limitations of the model in a case study on the activities of the petroleum industry in Canada. The author agrees with the initial assumption that “in periods of economic growth the government will eventually resent its lack of economic rent and move to increase its tax revenues”.60 However, he subsequently argues that the model “overestimates the power of the state to dictate policy to the MNCs and underestimates the ability of MNCs to respond to such policies”.61 The author maintains that additional variables must be included to explain differences in the evolution of bargaining power at the MNC level. Jenkin’s case study, however, fails to confirm the theory’s predictions on four distinct points. First, the IOCs were not held hostage by their investments in the Canadian oil industry. Instead, IOCs displaced drilling rigs, renegotiated contracts in stages and cancelled long running projects to avoid such a situation. Second, IOCs benefited from the power of their own home-governments to ensure that their interests were accommodated by the host-government. Third, much like Kennecott, local allies proved to be an invaluable lobbying source vis-à-vis the Canadian state. Fourth, developments in the international economy (world recession, falling oil prices, and declining demand for oil) undermined the Canadian bargaining position.

Other limitations concern key assumptions of the model. Kalotay, for instance, refutes the assumption that the state is a homogenous entity. The author defends the multilayered nature of the state and contends that the sub-national and intergovernmental levels of decision making should be included in the framework. As far as MNCs are concerned, the rise of outward-investing firms originating from developing countries also adds heterogeneity to MNC strategies and motivations. Moreover, he disagrees with the benign perspective on the honesty

61 Idem, p.145.
of the parties involved in the bargaining. Indeed, where high stakes are involved, the risk of corrupt practices, hidden agendas and secret deals can increase substantially.

All in all, it seems that the widely held view among scholars is that the OB-model has outlived its relevance. Numerous cases have supported evidence that MNCs were able to withhold bargaining power and prevent opportunistic and hostile behaviour by host governments. As such, bargains rarely obsolesced. Currently, the general view held by most contemporary scholars in the particular field of MNC-HC relationships is one of cooperation as opposed to conflict. Win-win situations predominate in a bargaining situation that is no longer deemed zero-sum. The applicability of the OB model, then, seems limited.

Nevertheless this paper disagrees with this cooperative shift and argues that the OB-model is still highly relevant to bargaining situations in the petroleum industry, and so-called other ‘strategic sectors’. This relies on the assumption that stakes are relatively higher in these sectors and that the political benefits of government intervention may prevail over economic benefits. Indeed, such are the characteristics of the petroleum sector (see following section), that the industry is considered to have a ‘structural vulnerability’ to obsolescing bargains. In addition, developments such as the standardization of oil-related knowledge and technology, and the growing competition in the industry through the rise of National Oil Companies (NOCs), have all served to undermine the bargaining power of the international oil majors.

### 2.5. The Oil Sector and the Obsolescing Bargain

All sectors of the economy possess different characteristics that differentiate them from other industries. Some sectors, such as the clothing sector for example, offer low barriers to entry, whilst others are capital- and research-intensive, such as the automotive industry. Incidentally, the oil sector holds a number of traits that distinguishes it from other industries. In the past the sector has been marked by “large, capital-intensive, multinational, vertically integrated firms, operating according to long-range plans’. Adding to this, Manzano and Monaldini have identified a number of key characteristics typical of the oil sector, which are of great influence on state-MNC relationships, the main focus of this paper.

Firstly, both oil and natural gas extraction generate important economic rents and can be leveraged in order to secure the economic growth of a state. Rents, the difference between the value of a resource and the cost of producing that resource, increase or decrease according to

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67 C. Lipson, *Standing guard* p.117.
the oil price and remain highly volatile incomes. Since the state is usually the owner of the subsoil (notable exception is the United States) an inevitable tension arises as to the manner upon which rents are shared. This is particularly so for extractive industries where companies, depending on the sort of contract, act as the state’s agents rather than as resource owner’s in their own right. Rent volatility, combined with an inadequate progressive tax or poorly drafted agreement, only serves to heighten these tensions. What is more rent-seeking behaviour is likely to arise when differing actors compete for these rents. This can lead to other inefficiencies such as corruption or bribery.

Secondly, the industry is one in which significant sunk costs are made—highly specific, capital-intensive assets that are mobilized before revenues can even be collected. Large investments are needed, such as seismic studies, data analyses, and drilling, exploration and production wells at the initial stages before production can begin. Even then, success is not guaranteed as companies consistently run the risk of ‘dry holes’ or disappointing production. On the upside, once these large investments have been made, the economies of scale are considerable. At the same time, barriers to entry (and to exit) for oil companies can be high. Production licences and highly specific fixed asset investments, such as drilling rigs, can prevent other companies from entering a specific market. Furthermore, it is important to acknowledge the oil-related spin-offs for a local (national) economy. Albeit anything but labour-intensive, IOCs and NOCs alike employ local inhabitants and give way to important investments in areas such as infrastructure, housing, and healthcare for the local community.

Thirdly, the structure of the oil market has changed substantially over the past years. As global demand continues to grow, coupled with a declining resource base of ‘easy oil’, exploration efforts have been pushed into increasingly remote areas. A significant proportion of these areas are located in states with high political risks and weak institutions. The expanding role of the state in the sector has been undeniable. Whereas IOCs had full access to 85% of oil reserves in 1970, by 2007 this number had shrunk to a mere 7%. Conversely, by 2005 the NOCs controlled 77% of the world’s proven oil reserves. The short-term benefits and relative ease of expropriating assets, combined with host-country economic or political instability, have made the oil industry a very tempting target in the past. Often, incentives for governmental reneging have been founded on economic and political opportunistic

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70 A. Taylor et al. When the government is the landlord: Economic rent, non-renewable permanent funds, and environmental impacts related to oil and gas developments in Canada, Drayton Valley, Alta: The Pembina Institute (2004, July) p.7.
72 Although a well has a limited production rate and reach, economies of scale may arise in other areas such as drilling rigs, seismic studies, pipelines, treatment/refining facilities and so forth.
73 This is not always the case though. IOCs often favour their own workers as opposed to local employees.
74 S. Pirani, Change in Putin’s Russia: Power, money and people (London 2010) p.53.
objectives.\textsuperscript{75} For, direct control of the oil sector allows a state to redistribute benefits to its supporters at its own will.\textsuperscript{76} However, expropriation has its costs. It can seriously jeopardize a HC’s reputation together with its attractiveness for incoming private investment in the future.

Fourthly, extraction of non-renewable sources is a long-term enterprise, characterized by information asymmetries between the firm and the HC. The lead-time between oil exploration to the actual production process is significant and influences the bargaining dynamics between MNC and state. Oil exploration implies high initial geological and financial risks. Through time these risks decline significantly in the field development and production phase.\textsuperscript{77} Before drilling, the IOC reveals the average value of what they expect to find over a whole group of projects.\textsuperscript{78} Typically, in the initial bargaining phase, IOCs will have an incentive to underestimate reserves and overestimate up-front costs. By doing so, they have a strong initial bargaining position, allowing them to overperform relative to early estimates. A HC may try to mitigate this issue by involving a NOC from the onset.\textsuperscript{79} In addition, the state will have an incentive to overestimate reserves and underestimate these costs. This improves their borrowing conditions and bargaining position towards IOCs.

Fifthly, oil is “the world’s most important traded commodity”\textsuperscript{80}, of which the pricing is both economically highly sensitive and politicized.\textsuperscript{81} Oil producing states, for example, often heavily subsidize the domestic price of oil and gas. Not only is this important in order to please domestic customers, but also to give a competitive advantage to national industries that depend on relatively inexpensive energy. Therefore, politicians are often bent on avoiding significant increases in domestic energy prices. Finally, since the oil price in the international markets is volatile, oil rents react accordingly. Oil-dependent governments can have a particularly tough time adjusting their expenditure to this income volatility and may be tempted to renge on contracts even when oil prices are low.\textsuperscript{82} As an indication, in Russia’s case, it is estimated that for every US dollar increase in the price of oil, Russian revenues increase by $1.4 billion.\textsuperscript{83} In addition, the IMF estimated in 2005 that a one dollar increase in the price of a barrel of Urals for a year raises federal budget revenue by 0.35% GDP.\textsuperscript{84}

\textsuperscript{76} C. van der Linde, The state and the international market. Competition and the changing ownership of crude oil assets (Dordrecht 2000) p.6.
\textsuperscript{77} R.F. Mikesell, Foreign investment in the petroleum and mineral industry (Baltimore 1971) p.39.
\textsuperscript{78} M.A. Adelman, ‘Basic conditions for crude oil production and cost functions in the short and long run’ In: Encyclopaedia of hydrocarbons volume 4 p.79.
\textsuperscript{79} C. van der Linde, The state and the international market (Dordrecht 2000) p.103
\textsuperscript{80} S. Strange, States and markets (London 1988) p.192.
\textsuperscript{82} This and the previous paragraphs are an abridged summary of Manzano and Monaldini.
\textsuperscript{83} J.R. Patton, ‘Russian federation energy policies and risks to international joint ventures in the oil and gas industry’ International business: Research teaching and practice 2(2001)1 p.66.
These sector-specific attributes suggest that the OB-model is particularly well suited to explain the dynamics between HCs and IOCs. Therefore, the oil industry is considered by many scholars as having a “structural vulnerability” to the dynamics of the obsolescing bargain model – more so than any other natural resource.\textsuperscript{85} This claim certainly has some truth to it, in light of the substantial rents that can be captured, the conflicting objectives between HCs and IOCs (see table 1), the limited locational flexibility of company assets, the size of investments required to extract oil, and the highly politicized nature of the sector.

| Table 1 Conflicting Objectives of IOCs and Oil Producing States \textsuperscript{86} |
|---------------------------------|---------------------------------|
| **IOC Objectives**             | **State Objectives**            |
| Performance                     |                                 |
| Maximize after-tax profits and shareholder value | Maximize growth of GDP through appropriation of hydrocarbon rent |
| Minimise cost base consistent with consumer needs | Maximize quantity and quality of employment opportunities |
| Technology                      |                                 |
| Develop technological competencies (conventional oil development, deep water drilling, unconventional oil production technologies, eventual renewable energy technologies) | Stimulate the development of locally rooted technology |
| Establish technological and industrial leadership | Attract high-technology and technical expertise to result in technological transfers |
| High-order functions            |                                 |
| Locate headquarters and other high-order functions to fit optimal pattern of the firm’s overall operations | Maintain indigenous headquarters |
| Local staffing vs. international staffing | Attract IOCs and regulate key operations to prevent IOCs from obtaining dominant positions |
| Responsiveness                  |                                 |
| Retain flexibility to move profits in optimal manner | Retain power to gain a fair return on local operations of IOCs through taxation policies |
| Retain flexibility to modify the geographical configuration of the firm’s production network to meet changing conditions | Ensure investment in low-yield and high-yield developments to ensure stable development of resources |
| Retain flexibility to invest resources in high-yield developments (investment ranking) | Maximize the extent and benefits of local suppliers linkages |
| Retain flexibility to use the labour force as required | Develop a flexible, high-skill, high-earning labour force |

2.6. A New Bargain?

So far, we have elaborated on the core assumptions and critique surrounding the OB-theory. Moreover, we have also established that HC-MNC relationships in the oil industry have a structural vulnerability to the dynamics of the obsolescing bargain model. But can the theory be applied to our case? Without doubt, the collapse of the Soviet Union gave way to more


\textsuperscript{86} P. Dicken, Global shift: Mapping the changing contours of the world economy (London 2007) p.233, and A. Clo, ‘the oil industry: Its players and structure from its origins to the oil shocks of the nineteen seventies’ In: Encyclopaedia of Hydrocarbons Volume 5 p.278. and own assumptions.
complex situation than that assumed by the OB model. Unlike the traditional paradigm, wherein a developing country is assumed to have little or no prior experience in the extractive sector, the Soviet Union had extensive infrastructure and, to some degree, knowledge of both the commercial and technical aspects of oil extraction and oil development. Moreover, additional actors than just IOCs and the government were involved in the developments in the oil sector.

Despite these factors, this paper contends that in 1991 a new obsolescing cycle occurred within Russia. This assumption is founded on two major developments in the beginning of the 1990s: 1.) The transition from a 100% state-owned economy to a 75% privatised economy. This created opportunities for the private sector to strike favourable deals with the government in exchange for oil concessions and existing oil assets. 2.) The opening up of the post-Soviet economy to foreign investors. Surrounded by Western advisors, Russia encouraged FDI to revitalise the economy and the failing oil sector.

The inclusion of domestic actors is a departure from the traditional OB-theory, which focuses solely on MNC-HC relations. The core hypothesis here is that a weak Russian government gave away ‘unfair’ concessions in the oil sector to both private Russian oligarchs and IOCs. This seems plausible in the chaos that erupted following the collapse of the Soviet Union (SU) in 1991 and the poor state of the oil sector. Furthermore, simultaneous to the strengthening of the Russian state we seek to uncover whether bargains between the state and the IOC obsolesced in the same manner as the bargains did between the state and the oligarchs. Central to our analysis is the identification of driving factors that gave the state the incentive to intervene in its relationship with these actors.

A second departure from the traditional bargaining model is the manner upon which we determine the bargaining power Russia. Whereas the OB-theory asserts that the degree of technical and capital abilities of a state defines its bargaining power vis-à-vis IOCs or other investors, we also attribute weight to the political and economic context that the state operates in. The assumption here is that a state, benefiting from a strong government and favourable economic circumstances will have more leverage in its relations with other actors, than one that does not.

87 The Russians, for example, lacked the knowledge to develop the ‘sour’ crude oil (rich in sulfur) in the Central Asian republics
2.7. Analytical Framework

Whilst the traditional OB-theory provides a useful framework to break down a case into two sequential components, it offers only a limited amount of variables behind a state’s policy towards private investor. The variables it does provide are primarily centred on purely economic factors, such as the need or fulfilment of capital, financial and technological requirements. What’s more, the theory does not assess whether these same policies are rational or not. In order to bridge this gap we complement the framework with elements of the rational actor model.

A choice from competing alternatives is said to be rational when its yields supersede net benefits that exceed the opportunity cost. A rational individual is assumed to be able to objectively compare these alternatives using a cost/benefit analysis. We assume that actions chosen by a state are hinged upon maximizing its interests, strategic goals and objectives. As such, its behaviour is rational when it is consistent with the values, interests and objectives given the available information.

Allison’s rational actor model assumes the state to be a unitary, rational actor, able to choose value-maximizing policies, as if comparing the costs and benefits of each policy alternative. Admittedly, the assumption that Russia, a state divided into 89 federal subjects is a unitary actor is a huge oversimplification of the reality. In order to avoid analytical complications we analyse the policy of Russia as if it was the policy of one actor – the president of the Russian Federation. This is a highly disputable assumption – a president does not act alone, since it is surrounded by the likes of advisors, family members and other stakeholders. However, we found this assumption on the authoritarian leadership style of both Yeltsin and Putin and their position as key decision-makers. Furthermore, we assume that the rationality of a leader’s policy is a function of whether the outcomes of its policies match the policy option(s) with the highest value for the state. In order to pinpoint what the most suitable policy option(s) for Russia were at the time we propose a scorecard attributing a value to each of Russia’s options in the period 1991-1999 and 2000-2008. In doing so, we adopt the view that natural resources should be developed to the maximum benefit of its citizens (the state).

Naturally, we limit ourselves to policy options related to the oil sector. Thus, with the benefit of hindsight, we are able to establish what the best options for Russia were. The extent to which the state consequently implemented these policies and their outcomes will enable us to evaluate the rationality of the state.

The rational-actor model proposes a simple framework to evaluate policy, but like all theories, it has its flaws. Firstly, the model does not explicitly discuss the possibility of an

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actor possessing multiple goals. Although, empirically, an actor motivated by a single goal would be coined as irrational (or monomaniacal) Allison remains ambiguous about this core feature. Secondly, the model is typified as a single-time-period model. Thus, the rational actor analyzes a problem emerging at a certain point in time; and once an alternative has been opted for and implemented, the matter is seen as over. This may be appropriate for a crisis, but ignores any existence of a learning curve, an element inherent to the obsolescing bargain model. Thirdly, it ignores the existence of bounded rationality, the “limitations of knowledge and computational ability of the agent”. Bounded rationality is exacerbated by factors including stress and time limitations, elements that are all inherent to the domain of politics.

2.8. National Objectives and Identities
The rational actor model assumes that states are capable of determining the most effective and efficient way to realize their interests within environmental constraints they operate in. Rationalists believe that the interest of these actors are exogenously determined, meaning that they interact with one another with pre-existing preferences. This paper disagrees with this view and adopts the constructivist assumption that the identity of a state implies its preferences and consequent actions. As Wendt so aptly puts it: “States do not have a ‘portfolio’ of interests that they carry around independent of social context; instead, they define their interests in the process of defining situations”. Such processes are considered to be continuous, responding to the context a state finds itself in.

Building upon this view, we assume that the identity and interests of Russia respond to the environment it operates in. This context is shaped by both domestic and international factors. Since this paper analyses the actions of the Russian president, we focus primarily on the domestic political and economic context in Russia at the time.

2.9. The Rationality of Attracting Private Investors
The OB-model has been elaborated on in the first section. It is therefore, not necessary to explain in detail what the rationality behind attracting investors entails. We assume that a state only allows FDI if the benefits outweigh the costs; if the costs are considered higher than the benefits the state will simply prevent FDI from entering the country. With respect to the oil sector, we assume that two factors are decisive: The need for capital, and the need for higher efficiency, technological know-how and expertise. We briefly summarize these factors.

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99 This political ideology towards FDI is known more commonly as ‘pragmatic nationalism’.
2.9.1. Capital
Paired with increasingly complex projects, the costs of oil production and exploration have been consistently on the rise. The sector is highly capital-intensive and turning existing resources into production requires huge investments. Nevertheless, the original state of the industry, the complexity of the projects and the existing infrastructure are decisive in the extent to which capital is required. For countries that want to develop their resources quickly, FDI can substantially increase the speed of investments and can help decrease the probability of supply shortages.

2.9.2. Technology, Know-how and Efficiency
According to the OB-theory MNCs begin in a position of monopoly control over technological capabilities to develop a particular project. In the oil industry state-of-the-art technology is extremely important. The use of new technologies can have a positive impact on the whole value chain – exploration, drilling, production, transportation, refining, and reservoir exploitation. This can contribute to raising the success percentage of exploration, converting heavier crudes into lighter distillates, enhancing the recovery factor of fields whilst additionally improving both safety and the impact on the environment. The most significant impact on the success of Exploration and Production (E&P) has been the advent of seismic 3D-surveying and horizontal drilling techniques, alongside sub-sea and submerged production techniques. Service companies, and to a lesser extent IOCs, have always managed to be at the front-line of technological innovation making them logical partners.

<table>
<thead>
<tr>
<th>Table 2 Rationale Foreign/Private Investment Oil Producing State</th>
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<tr>
<td><strong>Possible Benefits</strong></td>
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<tr>
<td>Provision of technology, management and resource</td>
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<tr>
<td>Rent collection (assuming adequate fiscal regime)</td>
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<tr>
<td>Capital inflow</td>
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<td>Employment</td>
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2.10. The Rationality of State Approbation
Oil’s fundamental importance on the economic level and its strategic weight on the political level have led to a philosophy of public intervention, which is unparalleled in other sectors (an exception is the agricultural sector). We define intervention as any measures that result in...

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100 G. Bahgat, ‘Geopolitics and security: The American point of view’, In: Encyclopaedia of Hydrocarbons Volume 4 p.382
103 Admittedly, to state that IOCs provide capital and technology is an over-simplification of the reality. Nowadays, to a large extent companies ‘provide a service of ‘procurement’ for and on behalf of governments and themselves for both capital and much of the technology’, (D. Johnston, ‘Changing fiscal landscape’, Journal of world energy law & business, 1 (2008) 1 p.31.
105 A. Clô, ‘State and market requirements determining oil policies’ In: Encyclopaedia of Hydrocarbons Volume 4 p.191.
“alterations in the structure of the markets, both domestic and international; restrictions on the
degree of freedom enjoyed by companies; condition of their strategies, behaviour,
performances”.106 The OB-theory states that intervention by the state may occur if the IOC no
longer has a competitive advantage vis-à-vis the capabilities of the state. Nevertheless, a
change in bargaining power alone is inadequate in explaining why a government would decide
to renegotiate contracts or even expropriate foreign assets. So, what is the rationale behind
state intervention? Rather than listing the myriad factors that influence a government’s policy
vis-à-vis MNCs or other investors, in this research we assume that only two main drivers form
the rationale behind state-intervention in the oil sector. These are: 1.) economic considerations;
and 2.) political considerations.

Albeit certainly non-exhaustive, the following list of factors and sub-factors permits us to
narrow down our research, and systematically analyse the state’s policy in intervening in the
oil sector. Furthermore, although we assume that these drivers are fixed, we recognize that the
relative importance (ie: direction and intensity) a leader attributes to each factor varies. In a
country such as Venezuela, for example, ideological factors may carry more weight in the
state’s energy policy than Canada. This does not necessarily mean that it is in the benefit of the
state though.

2.10.1. Economic Factors
Maximization of Rent-Capture
One of the key characteristics of the oil and gas sector is the presence of large rents. Common
sense says that states, as rational actors, always strive to attain the highest level of possible
economic rent from the exploitation of a depleting natural resource. Hydrocarbon-rich states
that display this kind of behaviour are incidentally often typified as ‘rentier-states’.107 Rent is
defined here as “receipt in excess of costs”.108 Or in other words, the revenue received from
the sale of the resource minus the cost of producing it. For oil, this is the surplus of oil
revenues, over production costs and the return to capital. Rent is larger when the revenue of the
resource (reflected by the amount sold/exported multiplied by the price) is high and the costs
of production are low. The level of the oil price and its variations are an exogenous factor
[though some states can influence the price to some extent through their role in The
Organisation of the Petroleum Exporting Countries (OPEC)]. The volume of exports on the
other hand is less of an exogenous factor. This can be manipulated to increase or decrease rents.

It is important to not confuse rent-seeking with profit-seeking. Profit seeking is intended to
either satisfy a new demand or rearrange resources in a value-added way, whilst rent-seeking

106 A. Clô, ‘State and market requirements determining oil policies’ p.192
107 A.M. Estrada and C. de la Cámara Arilla, ‘Is Russia drifting towards an oil rentier economy?’, East European Economics 43
108 J.M. Buchanan, Rent seeking and profit seeking, in J.M. Buchanan, R.D. Tollinson and G. Tullock eds., Towards a theory of the
rent-seeking society. (College Station 1980) p.3.
tends to destroy value by wasting important resources. Moreover, natural resources differ from other economic inputs in the sense that they are a collective good and should be developed to the maximum benefit of its citizens.

Rent-seeking describes the competition between various actors to obtain rents. Each rent-seeker tries to get the biggest slice of the pie possible. Rent-seeking behaviour illustrates how rent reorients economic incentives towards competition for access to economic rents and away from productive efficiencies. In general, oil rents exacerbate regional inequalities and the gap between those that have access to rents and those that do not. Inefficiencies, such as kickbacks and corruption are explicit forms of rent-seeking activities. In order to minimize the negative effects of rent-seeking, it is important to limit the access to rents to one actor: the state. However, these effects will only be avoided on the condition that no rent-seeking take place within the state. From this viewpoint, a state will seek to have a monopoly over the entire value-chain to maximize its rents. What’s more, the state will focus on upstream activities as they are relatively more profitable than both mid- and downstream parts of the value chain.

In order to collect rents a state can increase equity ownership or adapt its fiscal regime. It is then essential that the state have a strong control on the levy of taxes and that rent-seeking within the state is mitigated. In addition, rent-seeking is likely to be especially tempting in an environment in which property rights are uncertain and institutions are weak. In such a situation, the legal system is unable to contain contests for property rights. A high oil price can act as a catalyst on the motives for a state to intervene. The simple reason is that high oil prices increase the economic rent and, thus, the incentive to nationalize assets. Given the volatility of the oil price (see figure 2) this can increase and decrease incentives extremely quickly.

By ensuring a monopoly over the rents (and the collection hereof), states are free to decide how to distribute this wealth over the economy. This distributional equity is particularly important when considering the enormous financial benefits oil and gas revenues generate.

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109 J.M. Buchanan, *Rent seeking and profit seeking*, p.4-5.
**Sustainable Oil Production**

Till date there is no international standard or measure of good governance for the petroleum sector. The scope of this paper is also too limited to elaborate fully on this subject. Nevertheless, as owner of the subsoil, the state has the responsibility of managing its resources in a strategic manner. Given the fact that the petroleum industry is based on finite resources, we assume that a state is focused on the long-term profitability of its resources. This involves two sub-goals. Firstly, the state shall place the emphasis on long-term objectives rather than short-term goals. This includes the protection of the environment, timely investments and efficient extraction. Secondly, if hydrocarbons are the main productive component of a state’s GDP the petroleum sector is likely to be subject to policies and objectives aligned with broader state development goals.

The issue of developing proven reserves and stimulating oil and gas exploration is primarily a question of pure economic policy. Ensuring more exploration can lead to higher production on the long term. This is reflected by the reserve-replacement ratio. Therefore, the challenge for the state is to find a balance between production and the rate at which new reserves are being discovered. If production exceeds the ratio, this will result in the eventual depletion of the state’s reserves. Poor resource management can lead to the over-production of oil fields, economic inefficiencies and environmental damage. Moreover, a lack of E&P investment may serve to undermine the reliability of the state as a supplier of oil on the long term. Consequently, we assume that a rational state is set upon ensuring a sustainable production by stimulating long-term investment of infrastructure and exploration.

**Fulfilment of Technological, Know-how and Capital Requirements**

Central to the OB-theory, the fulfilment of antecedent technological or capital requirements by the HC erodes the bargaining position of the IOC. According to the theory this is usually a question of time, though its length may vary. Nevertheless, the trade-off here is not as simple as the theory prescribes. On the one hand, IOCs and other MNCs are highly protective of their technology, know-how (i.e. their competitive advantage) and are not likely to allow domestic companies to gain access to this information. On the other hand, technology and machinery involved in the development of natural resources can be highly complex and will undoubtedly necessitate maintenance and upgrading as they age. Of course, this problem can be resolved by outsourcing this particular aspect to service companies, which are in abundant supply these days.

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115 A. Cló, ‘State and market requirements determining oil policies’, p.191
Support of the Development of National Industries
This factor serves a dual purpose for states. Not only does it prevent foreign companies from occupying a dominant position in the domestic market, it also enables national firms to enter the market or at least improve their initial position. By supporting state-owned enterprises, the state can still monitor, manage, and eventually control some or all of its oil industry. Close cooperation between domestic companies and IOCs can also be beneficial as it facilitates technology and knowledge transfers.

2.10.2. Political Factors
Domestic Political Utility
We have already demonstrated the politicized nature of the domestic oil sector within oil producing states. Domestic populations, national media, opposing political forces as well as ruling governments themselves portray the strategic oil sector as the ‘commanding heights’ of state economies. Therefore, allowing foreign involvement in the oil sector is often perceived as a breach upon the sovereignty of a host-country, a form of Western industrialization or colonialism. From a domestic political point of view two factors can push a government to intervene. First, states in the past have been known to use foreign companies as scapegoats for domestic troubles. By playing in on populist resent of foreign involvement, this is an effective way of rallying the population against a common enemy. Secondly, domestic socio-economic factors can put pressure on a national government. Expropriating assets, increasing taxes or renegotiating contracts can serve to create jobs (in the case of expropriation) or capture more revenue that then can be re-distributed to increase social spending.

Geopolitical Objectives
Structural systemic changes in the global energy market have increased tensions between states, resulting in shifts in the international balance of power. This has been caused by a number of broad factors. First, oil is a finite resource and is unevenly distributed across the world. 65% of all proven oil reserves and 70% of the world’s proven gas reserves are situated in the strategic ellipse stretching from the Middle-East to the heart of The Russian Federation. Second, the energy market is largely dependent on fossil fuels, with transportation primarily based on petroleum products. As a result, competing consuming states are continuously searching to improve their security of supply. However, this was not always the case. After a

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116 This expression originated from a speech by Vladimir Lenin, who used it to invoke the segments of a national economy that largely control or support the others, such as energy, transport and finance.
period of excess supply on the market from 1986-99, the focus on security of supply and control over resources has increasingly found its way back on the international political agenda. Third, not only is cheap energy vital to the economic and stable growth of states, it is also a strategic commodity, through its worldwide use in the armed forces. Bearing this context in mind, it is then not difficult to imagine the geopolitical importance oil exports have.

But exporting oil is not only a useful lever in its relations with other countries; it is also a major source of revenue for oil producing countries. Fundamentally, the profit margin on exports is determined by the world oil price and the local cost of production. Unlike the Middle East, the production cost of oil is relatively high in Russia. This means that a period of prolonged low oil prices can severely affect oil rents. In addition to the outlook on oil prices, the state must ensure that its transport capacity is in line with the production destined for export.

| Table 3 Rationale Appropriation Oil Producing State<sup>121</sup> |
|-----------------------------|-----------------------------|
| **Possible Benefits**        | **Possible Costs**          |
| Rent capture                 | Reputational costs          |
| Creation of political good-will | Loss of technology, management, efficiency and know-how |
| State control                | Loss of investment in E&P   |
| Strategic management of production and exports (renewal of resources) | Absence of competition on the domestic market (market inefficiencies) |
| Protection of national oil companies |                             |

2.11. Methodology

The methodology of this paper is a cross-case study based on qualitative data. This approach allows us to provide a detailed analysis of the developments in the oil sector between 1991 and 2008 in the Russian Federation based on a mix of quantitative and qualitative data. Unfortunately, this method has two shortcomings. The first problem in applying the obsolescing bargain theory is how to measure bargaining power and how to define bargaining outcomes. The traditional bargaining power framework contends that the outcomes of MNC-HC interactions reflect the relative bargaining power and resources of the MNC over the host country (and vice versa).<sup>122</sup> Hence, MNCs with greater bargaining power are likely to obtain more favourable terms in HC negotiations and vice-versa.<sup>123</sup> This however gives precious little insight into the processes and fails to account for the reasons behind certain outcomes. It is, however, painstaking to find reliable sources that accurately depict the bargaining process between MNCs and HCs. In addition, the highly secretive nature of IOCs leaves a vacuum of publicly available information. In order to simplify our application, we only measure the

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<sup>121</sup> Based on own assumptions.
bargaining power of the state. We do so by analysing the political and economic context the state operated in. Our analysis follows the cycle prescribed by the OB framework, with the state having initially relatively little bargaining power, and increasingly more as the bargain obsolesces.

The second key issue in our cross-case comparison is the difficulty of comparing seemingly different entities. Albeit both focused on profit maximisation, both oligarchs and IOCs are completely different entities with different objectives. By consequence the state, in its behaviour to these entities, will most likely display a different behaviour to these entities. This is not necessarily a serious drawback, but a factor that may undermine the validity of our conclusions.

2.12. Conclusion
In response to the investigative title of this chapter, we have argued that the OB-theory has not outlived its relevance. On the contrary, we have demonstrated that the model is highly applicable to the dynamics between IOCs and HCs in the oil sector. What’s more it allows us to break up the case into two sequential components. The first period departs from the assumption that a weak state will attract foreign investment by offering profitable terms to interested companies. The second period rests on the assumption that the bargains between the state and private investors will obsolesce, insomuch that the bargaining power of the state is stronger than that of the private companies.

Yet, the model has two limitations with regards to our case. First, the theory is confined to HC-MNC relationships and not to those between a HC and domestic companies. Second, the OB-theory remains unspecific about what the main drivers are behind a HC’s decision to either attract investment or appropriate foreign assets. In order to resolve these limitations, we have designed a state-centric framework, containing a number of hypotheses that may play a role in a HC’s policy towards private investors – foreign or non-foreign. Elements of the rational actor model have been incorporated in our theoretical framework to enable us to identify and compare factors in: 1.) the attraction of foreign investment in the oil sector, and; 2.) the intervention in the oil sector. By comparing the needs of the Russian oil sector with the outcomes, we can evaluate the policy of the state with regards to these actors.
3. Yeltsin and the Withdrawal of the State

We understand that the only source of hard currency is, of course, the source of oil. . . . If we do not make all the necessary decisions now, next year may turn out to be beyond our worst nightmares. . . .

1989, Chairman of the State Planning Committee Yury Maslyukov

3.1. Introduction

The dissolution of the Soviet Union in 1991 devastated the political and economic fundamentals of the Russian state. This led to a sustained period of chaos and uncertainty, ripe for a new OB-cycle. The research question of this chapter is: “What were the drivers behind Russia’s privatization policy of the oil sector in 1991-1999 and was this policy rational?” In order to answer this question, the following outline is adopted. First, we discuss in detail the impact of the transition on the Russian oil sector and the legacy of problems left behind for Russia. Second, we analyse the rationale for the Kremlin in stimulating private investment in the oil sector as prescribed by the OB-theory. This allows us to pinpoint the needs of the sector through an OB-lens. Third, we demonstrate the fragile bargaining position of the Kremlin by highlighting the economic and political context in that period. Fourth, we debate the ability of the IOCs and oligarchs to respond to the needs of the Russian government with regards to its oil sector. Finally, we examine the resulting respective bargains between the states, IOCs and oligarchs. The rationality of these agreements is evaluated based upon the extent of which the resulting bargains matched the initial needs of the government.

3.2. From the Soviet boom…

The oil sector was of crucial importance to the Soviet Union. The economic wellbeing of the state hinged on its ability to produce and export raw commodities – namely oil and gas. On the one hand, it provided Moscow and the Former Soviet Republics (FSR) with vital energy needs, imperative to the economic activities of the huge industrial base and for supplying subsidized heating and electricity to the domestic populations. On the other hand, the oil and gas sector employed one million Russians directly and contributed towards generating important export revenues, totalling 60-70% of the SU’s earnings. Earnings in hard currency from the sale of hydrocarbons went towards strengthening the economic development of the SU, and generated the lion’s share of hard currency needed to finance its military objectives (the Soviets...
left Afghanistan only in February 1989) as well as its expensive space program. Beyond the subsidization of the Former Soviet States, Moscow also supported allied states such as Cuba and North Korea. In reality, this meant giving away tremendous amounts of oil at below market prices or even in return for barter (Russia swapped oil for sugar cane with Cuba for decades). Approximately half of Russia’s fossil fuel (including coal) exports went to East Europe.

In the days of the Soviet Union all oil enterprises were 100% state owned and reported directly to the all hierarchical and tightly organized Ministry of Fuel and Energy. In addition, every step of the oil value chain was controlled by a separate specialized ministry. Minnefteprom oversaw extraction, Minneftekhimprom refining, Gossnab distribution, and Soyuznefteksport export. This structure often created institutional blockages and counterproductive practices. Natural gas, for instance, was routinely flared by the Ministry of Oil Industry since they had no incentive to sell it on the market (unlike the Ministry of Gas Industry). Prices were set by central planners, and not by a market, allowing the state to subsidize domestic prices at a fraction of the world price. Unfortunately, these planners often had no proper understanding of the economics of energy production. This not only led to poor decision-making, but also resulted in an inability to coordinate maintenance and construction in the sector.

Imports for equipment, technology or other inputs were also organized centrally, far removed from the production centres situated in Romania and Azerbaijan. Often imports mismatched requirements and depended on factors such as the availability of foreign exchange or the possibility to barter deals with foreign suppliers of equipment. Investment in E&P was equally skewed. Variables traditionally used to determine the choice of capital placement were simply unavailable or ignored. This included the spacing of wells, the rate of reservoir extraction, the ratio of reserves to production and the rate of development versus exploration drilling. With little consideration for these crucial factors, oil and gas reservoirs were exploited at excessive rates. Although this permitted high production rates at a relatively low investment outlay, it severely decreased the longevity of reservoirs.

Fundamentally, the Soviet planning system was deeply flawed since it removed all incentives to innovate, to improve efficiency or to manage a company in a strategic manner.

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133 T. Gustafson, Crisis amid plenty: The politics of Soviet energy p.52.
135 S. Whitefield, Industrial power and the state (Oxford 1993) p.63.
Instead, production of oil and gas resources was not aimed at achieving high profits, nor at ensuring high quality crude, but at meeting short-term output targets that had been set by government institutions.\textsuperscript{137} Performances of managers were judged by either the fulfilment or nonfulfillment of a fixed plan. The Ministry of Oil Industry and Ministry of Gas Industry, together with the State Planning Committee (Gosplan) established quotas and physical goals. These ranged from the amount of tons of oil produced to the number of wells that had to be drilled per year. Gosplan targets were notoriously under fulfilled due to technological inadequacies and obscure incentives. Thus, state enterprises were rewarded for complying with these output targets, but not for improving profitability or other financial objectives.\textsuperscript{138} Ultimately, in the absence of a competitive market, little enticement was provided to ameliorate cost-efficiency, innovation, finished product quality or sustainable long-term production.\textsuperscript{139}

\textit{Figure 3 Distribution of Soviet Oil Production by Republic 1970 & 1988}\textsuperscript{140}

With so many structural deficiencies, it was a wonder that the Russians could produce such large quantities of oil in the first place. Yet, in 1987 the Soviet Union was still the world’s largest producer of crude oil at 12.5 million bbl/d, ahead of Saudi Arabia at 5.3 million bbl/d and the US at 8.1 million bbl/d.\textsuperscript{141} At the same time, it was also the world’s largest producer of natural gas. As figure 3 demonstrates, the Russian Republic was responsible for the bulk of production, accounting for 92% of its crude oil output. However, production would soon peak. Whereas output was in excess of 11 thousand bbl/d in 1987, a year later oil it would commence a long and sustained decline. By 1992, the Saudis would overtake the Russians and become the largest oil producers in the world (see figure 4).

\textsuperscript{138} T. Gustafson, \textit{Crisis amid plenty: The politics of Soviet energy} p.49.
3.3. …To Post-Soviet Bust

A number of analysts point to the decline in Soviet oil output and, consequently in oil revenues, as one of the root causes of the dissolution of the SU.\(^\text{142}\) Whether this claim has any truth to it is debatable. However, it is undeniable that at the end of the 1980s, oil output was in decline and severely affecting export revenues. Whereas in 1986 revenues totalled $22 billion, in 1991 this figure would stand at $7 billion. The decrease in revenue was partially due to contracting volumes of exported oil and partially due to reduced profit margins on oil. This was instigated through two developments.

First, oil prices slumped in the second half of the 1980s and would remain low for at least a decade. In 1985 Saudi Arabia had increased its oil output from 2 to 6 million bbl/d, thus saturating the oil market and lowering the world price for oil.\(^\text{143}\) Whilst in November 1985 a barrel of crude oil sold at $30, in March 1986 the same barrel cost only $12. Admittedly, the SU usually exported only a minor part of its resources on the international market, since most was exported to the Comecon in exchange for barter. Nevertheless, in the years prior to its collapse, Moscow began to shift its exports from Comecon to the world market to generate hard currency. Schweizer estimated that a $1 decrease in the price of oil implied a drop in $1 billion of foreign currency earnings per year for the Soviets.\(^\text{144}\) According to former prime minister Yegor Gaidar, this resulted in a loss of approximately $20 billion per year.\(^\text{145}\) This was problematic, since imports of basic necessities (such as grain, meat and medication) had to be paid for with hard currency. As an indication: Scholars estimated that Russia imported $15-

\(^\text{142}\) P. Schweizer, Victory: The Reagan Administration’s secret strategy that hastened the collapse of the Soviet Union (New York 1994) p. 203-18
\(^\text{143}\) Allegedly the US government had asked the Saudis to increase their oil supply. They hoped that this would lower the world price of oil, depriving the SU of vital hard currency revenue and destabilize the Soviet regime.
\(^\text{144}\) P. Schweizer, Victory: The Reagan Administration’s secret strategy, p.15.
25 billion worth of pharmaceutical and food products per year. Any absence of these basic supplies could potentially affect the general health of the population, leading to political unrest.

Figure 5 Russian Oil Production 1985-1999

Second, production costs had practically doubled between 1975 and 1980. Half of total Soviet oil output came from a dozen giant and supergiant fields in the Russian Republic and no replacements of similar size and productivity had been found. Since oil managers now persistently failed to meet Gosplan production targets because of depleting reserves, the focus started to shift to increasingly harder-to-reach oil reserves in Siberia. This led to higher marginal costs and substantial, unsustainable annual investment requirements, reaching the tens of billion of dollars towards the end of the 1980s. To illustrate: In the 11th plan period (1981-1985) oil industry investments accounted for 17% of all industrial investments. On top of higher production costs, production sites increasingly located in the East of the state, far from the core consumer base, made transportation also more costly.

With so many cracks appearing on the surface, measures had to be taken to restore production. As of 1985 Mikhail Gorbachev, the General Secretary of the Communist Party began to gradually decentralise the oil industry and stimulate FDI. On the one hand, he enhanced the autonomy of all state-owned enterprise directors through the Law on State Enterprises in January 1988. On the other hand- in a dramatic policy reversal- foreign oil companies were to examine investment opportunities in Russia in the form of Joint Ventures. This was part of wider economic reforms, known as ‘Perestroika’, that were to mark the beginning of a lengthy and painful transition to a market-based economy. Ultimately though, Gorbachev’s Perestroika would be a failure: the domestic economy collapsed under the weight of huge external debt and a massive state deficit. Ensuing shortages of basic food supplies led to

domestic unrest, contributing (among many other factors) to the eventual dissolution of the Soviet Union and the seizure of power by Boris Yeltsin in 1991.

3.4. Changes in the Sector

Although Russia possessed an established oil industry, through the use of outdated field development techniques and Soviet-style management practices, a legacy of oil sector related problems was left behind by the Soviet regime.\(^{153}\) In addition, a shift to a market type economy entailed future problems such as the sale of its assets, the control and liberalization of the price structure, the receipt of tax revenues, and the international effects of exports.\(^{154}\) What follows is a comprehensive summary of the major oil sector challenges the Russian government faced following the collapse of the Soviet Union. Six major issues can be identified.

First, mass rent-seeking behaviour and supply disruptions affected the oil industry as it underwent significant deregulation. In September 1991 the Ministry of Fuel and Energy was transformed into a stock company named Rosneftegaz. Barely a month later, the acting Minister of the Petroleum Industry at the time, Vagit Alekperov, used his authority to set the Langepaz, Urengoi, and Kogealym petroleum oil fields aside. He combined these assets to form LUKoil and named himself Chief Executive Officer of the newly formed company, boasting more oil and gas reserves than Exxon at the time.\(^{155}\)\(^{156}\) Later in 1993, a Presidential decree subdivided Rosneftegaz (renamed Rosneft) into three holding companies: Yukos, Surgutneftegaz and a re-registered LUKoil. Whilst a government manager of the Ministry of Oil, Vladimir Bogdanov, took over as Chief Executive Officer (CEO) of Surgutneftegaz, Yukos was run by Sergei Muravlenko, an established oil ministry figure.\(^{157}\) These were so-called ‘red directors’, individuals who had been powerful under the Soviet regime. As such, between 1992 and 1995, many of the privatised assets came in hands of individuals who had taken advantage of their political connections.

Second, domestic prices were still set by the state and were significantly lower than world prices. In the spring of 1992, the Russian subsidized price of oil was only 1% of the world market price.\(^{158}\) Even in 1993, the price had not risen to more than 8% of the world market price.\(^{159}\) Price increases to curb consumption were blocked by soft-budget constraints of many consumers.\(^{160}\) This meant that cheap oil and gas were overused to the detriment of export

\(^{154}\) D. Lane, *The political economy of Russian oil* (Maryland 1999) p.15.
\(^{156}\) P. Klebnikov, Godfather of the Kremlin, Boris Berezovsky and the looting of Russia (Orlando 2000) p.190.
\(^{157}\) S. Fortescue, Russia’s oil barons and metal magnates: Oligarchs and the state in transition (New York 2006) p.49.
supplies, diminishing potential returns. In the face of declining production, in 1990 the Soviets were forced to cut oil exports by 10% via the Council for Mutual Economic Assistance. Third, despite the subsidized prices, domestic industries and consumers had trouble meeting their payment. Cash collection on domestic sales was so dismal that a large proportion of transactions continued to be carried out in barter in the post-Soviet years.\footnote{N. Moser and P. Oppenheimer, ‘The oil industry: structural transformation and corporate governance’, p.304.}

\textit{Figure 6 Oil Value Chain}

![Figure 6 Oil Value Chain](image)

Fourth, the Soviet Union’s dissolution caused a general dislocation in Russia’s ownership and sovereignty of the oil and gas value chain. The collapse of the FSU produced several newly independent states, some energy rich such as Kazakhstan and Turkmenistan. As a result, the ownership of transit infrastructure that transported gas and oil from Siberia and the Central Asian states to both Comecon and the European Community was radically altered. Components of the Soviet value chain were split up and became the property of new sovereign states. At the time, most of the harbours and borders through which the energy resources had to be transported were situated in the FSR. Subsequent to the disintegration of the United Of Soviet Socialist Republics, countries such as the Ukraine and Belorussia suddenly gained partial control of midstream infrastructure used to transport 80% of the European Community’s gas imports from Russia. In addition, Russia lost the rich Caspian Basin offshore and on-shore oilfields in Azerbaijan and the Central Asian states.\footnote{C. van der Linde and G. Greving, ‘Turbulentie in de pijpleiding: Gasconflict Rusland-Oekraïne en Russische - Europese energierelaties’, \textit{Internationale spectactor} 60 (2006) 4 p.189.} The fragmentation of the FSU also disrupted inter-republic trade. This was problematic, since a vast majority (approximately 70\%) of the SU’s oilfield equipment was produced in Baku, Azerbaijan.\footnote{M. Radetzki, USSR energy exports post-perestroika survey of prospects and issues, \textit{Energy policy} 19 (1991) 4 p.294} In addition, a substantial part of the Soviet refining activities was situated in Kazakhstan. Ultimately, supply disruptions hampered the export of oil to other countries leading to a 50\% reduction of Russian oil exports between 1990 and 1991.\footnote{S. Fischer, L. Summers and W. Nordhaus, ‘Stabilization and economic reform in Russia’, \textit{Brookings papers on economic activity} 1 (1992) p.85.}

Fifth, Russia’s oil fields had been the subject of ‘perverse’ extraction policies. Indeed, after peaking in the late 1980s output was declining at an alarming rate. The inefficient and irrational extraction of resources was an important factor in this development.\footnote{Rather than equally spreading wells over a specific field to assure an even extraction of oil, the Russians opted to save on infrastructure by drilling five or six wells from a single wellhead.} The state-imposed production quotas had led to the continuous overproduction and depletion of the...
larger easier-to-develop fields in West Siberia. This policy, implemented by Gorbachev, damaged many oil reservoirs.\textsuperscript{166} The emphasis lay on maximizing output volumes, which was at the expense of exploration, the sustainability of production, and the ultimate recovery of oil. In the late 1980s exploration had accounted for only 18-19\% of the total drilling. The remaining 80\% constituted of wells drilled in antecedently exploited fields in an effort to increase extraction from these reserves. As figure 7 indicates, average output of these wells was declining through time. This was caused by a larger concentration of wells in the same fields. In 1986, 70\% of oil production originated from only 20 huge oil fields. With these fields approaching maturity the Russian would have to shift to smaller fields, requiring considerable investments. But since no investments took place, little new ‘oil’ came online.\textsuperscript{167}

\textit{Figure 7 Average Output of New Oil Wells being put in Operation in the USSR (in thousands of barrels of oil annually)}\textsuperscript{168}

Poor equipment, unsophisticated reservoir management and well completion techniques, and the inappropriate use of water flooding techniques had degraded the quality of the fields.\textsuperscript{169} Water had been injected to restore the pressure needed to facilitate the extraction of petroleum. This was initially successful but abuse and excessive water injection eventually created water flooding problems. The inefficient drilling for oil was illustrated by the huge concentration of wells. Whilst in 1988 the number of idle wells stood at 7.000, by early 1992 this figure stood at 23.500.\textsuperscript{170} Instead of relying on the discovery of new fields, the Soviets had tried to increase production by simply drilling more wells in the same large fields. Ultimately, this forced the sector to look at smaller and geologically more complex fields.

Finally, demand within both Russia and the former Soviet Satellites shrunk (see figure 8). This was a reflection of the difficulties these states were having in transforming there once state-led economies into market-based ones. Prior to the collapse of the SU, energy consumption had been highly excessive and wasteful. Most of the oil and gas was supplied to


\textsuperscript{170} J. Watson, ‘Foreign investment in Russia: The case of the oil industry’, p.431.
the huge military-related Soviet-era oil outlays and the large industrial customers. As an illustration, in 1987 Soviet energy intensity (energy per unit of GDP) was 90% higher than the OECD average at the time. Whereas between 1979 and 1987 domestic oil consumption had risen by 5% per year, between 1990 and 1995 it would decline by 40%. Although this was an indication that the industrial base was clearly struggling to maintain output, it also meant that more oil was available for the more lucrative international export market - resulting in higher revenues.

3.5. Assessing the needs of the sector

3.5.1. Introduction

The previous section has exposed the dire state of the Russian oil sector. The OB-theory predicts that a nation will attract private investment to a national (extractive) industry if it is unable to exploit the resources independently. The contention of this paper is that the Russian oil sector was ripe for foreign investment, since much of the needed requirements were unavailable in Russia. In accordance with our framework, we subdivide theses requirements in those related to capital and those related to management, technology, expertise and so forth.

3.5.2. Capital Requirements

When Yeltsin rose to power, the Russian state was awash in debt and did not have the funds to invest extensively in the oil sector. The Russian Ministry of Fuel and Energy estimated the total investment needs of the oil industry between 1992 and 2000 at $35 billion. The WB adopted a more sceptical stance and ran estimates of up to $50 billion. From the onset it was clear that Moscow would not be able to fund these requirements independently. Two key areas required significant funding. First, investments in E&P had been neglected for a substantial period of time. Little of the revenue generated by exporting natural resources or by supplying the domestic market had actually been re-injected into the industry. This led to underinvestment in

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172 M. Radetzki, USSR energy exports p.293.
173 Sources: BP statistical review and Economist Intelligence Unit.
E&P. Moreover, the incremental removal of enormous state-subsidization, which had supported the industry during the 1970s and 1980s, had starved the sector of important funding. Although its impact on the sector was to be felt towards the end of the 1990s, the lack of investment led to a supposed 25% decline in oil exploration from 1989 to 1992.  

Second, Russia inherited a pipeline infrastructure badly in need of investment. With 76,000 km of pipeline to maintain and 90% of Russia’s crude passing through its infrastructure, the problem was both acute and sizeable. This had two major consequences. On the one hand, pipeline and port capacity constraints severely limited Russian exports. Russia’s export pipelines as well as the Black Sea and Baltic Ports were operating at full capacity, permitting no room for additional volumes. This starved the Russian economy of crucial hard currency. On the other hand, as a direct result of neglected infrastructure, Russia was plagued by environmental problems. The oil industry was estimated to leak per year the equivalent of 400 supertanker cargoes from pipelines into the Russian soil. A main reason for this was that the pipelines were corroded. This was the result of a high level of hydrochloric acid in the oil, a substance that was injected into fields along with water. On top of this, leakage detection and tracking mechanisms were absent, or simply not performing well. In some regions, the local population was concerned by the potential effect oil exploration could have on the fishing and maritime industry. The general consensus at the time was that only western involvement would serve to protect these environmental interests, as opposed to Russia’s domestic oil companies.

3.5.3. Technology, Management and Know-How

As elaborated upon before, specific technology and expertise is indispensable in extracting and developing oil from hydrocarbon reserves. For simplification purposes, we subdivide Russia’s reserves into two types of oil fields: easy-to-reach and hard-to-reach oil fields. The former had mostly been explored in the Soviet era and had been developed without foreign help. The latter were characterized by highly complex geological and meteorological conditions, and were far more dependent on foreign expertise.

Despite damaging the wells in the easy-to-reach fields through rudimentary extraction techniques, the Russians had successfully developed these wells in the Soviet era. Moreover they could continue to do so without the need for any major technological upgrades. This did

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179 J. Stranislaw and D. Yergin, Oil: Reopening the door, Foreign Affairs 72 (1993) 4 p.87.
not hide the fact that Russia had sub-standard infrastructure, technology and equipment due to a deficient investment policy dating back to the Soviet period. This was apparent in the ageing equipment used in Russian oil fields at the time: less than 20% of their material was up to the standard of Western companies. The reasons behind this were twofold. On the one hand, the SU had fallen victim to US led embargos and restrictions imposed by Moscow on contact between Soviet petroleum engineers and foreign specialists. On the other hand, due to the growing macroeconomic instability, Russian state enterprises had become less and less interested in selling their manufactured products for roubles, preferring to exchange their goods for barter. Unable to pay for the goods, this deprived the oil industry of necessary machines and equipment. All in all though, foreign technology and expertise was not indispensable for the easy to reach fields, though enhanced recovery techniques would certainly have improved the extraction rate.

The harder- to-reach fields were geographically confined to West Siberia, the Arctic and the Russian Far East, such as Sakhalin. These areas, along with the reputed West Siberian continental shelf, consisted of one of the most technologically challenging acreages in the world. The Russian oil industry had only very limited experience in offshore and had barely any infrastructure was in place. Such was the insurmountable nature of the geological and environmental problems posed by the area, that the Russians had asked the Japanese government to help develop the Sakhalin oil back in the 1970s – an exceptional occurrence at the time. Beyond the all year round seismic activity, the region offered only a four-month operational window depending on ice conditions. Involvement of the IOCs would be imperative, since the Russians had not been able to bring any of the offshore fields online in the past.

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Scores: very high; high; average; low; very low

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187 This was the first time that the Soviets had allowed foreign investment or even foreign involvement in the sector.
3.6. Meeting the Needs of the Oil Sector

In order to assess whether either the oligarchs or IOCs were able to answer the needs of the Russian oil sector as portrayed above, we now analyse the competences of the respective actors.

3.6.1. IOCs

3.6.1.2. Capital Requirements

The IOCs could offer a fitting solution to the Russian capital requirements. Despite the highly unstable business climate, the oil companies were prepared to invest heavily in cost-intensive, upstream projects in order to restore production.\textsuperscript{188} This was crucial for two reasons. First, Russia simply had no money to invest in the sector. Second, the projects that the Kremlin hoped to develop were completely isolated from the Russian market and necessitated huge infrastructural investments. Fortunately, the majors were very eager to gain a foothold in Russia and described Russia as “the last frontier for an oilman to find new reserves” and the “new prize for world oil”.\textsuperscript{189} Moreover, besides forming a reliable tax base, the IOCs could also generate important economic spin-offs for the local population. Russian equipment suppliers would receive additional orders, local employment would be boosted, and the local economies of oil-producing regions would benefit from the large inflows of foreign money.\textsuperscript{190}

3.6.1.2. Technology, Management and Know-How

As far as Russia’s second requirement was concerned, the IOCs could add value in three specific ways. First, the technology, skilled workers, management, support services and expertise the foreign companies possessed were far superior to that of the state – this was by far the most important ace up the IOCs’ sleeve. Throughout the 1980s, Western oil companies had been able to develop increasingly advanced geological and geophysical exploration and production techniques.\textsuperscript{191} In contrast to Russian domestic firms, the majors also had experience in offshore development in difficult environments such as Alaska and the North Sea. These circumstances were, however, not to be compared to the huge challenges that the Siberian fields formed. Moreover, whereas the IOCs had state of the art technology and enhanced recovery methods, Russian companies complained of many shortcomings. Rigs, drilling fluids and cement dated back to the Soviet days and were of a lower standard in comparison with Western equipment. Even the Russian drill bits were said to be only one-fourth to one-fifth the length of Western equipment.\textsuperscript{192}

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\textsuperscript{189} P. Klebnikov, ‘Godfather of the Kremlin’, p.189.
\textsuperscript{190} J. Watson, ‘Foreign investment in Russia’, p.429.
\textsuperscript{191} J. Stanislaw and D. Yergin, ‘Oil: reopening the door’, p.81.
\textsuperscript{192} J. Thornton, ‘Nationalization of energy assets and regional welfare’ p.4.
Second, the IOCs were reputed for being more efficient in the field of extraction and development. Empirical evidence suggested that Russian fields, when compared with similar reservoirs in the West, experienced a shorter reservoir life. According to Smith, Russian producers lost around 40% of the total economic value of resource stocks during production as opposed to negligible amounts in similar fields exploited by Western companies.\(^{193}\) If IOCs succeeded in upgrading the efficiency of exploration and production, the Russians would enjoy a better return on investment. Finally, a growing concern among policymakers was the protection of the local environment. This was of course closely linked to the high rate of pipeline leakages that affected the country. The IOCs could address these concerns by promptly upgrading the ageing infrastructure (if allowed to invest of course).

3.6.2. Oligarchs

3.6.2.1. Capital Requirements

It is safe to say that the oligarchs could only answer one of the state’s key oil-sector requirements – capital. At that point in time, the oligarchs were the only Russian owners who could afford to, and who were willing to, invest and restructure domestic industries in a very hostile business climate.\(^{194}\) They had become wealthy through clever use of subsidized credits, currency speculation and direct government subsidies in the years shortly before- and after the fragmentation of the Soviet Union.\(^{195}\) This, and their successful manipulation of Russia’s privatization programmes, had allowed them to control financial and industrial assets. Consequently, most had entered the banking sector and controlled large amounts of capital as well as the accounts of government institutions.\(^{196}\) In addition, unlike the conditionality of international loans from the IMF or WB, the oligarchs were unlikely to press for harsh, unpopular economic reforms.

3.7. The Chaos of Transition

Before examining the resulting bargain, we need to establish whether the Russian state was in weak bargaining position as Vernon’s paradigm suggests. We do so by analysing the political and economic context.

3.7.1. Economic Outlook

When Boris Yeltsin came to power in 1991, the economic outlook was dismal. The break-up of the country and the Soviet unified economic space had given way to huge economic repercussions, pushing the state towards bankruptcy. To remove the core of the state-planned

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\(^{194}\) S. Guriev and A. Rachinsky, ‘The role of oligarchs in Russian capitalism’, p.131.

\(^{195}\) A. Åslund, ‘Why has Russia’s economic transformation been so arduous?’ p.8.

\(^{196}\) P. Klebnikov, ‘Godfather of the Kremlin’, p.5.
system, Yeltsin was determined to implement irreversible free market reforms. Surrounded by Western economist Jeffrey Sachs and young Russian economic neo-liberals, most importantly Yegor Gaidar and Anatoly Chubais (later to become deputy prime minister), he sought to create a rejuvenated market economy in Russia, based on the Washington Consensus and on the supremacy of the market over the state. The to-do list of primarily unpopular measures was deceptively short: decontrol prices, stabilize the currency, create a new fiscal system, privatize and restructure state-owned companies, and protect property rights and contracts. But to make the transition a success, he needed to implement these extensive reforms extremely quickly. Any delay in passing reforms would give the Communists time to regroup and pose a threat to his weak grip on power. As such he committed himself to the IMF-backed programme of ‘economic shock therapy’. This was a risky policy, as the combination of significant time pressure and complex reforms implied a high margin for error.

Shock therapy resulted in a mass privatisation of the state run economy. In July 1992, a presidential decree announced that by October the 1st all large state enterprises were to become privatised through a voucher scheme. This decree was an attempt by the government to create a share-holding middle class overnight that would have a vested interest in the success of a new market system. As a result, 150 million Russians received a voucher worth approximately $60 each. Each single voucher represented a minute stake in the Russian economy. Anatoly Chubais claimed at the time: ‘Each factory sold was a nail in the coffin of communism. It didn’t matter if it was sold cheaply or not, given away for free or sold off to settle debts […] every new entrepreneur became indispensable fuel’. Mathematically the sum did not quite add up though. The Russian economy was only valued at $9 billion. Moreover, the general population did not understand the benefit of these shares and demand for them soon dropped. Consequently, the market value of the shares fell to $25 and later $10 per share in quick concession. Inevitably, the end-result did not match the initial objective: Instead of creating a broad class of shareholders, the vouchers were bought up en masse by a handful of corrupt ‘Red Directors’ and by a number of Moscow-based commercial banks, owned by the oligarchs.

198 T. Gustafson, Crisis amid plenty: The politics of Soviet energy under Brezhnev and Gorbachev p.12.
199 It is important to note that IMF conditionality also contributed to the oligarchs’ capture of valuable assets. Chief Economist of the World Bank Joseph Stiglitz, has criticised the IMF for insisting on rapid privatisation in post-Soviet Russia, regardless of whether market institutions, such as competitive systems were in place. This resulted in IMF acquiescence in the loans-for-shares scheme. For a detailed account see J. Stiglitz, Globalization and its discontents (New York 2002).
201 As cited in ‘The rise and the fall of the Russian Oligarchs’ produced by Human Edge minute 19.
204 P. Klebnikov, ‘Godfather of the Kremlin’, p.5.
Yeltsin’s management of the reforms soon proved equally disastrous as its implications were: The state was crumbling under external foreign debt, it lacked fiscal income, and its industrial output had shrunk by 20%.\textsuperscript{205} The liberalisation of prices had led to hyperinflation, producing a 350-400% increase in Russian prices (see figure 9). The consumer situation was by all accounts worse in 1990-1991 than it had been in 1985. The economy was enduring accelerating negative growth of national income (see figure 8) and was plagued by low oil prices, surging criminality and a growing budgetary deficit. To top it off, the destruction of the institutions of the former centrally planned economy led to economic disorganisation, a lack of coordination and mass corruption.\textsuperscript{206} Capital flight was also a serious problem and went paired with the privatisations of state assets. The oligarchs were particularly notorious, placing a substantial part of their wealth in offshore accounts to evade tax. In the mid 1990s total capital flight was estimated at a staggering $1 billion a month.\textsuperscript{207} From 1992 to 1995 for the oil industry alone it totalled $7 billion.\textsuperscript{208}

![Figure 9 Inflation Rate and IMF debt](image)

\textbf{Figure 9 Inflation Rate and IMF debt}\textsuperscript{209}

It is important to note that, although Yeltsin had privatized many sectors of the industry in the first wave of privatisation in 1992, he succeeded in blocking the direct sale of assets in the strategic sectors. Land, iron and steel, defence and oil and gas were to be retained under state control at all costs. More importantly- and Yeltsin was also a staunch supporter hereof - these assets were not to be sold to foreign investors. The president even signed a decree in 1992 exempting the oil and gas sector from privatisation.\textsuperscript{210} As the most profitable part of the Russian economy and the largest export earner this was politically simply not acceptable.\textsuperscript{211} Resistance to Western participation came from a variety of sources, including an inherent distrust of foreigners, a nationalistic sentiment that “Russian oil belongs to Russian companies”, and a fear that too much equity would be handed over to foreign companies.\textsuperscript{212} This aversion was reflected

\textsuperscript{205} Part of the problem with the lack of tax revenue, was the fact that the Russian population had no prior experience with income taxation as it did not exist in the Soviet era.

\textsuperscript{206} A. Brown and L. Shevtsova, Gorbachev, Yeltsin, and Putin: political leadership in Russia's transition (Washington 2001) p.53.


\textsuperscript{208} A., Heinrich, J. Kuznir and H. Pleines, ‘Foreign investment and national interests’, p.496.

\textsuperscript{209} Source Economist Intelligence Unit.

\textsuperscript{210} T. Gustafson, Crisis amid plenty: The politics of Soviet energy p.75.

by an extremely difficult business climate for foreigners. Investors had to deal with complications in areas including property rights, corporate governance, the rule of law, corruption, taxing power, contract enforcement, export jurisdiction and foreign exchange.

Beyond the anti-foreigners rhetoric, the successful initial retention of the oil sector under state ownership was driven in large extent by rent-seeking behaviour. The industry had been broken down into a number of privatised units, forming a group of giant vertically integrated firms. Initially the sector was intended to be founded on private property rights (held by the companies), a competitive system (with the creation of vertically integrated companies), and full state ownership of both the subsoil and the pipeline network. Control of the transit infrastructure was reserved for the state because of the wish to control export income. The establishment of these companies, based on the former Soviet Ministries, was intended to create a competitive free market. Yet, each company came under the leadership of a West-Siberian ‘oil general’ and the state retained a controlling block of shares in the newly founded companies. The oil giants were each assigned their own regional market sector over which they held a virtual monopoly, effectively eliminating competition. Since the domestic oil commodity prices were not yet liberalized, the oil generals bought oil (others included metal) at the fixed state price from ‘their’ state enterprises. Through connections in the foreign trade administration they then resold the commodities illegally for the higher world market price, pocketing vast private revenues. This deprived the state of revenue and enriched individuals, who could then channel their funds abroad.

3.7.2. Political Situation

Boris Yeltsin was part of the old Soviet ruling class and rose to prominence under the communist system. When he was elected as Russian president on June 12 1991, he faced daunting political challenges including the implementation of democracy, the elimination of the communist system, the complete dismantling of the former Soviet Empire and overcoming a national crisis. Through a mixture of economic ‘shock therapy’ and anticommunist ideology, he enjoyed initial minor success and broke the power of the Soviet Managerial elite. Yet, albeit immensely popular in the years prior to his rise to power, his power base and political support quickly eroded. Without his own political coalition, he surrounded himself with old friends.

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214 Ownership does not necessarily imply control. The state had many ordinary shares but did not necessarily benefit from influence in the decision making process.
216 T. Gustafson, Crisis amid plenty: The politics of Soviet energy, p.52.
and several competing groups (known as the ‘family’). Nonetheless, similar to his health, his political judgement and decision-making were highly unstable. In erratic displays of power he often took to resolving conflict by dismissing a variety of aides and ministers. In the eight years of his presidency, he changed prime minister 7 times and prosecutor general 6 times, creating incessant policy shifts.  

With such a weak grip on power, it did not take long for Russia to degenerate into a highly decentralized system. In the early years of the post-Soviet Russia, fierce competition between the legislative and executive branches was rife. In addition, Yeltsin had to manage 89 semi-autonomous regions whose elected governors could not be removed. Decentralized, Moscow now had to secure the backing of provincial governments for changes in the Kremlin. To aggravate this situation, corruption was widespread in the regions and regional elections manipulated, with governors of the hydrocarbon rich regions eager to get hold of as many rents possible. As a result, the Kremlin lost vital control over the levying and control of taxes in the provinces.

These tensions reached their boiling point on September 21 1993 when Yeltsin dissolved the parliament and introduced de facto presidential rule. The parliament, however, decided not to play along and held siege in the parliament building, the so-called ‘White House’, letting individuals leave but not enter. Negotiations between opposition forces and Yeltsin failed, culminating in the shelling of the White House by armed forces. Eventually the deputies were forced to surrender. This resulted in a violent yet crucial victory for Yeltsin who subsequently succeeded in enhancing his presidential power.

Despite Yeltsin’s reassertion of power, the Russian population became increasingly critical of his government. The mass privatisations had only served to enrich a number of well-connected businessmen, mafia and numerous well placed former Soviet politicians, whilst the man on the street continued to suffer at the hands of stringent market-reforms. Unemployment was on the rise, wages and pensions were left unpaid for endless months and many family’s savings had been wiped out by hyperinflation. With no welfare system, the population was also shrinking, because of contagious diseases and premature deaths, drastically reducing life expectancy. The Kremlin had also endured a number of foreign policy failures under Yeltsin’s rule including creeping North Atlantic Treaty Organisation (NATO) expansion and a bungled war in Chechnya. This all came at a particularly unfortunate

time for Yeltsin since it was also nearly an election year. The prospect of a Communist victory worried both Yeltsin and the new Russian capitalist elite - the oligarchs. The president risked political revenge and corruption allegations, whereas the oligarchs would undoubtedly see their prized assets re-nationalized. In order to gain popular support and make the success of the reforms seem credible, Yeltsin and his government needed a financial injection. This would help keep the economy afloat, and more importantly, pay the wages and pensions of the unhappy population. This discontent was reflected in the polls, in February 1996 only a meagre 6% of the population considered voting on him.  

3.7.3. National Identity

The end of the cold war and the new international environment had a tremendous impact on the way Russia regarded itself. Yeltsin and his government initially turned to the West in search of material and moral support for market reforms. The Kremlin sought to create a new Russian state based on Western liberal democracy. Having acknowledged Russia’s fall from superpower status, the government was inclined towards becoming part of the West. Till 1993 Yeltsin loyally supported the West’s international security agenda, with Yeltsin even contemplating on joining NATO. However, following disappointing modernization and Westernization results, in the second half of the 90s, the Kremlin became disillusioned with Western market reform and sought to restore Russian traditionalism and its relations with the former Soviet republics. Ultimately though, under Yeltsin, the Kremlin failed to truly define its national interest.

3.8. The Resulting Bargains

Given the economic and political disarray, elaborated on in the previous section, it is safe to say that the Russian state was in a weak bargaining position. Moreover, considering the requirements of the oil sector in Russia and the ability of the respective actors to respond to these needs, it is unquestionable that the IOCs were in a better position to respond to these challenges. This section analyses whether the IOCs’ better bargaining position materialized in oil concessions. We also analyse the bargain between the state and the oligarchs.

3.8.1. IOCs

Russia’s attitude towards FDI in the 1990s fluctuated between a desperate need for investment and a fear of losing control of a strategic sector to foreigners. Following the collapse of the SU and the implementation of market reforms, initial enthusiasm for FDI dominated, as it also

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228 A. P. Tsygankov, Russia’s foreign policy: Change and continuity in national identity (Oxford 2006) p.65-75.
served as an instrument to secure international political assistance. This soon turned into scepticism. Consequently, it took a considerable amount of time before an adequate legislative and fiscal framework was in place to enable foreign investment in the oil sector. By the end of the 1990s, Russia had three forms of long-term investment instruments in its oil sector: 1.) Joint Ventures; 2.) investment within the framework of a Production Sharing Agreement (PSA) and 3.) foreign equity investments. In Russia a JV was “a legal entity founded commonly by national and foreign partners”. The domestic Russian company contributed its mineral rights, whilst the foreign entity supplied cash, equipment and other property. In this way the Russians could maintain a certain form of sovereignty whilst simultaneously accessing foreign capital and Western technology. Due to the unstable investment climate, the number of JVs remained relatively small though, accounting for 7% of Russian oil production and 12.5% of exports.

The second form of partnership western companies entered with the Russians was in the form of PSAs. These long term contractual agreements, adopted by Russian law in December 1995, could be seen as a hybrid form of cooperation between the state and the IOC, in which the state, awarded “an investor for a certain period of time an exclusive right to search, prospect and extract mineral resources from a specific acreage”. In total only three of twenty proposed PSAs were signed in the decade after the fall of communism - a relatively low number. Azerbaijan, in comparison, signed over twenty PSAs with IOCs in the same period. Yet, the PSAs that were signed by the IOCs (including Exxon, Total and Shell) did contain lucrative terms as suggested by the OB-theory. The former CEO, Steven McVeigh, of the Sakhalin Energy Investment Company (SEIC) (that included Shell as consortium member) claimed in a Harvard Business School case study that the Sakhalin-2 had “the best PSA terms that you will ever get in Russia”. The three PSAs were geographically confined to the continental shelf offshore of Sakhalin Island and were at a relatively large distance from Moscow. As such, the region was considered ‘relatively oligarch free’ and was of limited interest to domestic oil companies.

The third sort of foreign direct investment was through a foreign equity investment. Foreign companies could buy up a stake in a Russian oil company implying direct ownership and a
position on the management board. This form of FDI was not favoured by the government due to fears of a sell out to foreign interests. As a result, foreign companies were limited to a minority stake. For instance, from 1992 until 1997 a presidential decree prevented foreigners from owning more than 15% of the total assets of LUKoil, Yukos and Surgutneftegaz.

Despite the promising prospects, the ambiguous institutional and legal framework in Russia dissuaded foreign investment. Profits were threatened by unstable regulatory regimes and constantly changing fiscal conditions. In addition, the ownership stakes of IOCs in Russian oil companies were often diluted through the creative legal and accounting practice of their partners. Consequently, by 1999 a number of companies that had formed JVs in the early 1990s, such as Phibro Energy and Anglo-Suisse, had pulled out of Russia entirely. The difficulties encountered by IOCs who hoped to invest in Russia were reflected by the numbers (see figure 10). In 2000, for example, total FDI entering Russia was only $4.4 billion, of which only about 10% went to the energy sectors – oil, gas, and electric power.

Figure 10 Total Foreign Direct Investment in the Russian Oil & Gas Sector 1993-1999 (mln$)

3.8.2. Oligarchs

In the mid 1990s the oligarchs bought up essentially the entire Russian oil sector in a period of two years. In what was later to become know as the ‘loan for shares’ scheme, the oligarchs led by Vladimir Potanin (later to be the Russian Minister of the Economy) and Mikhail Khodorkovsky, found a solution to Yeltsin’s 1996 financial and electoral conundrum. In a rare display of collective action, they agreed to lend from their banks, the equivalent of $1.8 billion to the Russian state. With this loan, Yeltsin was able to finance his campaign and pay out frozen wages and pensions, allowing him to rally domestic support for his election. There was one string attached though - Yeltsin would be given the loan on the prerequisite that he agreed to put up the state’s strategic assets as collateral for the loan. These assets included shares in the iron, steel, gas and oil industries. In return, since they held a tight grip on the media, the oligarchs also promised Yeltsin political backing and favourable coverage to help him

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242 Source: Rossiysikiy statisticheskiy yezhegodnik 2002, p. 585; Rosstat annual publications in years since.
surnmount the nigh impossible feat of getting re-elected. A subsequent gentleman’s agreement was also reached in the unlikely event that Yeltsin (he had only single digit approval rates) would be re-elected. Rigged auctions would be held in which the oligarchs would be given the opportunity to effectively buy the assets they had received as collateral on their loans.\textsuperscript{244} To ensure knock-down prices, the bidding banks agreed from the beginning “not to get in each others way”.\textsuperscript{245} Sure enough, in September 1996, three months after Yeltsin’s successful victory over the Communist Gennady Zyuganov, a critic of the privatisation process, the state organized a number of rigged auctions (foreign participation was excluded) in which a handful of prized individuals walked away with controlling stakes in the major oil industries.\textsuperscript{246} Khodorkovsky got a majority share in Yukos for an undervalued price of $309 million (estimated value of $5 billion), whilst Roman Abramovich and Boris Berezovsky acquired Russia’s third largest oil company, Sibneft, company for only $100 million (estimated value of $3 billion).\textsuperscript{247} These incredibly low asset prices had been established without bothering to even valuate them in the first place.

By 1999, of the six largest vertically integrated majors – LUKoil, Surgut Holding, Yukos, Sidanko, Sibneft, and TNK - the Russian state held only a significant stake in LUKoil (16.6%) and TNK (49.87). Elsewhere, the government had shares in a few smaller companies including Rosneft (100%), VNK (36.76%), Slavneft (77.1%), and ONAKO (85%). In 2003 LUKoil, Yukos, TNK, Surgutneftegaz and Sibneft controlled almost 73% of all Russian oil production and in excess of 60% of all exports.\textsuperscript{248} The Russian oil sector thus was restructured in what Åslund dubbed a ‘liberal-oligarchic model’, with the oil sector dominated by powerful independent companies.\textsuperscript{249} However, instead of investing in their new Russian oil assets or developing oil fields, the oligarchs focussed on developing innovative ways of evading Russian taxes, stripping cash from the newly bought assets, moving cash offshore, and diluting minority rights.\textsuperscript{250} Their focus was short-term orientated and by all means perfectly rational. The world oil price was low and the domestic price was at a fraction of it, making production an unattractive option. Since the state held a monopoly over the export pipelines, it was difficult to circumvent the state and pocket all the rents. In addition, in a highly unpredictable institutional environment, property rights were extremely uncertain. As a result, the oligarchs concentrated their efforts upon liquidating the assets that, individually, were more valuable than the initial price they had paid.

\textsuperscript{245} A. Barnes, Owning Russia: The struggle over factories, farms, and power (Cornell 2006) p.111.
\textsuperscript{248} S. Rossiaud and C. Locatelli, ‘The obstacles in the way of stabilising the Russian oil model’, p.428.
\textsuperscript{249} A. Åslund, ‘Russia’s energy policy: a framing comment’, Eurasian geography and economics 46 (2005) 8 p.323.
\textsuperscript{250} F. Hill and F. Fee, ‘Fueling the future’, p.486.
3.9. Evaluating the Rationality of the Yeltsin Government

Given the resulting bargains (see appendix 1) it seems that the oil sector was the victim of a poor bargaining result. On the one hand, IOCs managed to sign a limited number of PSAs with the Russian government, whilst being practically excluded from all other oil related investment opportunities. On the other hand, the oligarchs gained considerable control of the soviet oil sector through a political bargaining game with Yeltsin. The disparity though, between the control the oligarchs had of the sector and that of the IOCs was considerable. Whereas FDI in the oil and gas industry till 2000 totalled no more than $3.3 billion, oligarch owned assets accounted for a whopping 72% of all oil sales in 2001.

But was Russia rational in its management of the oil sector? The outcomes point to a negative reply. Between 1988 and 1998 Russian oil production dropped by about 50%. In this period there was also a sharp decline in drilling and exploration. The state had gradually reduced its role in geological exploration from 1992 onwards, assuming that oil companies would bridge the gap by taking on a larger role in exploration.251 Little or no long-term investment was pledged in new wells or new technology to enhance recovery from depleted wells. Instead, the sector was sold at below market prices to oligarchs with no prior experience in the oil industry.252

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Scores: very high; high; mid; low; very low

The involvement of the oligarchs did not materialize in any visible rise in production either. Instead of investing to the benefit of the industry, they resorted to asset stripping, tax evasion and short-term profitability. Their short-term outlook and drive to liquidate assets was a reflection of low international oil price as well as weak property rights in Russia.253 This was blatantly against the interest of the Russian economy. In fact, the involvement of the IOCs would certainly have increased the value of Russia’s oil and gas assets in the first place and would probably have contributed to an overall improvement of Russian production.254

252 Although Khodorkovsky had briefly been a deputy Minister of Fuel and Energy in 1993, he had never seen an oil field before. A. Barnes, ‘Industrial property in Russia’ p.48.
3.10. Conclusion

This chapter has analysed the set of bargains struck by the state with the oligarchs and the IOCs. This process has been assessed with the help of a rationality framework elaborated upon in the theoretical chapter (2.9) of this paper. This chapter has also presented empirical evidence, establishing that a new bargaining cycle occurred after the dissolution of the SU. This argument relies on the weak bargaining position of the decentralized Russian state and the dual bargaining processes that took place. In order to summarize our findings it is helpful to reiterate the research question of this chapter: “What were the drivers behind Russia’s privatization policy in the oil sector in 1991-1999 and was this policy rational?”.

This chapter has applied the two hypothesized drivers that could have played a role in Russia’s policy in attracting investors: the need for capital and the need for technology and know-how. Empirical evidence has suggested that this list is not exhaustive: political factors played a dominant role in the state’s decision to auction off key state-owned oil assets to a handful of oligarchs. For, in the end, it was Yeltsin, and not the oil sector, that was the beneficiary of the loans-for-shares scheme. Whilst the failing Yeltsin secured a re-election thanks to financial backing and a clever, oligarch-sponsored media effort, oil assets were stripped and little value was added to the development and maintenance of the Russian oil fields. Therefore, we can conclude that our framework – that was based on the rationale described in the OB-theory – is not fully able to account for the privatisation policy of the Russian with regards to the oil sector.

Nevertheless, our analysis was not futile, as it demonstrated that the two aforementioned drivers were of great importance in the decision to involve the IOCs in the Russian oil sector. The majors were lured with advantageous terms to invest in challenging geological drilling sites. Three factors proved conducive to the involvement of the IOCs: 1.) the readiness to invest and build an infrastructural base from scratch; 2.) the possession of high (offshore) technology, and 3.) the ability to orchestrate large-scale operations. Other forms of FDI, which the OB-theory does not encompass in its theoretical paradigm, such as JVs or equity ownerships were inconsiderable, with regards to the investment needs of the sector.

In assessing whether Russia’s policy was rational, the answer seems negative. Whereas the IOCs could have added more value in terms of technological competence, material and willingness to invest, the IOCs were either excluded from buying up these assets or simply dissuaded, due to a highly unstable investment climate. Instead, the oligarchs benefited from political and financial leverage to gain equity ownership over a majority of previously state-owned oil assets. Consequently, very little investment was pledged to the development and maintenance of Russian oil fields and its infrastructure, in spite of the colossal problems that plagued the sector.
To conclude, the chaos of post-Soviet Russia eroded the bargaining power of the state, allowing other contending actors (regions, red directors, oligarchs and so forth) to take advantage of this power vacuum. With regards to the oil sector, this resulted in the inclusion of - amongst other actors - the oligarchs and the IOCs. The oligarchs, on the one hand, took advantage of the free-for-all post-Soviet asset grab and were not coerced to commit large fixed investments, as understood by the OB-theory. The IOCs, on the other hand, took a far smaller slice of the pie even though their ability to respond to the needs of the state was much higher than that of the oligarchs. Their investments were either limited to attractive PSAs or to other investment forms, exposed to the whim of Russia’s unstable investment climate.
4. Putin and the Era of Revival

“Regardless of whose property the natural resources and in particular the mineral resources might be, the state has the right to regulate the process of their development and use.”

- 1999, Former president Vladimir Putin

4.1. Introduction

After the resignation of Yeltsin, a strong leader emerged in Russia in the form of Vladimir Putin. This chapter aims to understand the policy shifts of Putin’s government in the oil sector. The research question of this chapter is: “What were the drivers behind the Russian state’s intervention in the oil sector and was this policy rational?” This chapter has an identical structure to the previous one. First, a snapshot is established of the oil sector in the beginning of the 2000s. This allows us to assess the needs of the sector. Second, we apply our framework to understand the rationale behind state intervention. Third, we determine the extent to which intervention against the IOCs or oligarchs would support this rationale. Fourth, since the OB-theory predicts that a HC will intervene as a result of a shift in bargaining power we analyse the economic and political context in the 2000s, considered to be an indicator of the bargaining power of the Russian government. Finally, we evaluate the resulting bargain between the states, IOCs and oligarchs.

4.2. Era of Revival

In spite of the August 1998 financial crisis, the 2000s marked the beginning of a boon for the Russian economy, and the oil sector in particular. Six developments in the oil sector are worth mentioning. First, the 1998 financial crisis shook up the oil sector. A number of oligarch-owned banks that held shares in the Russian oil companies were wiped out, reducing their activities in the sector. This and plummeting oil prices, culminated in an enormous loss of profits and huge individual debts. To illustrate, according to estimates of the United Financial Group, in 1998 Yukos had debts of $1.05 billion despite a market value of only $391 million and Tatneft $1.25 billion despite a market value of ($415 million). Following the August crash in 1998, a number of companies (including Yukos, Sibneft and TNK) edged towards bankruptcy, lacking a stable cash flow to service their short-term secured bank debt. As a result, a number of companies were forced to temporary shut down their operations or to radically downsize operations and cut back on expenditures. Subsidiaries were sold off to raise cash, giving way to

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257 P. Jones Luong and E. Weinthal, ‘Contra coercion’, p. 145.
a wave of mergers and acquisitions in the sector. For example, LUKoil acquired regional player Komi-TEK and Evro-TEK bought up 85% of ONAKO’s shares.\textsuperscript{259}

Second, oil production underwent a sharp upswing (see figure 11). This strong rise in production, dubbed by some as the “Russian oil miracle”, began in 1999 and continued till 2006, before output stabilized at an average of 9 million bbl/d.\textsuperscript{260} The incentives and means for the surge in production was provided by a more favourable cost-revenue structure. This was instigated by a fourfold rise in international oil prices and the collapse of rouble-denominated costs for the sector, in the wake of the 1998 financial crisis and the ensuing rouble devaluation.\textsuperscript{261} The dollars for which the oil companies exported their products abroad now bought four to five times as many roubles with which to cover production costs. Since these costs, including the likes of revenue taxes and labour, were all rouble denominated, average costs of production dropped from $9.50 to $5.50 per barrel as a result.\textsuperscript{262}

![Figure 11 Russian Oil Production and Average Oil Prices 1997-2008](image)

During the production upswing, monthly growth rates were in the double-digit range. Most of the extra output came from West-Siberian ‘brown fields’ (older existing fields) and did not reflect the discovery and production of new reserves as figure 12 demonstrates.\textsuperscript{264} Instead, Russian companies concentrated on pumping easy-to-produce oil from reserves that had been explored, supplied with infrastructure and developed in the Soviet era.\textsuperscript{265} These maturing reserves\textsuperscript{266} were recovered through the more efficient use of production technologies and the bringing on-line of idle wells.\textsuperscript{267} The remaining production growth came from the contribution of new fields. This relatively low share of the growth was enabled thanks to a slight increase in investment and development drilling.\textsuperscript{268} The Sakhalin projects, for example - though their

\textsuperscript{259} E. Janssen, ‘Russische olie: groeimarkt of valkuil’, p.22-26
\textsuperscript{261} M. J., Sagers, “The Regional Dimension of Russian Oil Production: Is a Sustained Recovery in Prospect?”, p. 509.
\textsuperscript{262} D. Lane, The political economy of Russian oil (Maryland 1999) p.19.
\textsuperscript{263} British Petroleum Statistical review of world energy, retrieved on 15 August 2010.
\textsuperscript{264} M. J., Sagers, “The Regional Dimension of Russian Oil Production: Is a Sustained Recovery in Prospect?”, p. 509.
\textsuperscript{266} For a discussion on the state and outlook of Russia’s oil reserves, see “M. Sagers, The Regional Dimension of Russian Oil Production: Is a Sustained Recovery in Prospect?”.
\textsuperscript{268} M. J., Sagers, “The Regional Dimension of Russian Oil Production: Is a Sustained Recovery in Prospect?”, p.513.
Third, international oil started to recover from a dip in 1998, in which oil prices averaged $12 per barrel (see figure 11), provoked by a drop in demand and excess supply. As of this year, average international oil prices rose, allowing the Russian sector (as well as those of other energy-rich countries like Kazakhstan) to benefit from windfall profits. After an initial dip from 2000-2002, because of over-supply on the market and a weakened US-economy, the oil price underwent a prolonged price hike, caused by a strong growth in oil and gas demand by the global economy (primarily India and China) and a cutback in supply by OPEC. In addition, due to an increased post 9/11 effort by the European consuming countries to diversify oil and gas supply from the OPEC and Middle-East, Russia had become an increasingly attractive supplier. This would raise European demand and eventually result in a proposed agreement with the EU on long-term energy cooperation.

Fourth, export capacity and volumes remained unable to keep up with the growth in production, causing regular bottlenecks. Although export capacity did increase to some extent, thanks to a new export terminal at Pimorsk and the Baltic Pipeline System, exports were restrained. This had two causes: 1.) an old, poorly maintained and insufficient transportation infrastructure, and; 2.) government policy. The rule at the time was that Russian companies could export 30% of their production and that the remaining 70% needed to be supplied to the domestic market. Excess supply on the domestic market was needed to subsidize domestic prices. As such, a large gap still existed between the price for crude on the domestic and foreign

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271 It is important to note that these windfall profits were solely caused by higher oil prices and not by increased volumes, since export capacity remained limited.


273 Reasons for the price-hike include the 2003 Iraq war, Asian growth, a weaker dollar, hurricanes Katrina and Rita and the Venezuelan PVDSA strike.

market. With prices in 1999 at 40% of world prices\textsuperscript{275}, selling oil on the domestic market became practically a loss-making enterprise for the domestic companies.\textsuperscript{276} This contributed to tensions between the government and the domestic companies, who wanted to export a larger share of their oil on the world market.

Fifth, the oligarchs started to run their oil companies in a more constructive manner. Prospective higher profit margins on upstream activities along with the high debt positions stimulated the oligarchs and managers of oil producing companies to seek strategic partnerships with Western companies. This would allow them to break into foreign markets and provide them access to foreign capital and technology. In order to accommodate potential (Western) minority interests and to boost international ambitions, they concentrated on ameliorating their reputation through improved corporate governance and increased transparency.\textsuperscript{277} This resulted in the appointment of Western advisors to key positions and the adoption of Western accountancy practises. It eventually paid off, securing interest from Western oil companies looking to team up with domestic firms. In the early 2000s BP for example, pledged a considerable investment in TNK and Sidanko.

Finally, windfall profits endorsed Russian oil companies\textsuperscript{278} with the capital to enhance production efficiency without the infusion of external investment.\textsuperscript{279} In an effort to increase production, capital expenditure in the oil fields tripled between 1999 and 2003\textsuperscript{280}, with over $4 billion alone in 2000.\textsuperscript{281} Audited financial statements suggested that the oligarchs were investing heavily too. In 2002 for example, Yukos invested $1.26 billion in property, plant and equipment.\textsuperscript{282} This enabled Russian oil companies to make considerable investments in the enhanced recovery of existing oil deposits and the reopening of idle wells closed in 1994. Eventually this led to Russia’s first increase in its number of active wells in a decade, contributing to increased production. According to the IEA, over half of the rise in production was attributable to three oil companies Yukos, Sibneft and TNK, who all made large investments in enhanced oil recovery technologies (hydrofracture, horizontal drilling).\textsuperscript{283}

\textsuperscript{275} Under Yeltsin, Russian domestic prices were gradually harmonized with world oil prices, but following the August financial crisis the state cut exports and increased supply on the domestic market to lower prices.
\textsuperscript{276} E. Janssen, ‘Russische olie: groeimarkt of valkuil’ p.63.
\textsuperscript{277} F. Hill and F. Fee, ‘Fueling the future’, p. 468.
\textsuperscript{279} F. Hill and F. Fee, ‘Fueling the future’, p. 468.
\textsuperscript{280} S. Pirani, Change in Putin’s Russia: Power, money and people (London 2010) p. 146.
Despite the initial increase of investments and production in Russia, little was actually reinvested in exploration. This would culminate in a slow-down in hydrocarbon output growth, falling to 2.5% in 2005 and 2.2% in 2006. Critics of the oil companies accused the oligarchs of aggressive recovery techniques to ameliorate short-term results at the expense of the future.  

In reality this was nothing new, as in most years since 1994 oil production exceeded the addition of new reserves. According to Dienes, the private companies were to blame. For, it were the financially most successful companies that demonstrated the most unbalanced drilling and reserve development strategies.

4.3. The Rationale of Appropriation

The previous section has demonstrated that, despite persistent structural problems, the oil sector was a far more profitable industry than under Yeltsin. The OB-theory predicts that a state may intervene to the detriment of private investors, once the initial uncertainty surrounding an investment disappears and the company starts to make profits. Consistent with the methodology of this paper, we first examine the hypothesized drivers behind state intervention. These assumed drivers, elaborated on in the theoretical chapter (2.10.), are 1.): maximization of rent capture; 2.) sustainable oil production and export policy; 3.) fulfilment of technological and capital requirements; 4.) support of national state-owned champions; 5.) domestic political utility, and; 6.) geopolitical objectives. We now review the cost-benefit analysis of each driver for Russia.

4.3.1. Maximization of Rent Capture

Contractual obligations and taxation is an efficient, transparent and reliable manner for the state to capture resource rents. However, as mentioned in the theoretical chapter (2.10.1.), this requires a strong state institution to ensure tax collection and compliance with the fiscal and

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284 Company information * Yukos ceased to exist in 2006 with the largest subsidiary sold to Rosneft explaining the respective surge/decline in production
contractual regime. In Russia, this was not the case. Since the collapse of the SU, the country had been plagued by fiscal collection problems, large-scale corruption and criminal practices.\(^{288}\) This was particularly damaging as the oil sector alone provided 25% of the nation’s tax base.\(^{289}\) Falling tax collection at a corporate, regional and civic level had starved the state of important revenue, forcing it to explore other income avenues, such as international loans. According to some estimates, throughout the Yeltsin era, the state was only able to collect approximately half of its projected tax revenues.\(^{290}\) This not only had a negative effect on the Russian economy as a whole, but it also implied heavy costs for the tax evaders on the long run, in the form of unreliable revenue streams, insecure property rights and time-consuming schemes to hide profits.

In the lucrative oil sector two main fiscal beneficiaries emerged: the oligarchs and the regions. The oligarchs had been evading taxes since the very beginning and had been the source of substantial capital flight. As far as the regions were concerned, throughout the 1990s, they had successfully lobbied for a greater portion of energy revenues and special tax treatment. As a result, they appropriated a larger portion of tax revenues from mineral sources originating from their territories.\(^{291}\)

As mentioned in the theoretical chapter (2.5.), a high oil price can act as a catalyst on the motives for a state to intervene. Indeed, the rise in high prices in the 2000s exasperated the state, as it was unable to fully reap the benefits of the price hike.\(^{292}\) In 2000, 78% of the rents from improved oil and gas sales remained in the hands of the energy exporters, with the state retaining only 22% of the $30 billion windfall.\(^{293}\) This would certainly have influenced the Russian government’s cost-benefit assessment, as now the sector was even more profitable than anticipated. Putin now had two options: increase equity ownership to the detriment of private investors or adapt its fiscal regime. The former policy option would grant access to the highly profitable upstream sectors and enable the state to position itself in more areas of the value chain, whereas the latter would entail less reputational damage. Yet, a drawback of fiscal reforms was that they did not guarantee increased compliance, an issue which lay at the heart of the fiscal impasse.

4.3.2. Sustainable Oil E&P

Ever since the Soviet era, the health of Russia’s economy depended on the stability of its natural resource base.\(^{294}\) The lack of a diversified economy led many scholars to suggest that Russia is

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\(^{288}\) D. Lane, *The political economy of Russian oil* (Maryland 1999) p.23.


\(^{292}\) Thompson, W., ‘Back to the future? Thoughts on the political economy of expanding state-ownership in Russia’ p.9.

\(^{293}\) P. Jones Luong and E. Weinthal, ‘Contra coercion’, p. 141.

\(^{294}\) See Gaddy and Ickes for a discussion on the subject.
“cursed” by its natural resource wealth.\textsuperscript{295} Exploration, timely investments, and a high reserve replacement ratio were therefore all conducive to the long-term sustainable economic growth of the country. The previous section demonstrated that investment in exploration of new fields and the bringing of new fields into production declined dramatically throughout the 1990s (see figure 14). It also established that the emphasis of Russian oil companies was based on short-term profit maximisation, incompatible with strategies to renew oil resources. This substantial gap in exploration would certainly imply complications in the long-term. For, even if geological exploration were to indicate vast oil reserves in the ground, the reserve-to-production period was often more than 15 years.\textsuperscript{296} The state was aware of the seriousness of this situation and had tried various ways to stimulate exploration in the past, but to no avail. One example of this was the promise to domestic companies to build more export routes if they increased their investments and improved reserve management.

In light of the persistent failure of the Russian companies to address the exploration needs of the country, it seems that only enhanced control of the upstream would allow the state to influence long-term development policy. Other ‘softer’ measures, such as tax breaks for companies who increased exploration, would have been useless, due to the companies’ lack of (fiscal) compliance.

\textbf{Figure 14 Trends in Upstream Investment and Drilling Developments in Russia\textsuperscript{297}}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure14.png}
\caption{Trends in Upstream Investment and Drilling Developments in Russia}
\end{figure}

4.3.3. Fulfilment of technological, infrastructural and capital requirements

The OB theory, states that through time, the fulfilment of infrastructural, technological or capital requirements by IOCs or private investors, will give the HC the incentive to appropriate these assets. As far as capital was concerned, the high oil price promised higher revenues for the state provided that the government could ensure a higher capture of these rents. This meant

\textsuperscript{295} For a discussion on the topic see P. Rutland ‘shifting sands: Russia’s economic development and its relations with the West’ (2001).
\textsuperscript{296} A. Moe and V. Kryukov, ‘Oil exploration in Russia: prospects for reforming a crucial sector’, p.313.
\textsuperscript{297} British Petroleum Statistical review of world energy, retrieved on 15 March 2010.
that the capital requirements – that were so important under Yeltsin – decreased considerably. With regards to the technological, infrastructural and know-how requirements, many structural problems still plagued the industry. For, with the exception of the PSAs, under Yeltsin very little investment actually occurred in E&P. To make matters worse, expanding state-ownership to the detriment of private investment would certainly dissuade future investment. This policy option would then only make sense if these needs had been fulfilled. Otherwise, Russia would risk compromising future dependence on technical expertise and know-how from both the IOCs and oligarchs.

4.3.4. Development of National Industries

When Putin rose to power in 1999 as prime-minister, only three oil companies existed in which the state had a high level of ownership: Rosneft (100%), ONAKO (75%) and Slavneft (75%), representing a 10.6% share of national production of oil. Plans to create a ‘national champion’ were put forward in April 1999, but did not materialize because of a lack of political support. Creating an established NOC would have positive advantages for the government: it would secure economies of scale, reduce dependency on IOCs on the long run, maximize rent capture and provide a source of supply under its own control to fuel Russian domestic consumers. In addition, consolidating power over the oil complex and over its constituting companies would enable Russia to act as a coherent unit, with the companies serving as instruments in transmitting centralised state policy. On a more critical note though, large state owned companies tended to be financially opaque and subject to rent-seeking practices. As such, this could result in poorer economic performances, corruption and a conflation of regulatory and commercial interests.

4.3.5. Domestic Political Utility

Without a doubt, the general population had suffered tremendously in chaotic post-Soviet Russia. Under Putin, it remained to be seen whether he too would be the subject of the same antipathy. Expropriating assets from foreign companies or oligarchs in a high oil price environment would be a convincing display of sovereignty and would play in well on the growing nationalism in Russia at the time. Yet, at the same time, such an unrelenting measure would certainly provoke a domestic or international political backlash.

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298 D. Lane, The political economy of Russian oil (Maryland 1999) p. 43.
299 Ibidem.
301 W. Thompson, ‘Back to the future? Thoughts on the political economy of expanding state-ownership in Russia’ p.11-12.
4.3.6. Geopolitical Objectives

With security of supply back on the agenda, Russia’s oil and gas reserves were ideally positioned to exert influence in major international negotiations. Central to its geopolitical strategy was the optimal development of its energy resources to create positive or negative interdependencies with neighbouring markets. What’s more, Russia, in the post 9/11 world, held a unique position as the world’s major non-OPEC and non-Middle East supplier. This strategy was even more understandable considering that most countries surrounding Russia were net-importing companies. Not only did Russia supply the European market (17% of Europe’s total oil imports in 2001), it was also well positioned to supply the Central Asian producers and Asian consumers (Japan, South Korea, and upcoming China) and, to a lesser extent, the North American market. In order to assure leverage over these markets, Russia would need to systematically increase consumer states’ dependence on Russian energy supplies (‘locking in demand’) and distribution networks (‘locking in supply’). Once dependent, Moscow would be able to exert influence through strategic carrot and stick tactics concerning the supply of oil and gas. Ultimately this would enable Russia to restore its former spheres of influence and gain new prominence in additional regions.

Central to Russia’s geopolitical strategy was its pipeline network. Given the remote location of many production fields, pipelines played a crucial role in transporting oil. Thanks to state-owned companies Transneft (crude oil pipelines) and Transnefteprodukt (oil product pipelines) the Kremlin had never really relinquished control over the pipeline network. Transneft, along with the respective ministries, regulated the quotas of oil flowing through the pipeline and established taxes and tariffs for transportation. Yet, despite the sector being the most strictly regulated part of the oil complex, Russia had not been able to substantially improve capacity or resolve operating inefficiencies. This was mainly due to Moscow’s refusal to allow any form of private investment in the sector. Admittedly, this was counterproductive. In order to harness the potential of its energy sector and capture new high-value markets, Russia required new export facilities such as large-diameter pipelines and deep-water marine

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303 Primarily thanks to the growth in demand of energy-hungry states such as China and India
306 It is important to bear in mind that gas is more likely to foster interdependencies than oil. Unlike oil (with the exception of Liquefied Natural Gas (LNG) of course), gas needs to be transported through a pipeline under pressure, unless stored or liquefied. In addition, pipeline gas requires a long term commitment and contracts can last up to 25 years.
307 Under Yeltsin, one private export pipeline, the Caspian Pipeline Consortium, was commissioned and built, starting in the Tengiz oil field, Kazakhstan and ending at the Russian Black Sea port of Novorossisk. Initially 100% private owned, the Putin government soon put the owners under pressure in order to acquire a 24.5% stake in the pipeline.
308 D. Lane, The political economy of Russian oil (Maryland 1999) p.23.
terminals. This would allow the country to transport increasing volumes in large ocean-going tankers favoured in international trade.  

In the eyes of the Russian state it was indispensable that it retain a monopoly over its pipeline infrastructure. Beyond the geopolitical benefits, the Kremlin could continue to maintain its system of differential pricing and preferential access to resources, enabling it to hand out rewards and punishments based on economic and political motives.  

4.4. Oligarchs and IOCs: An Obstacle to Russia’s Policy? 

Considering the numerous cost-benefits highlighted previously, we now examine case-by-case the extent to which intervention against the IOCs or oligarchs would support the cost-benefit assessment of the state.

4.4.1. IOCs

4.4.1.1. Maximization of Rent Capture

Given the terms of the PSA’s signed between the IOCs and the Russian government in the 1990s, the state was capturing less rent than it hoped. Although the Sakhalin-2 PSA was considered by far the most unfavourable of the signed agreements, it serves here as an interesting illustration of some of the inequalities of these PSAs. The Sakhalin-2 PSA had a number of uniquely favourable terms that would not be considered in most PSAs: First, the

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310 Idem, p.32.
contract had an indefinite duration. Whilst the negotiating entities had initially agreed upon a
duration of twenty five years, the PSA contained an unusual clause that allowed the SEIC to
extend the agreement indefinitely and continue extracting oil and gas.311 Second, the SEIC did
not have to take on any exploration risk. Exploration had already been carried out in the Soviet
era. Third, the terms defining the sharing of profits between the state and the IOCs was
disadvantageous to Russia. Normally once the company has recouped its costs from the initial
operating phase, a ration is agreed upon in which both parties are entitled to a certain amount of
the profits. In the Sakhalin-2 PSA, Moscow would be left empty handed until the SEIC had
recouped all costs plus interest (no cost cap was included) and had achieved a 17.5% rate of
return on capital. Finally, the royalties and taxes agreed upon in the PSA were comparably low
to other PSAs at the time. The royalty payable to the state stood at 6% and the tax rate was 32%-
3% lower than the standard Russian rate at the time of signing.312

However, unlike many domestic Russian companies, the IOCs were reliable taxpayers. By
the end of 2005, the Russian government stood to receive $460 million in bonus payments, taxes
and royalties from Shell’s operations in Sakhalin-2. With full production, the Russian
government was entitled to $300 million per year in royalties – a figure that would increase to
$2 billion after Shell’s initial cost recovery. In addition, the economic spin-off was significant.
Local contractors had won contracts worth $8.3 billion313 and 12,000 workers had been
employed.314 Sakhalin-1 was equally remunerative. By 2005 local companies had been awarded
contracts totalling $3.8 billion- without forgetting the hundreds of nationals that were being
employed by Exxon and its consortium partners. With regard to the activities of Total in the
Kharyaga field, by the end of 2006, the Russian government had received a total of $169.1
million in revenue, including $107 million in profit oil, $41 million in profit tax and $21.1
million in royalty payments.315 Moreover, along with the financial benefits, economic activity in
the region had led to the construction of public infrastructure (roads, bridges, housing).

4.4.1.2. Sustainable Production

In spite of the growing frustration over the terms of the PSAs, the Russian government was well
aware of the significant added value the IOCs were bringing to the sustainability of the oil
sector. Not only, had the majors been responsible for extracting Russia’s first offshore crude oil,
they had also contributed to opening up new LNG export routes from Russia to the Asia-Pacific
market and the West-Coast of the US and Mexico. Intervening against the IOCs would

312 I. Rutledge, “The Sakhalin II PSA: A production ‘non-sharing’ agreement,” Sheffield Energy & Resources Information
313 Many of the PSAs contained a local content requirement, stimulating the local economy.
potentially delay exploration, harm commercial ties and disrupt the bringing online of additional oil fields.

4.4.1.3. Fulfilment of technological, infrastructural and capital requirements

In terms of financial resources and technical competence, the IOC/domestic company playing field was starting to level out.\(^{316}\) Service companies and independent oil companies were positioning themselves in more and more areas of the value-chain, and starting to make the involvement of IOCs superfluous. Nevertheless, Putin actively encouraged Western investment in technically challenging projects. This was mainly because the Russian oil companies still trailed far behind in their ability to orchestrate large-scale projects and could still not match the geological, technical and geophysical expertise of the majors.\(^{317}\) As such, expanding state control to the detriment of IOCs risked alienating future commitment from the IOCs. This was problematic, as Russia would require the IOCs’ knowledge and capital in the future. The competitive low-cost fields of the Western Siberia would gradually need to be replaced by the more complex and cost-intensive reserves in the Arctic and Barents Sea, implying the need for larger funds. Eventually Russia’s energy production and transport infrastructure would also need to be relocated to these fields, requiring considerable investments. Official government sources estimated total investment needs for the Russian oil sector up to 2020 at $250 billion.\(^{318}\)

Expropriating assets of the IOCs would be beneficial to some degree though, as it would allow the state to take control of an established oil and gas base in Sakhalin that had been built from scratch. The PSA-1 consortium, for example, had pledged an initial US $15 billion (spread over a contractual period of 33 years) in offshore oil production.\(^{319}\) These high investments were in the majority of cases, sunk and non-recoverable. However, there was some degree of physical mobility concerning the offshore production facilities. If production were to be discontinued, SEIC consortium could still physically remove its oil storage facility, its tankers and even the oil-drilling platform, Moliqpak.\(^{320}\) However, removing these huge infrastructures made little sense because of the tremendous costs involved.

4.4.1.4. Domestic Political Utility

Since the very beginning, the IOCs had been the target of populist anti-foreigner rhetoric. The political backlash against the idea of permitting foreign companies to acquire control and ownership of Russian strategic energy assets only increased as prices rose.\(^{321}\) The root causes


\(^{317}\) Ibidem.


\(^{321}\) F. Hill and F. Fee, ‘Fueling the future’ p.484.
behind this anti-IOC lobby were primarily the ‘unfair’ PSAs. As a result, a strong anti-PSA lobby had formed consisting of the domestic oil companies and senior politicians, such as Anatoly Chubais, former Vice Prime Minister and German Gref, Russia’s Minister for Economic Development and Trade under Putin. The Russian oil companies had become confident in their ability to develop their country’s oil potential and felt little need for exclusive deals for foreign investors. Yukos and its owner Mikhail Khodorkovsky had vehemently opposed the signing of the PSAs in the first place and advocated for their annulment. He argued that they “created an unlevel playing field biased against Russian operators”. In addition, a majority of conservative Russian politicians regarded the PSAs as detrimental to the national interests of the country. Putin himself did not grow particularly fond of the PSA’s either and compared them to a “colonial treaty that has nothing to do with the Russian Federation”. State intervention would temper these growing frustrations and secure an easy political victory for the Russian government.

4.4.1.5. Geopolitical objectives

Expropriating assets from the IOC would not contribute to Russia’s foreign policy objectives as understood in the previous section for three reasons. First, it would be detrimental to Russia’s relations with the West. High-level government lobbying had been involved in the initial signing of the PSAs, viewed by the Russian government as an asset in securing international political assistance. As a result, any form of approbation by the Russian government would certainly put strain on Russia’s relations with those states. This cost-benefit trade off, though, would depend on the extent to which Putin’s Russia needed to secure international political assistance in the first place. Second, state intervention would further damage Russia’s reputation as a secure place to invest. In addition, the readiness to use oil as a political weapon would undermine Russia’s image as a reliable supplier. Third, the IOCs had a very strong network and access to many consumer markets, which could be of high use to the government’s objective of strategically penetrating foreign markets. This was specially the case in Sakhalin, close to the coasts of China and Japan. Fourth, the IOCs used specialised LNG and crude oil carriers. These vessels allowed all year round export route, using ice-
strengthened tankers and icebreaker support. This was of crucial importance, since in the winter the country has practically no access to ice-free oceans.

4.4.1.6. Development of National Industries

On the long-term Putin envisioned a world, wherein the Russian state would no longer be dependent on the technology and expertise of IOCs but would be able to rely on the know-how of Russia’s own ‘national champions’. Of course, the Russians were aware of the huge differences between the IOCs and the biggest domestic companies. In order to bridge that gap, Russia needed to ensure close cooperation and technological transfers between the IOCs and its state-owned companies. This was actively encouraged through minority-stake foreign participation in JVs. An alternative to this was the outsourcing of specific services to independent companies. Taking these factors into account, intervention would only be beneficial in the case of foreign involvement in projects where the state did not yet possess majority control.

4.4.2. Oligarchs

4.4.2.1. Maximization of Rent Capture

By the end of the 1990s, the Russian government and the domestic oil companies were locked in a vicious circle, in which high arbitrary tax rates set by the government stimulated evasion, which then encouraged even higher tax rates and more elaborate tax evasion schemes. Yeltsin had been unable to convince the Duma, Russia’s lower house of parliament, nor the recalcitrant regional leaders to adopt and implement tax reforms. A main reason for this was the oil lobby’s frequent use of its political connections to hinder and even overturn tax reform. As of 1999, the Kremlin retorted with harsher measures to ensure fiscal compliance such as tax inspections and restrictions to the state-controlled pipeline network.

Despite the state retaining the ability to tax oil exports (and the control of access to pipelines), many Russian companies still succeeded in evading tax. One of the most common forms of tax evasion was transfer pricing. Since income tax was based on trade rather than production, parent companies could downsize their official income by creating trading subsidiaries (often located in a low tax area within Russia) from which they purchased oil at below-market prices and then resold this oil at equally low prices to offshore Russian intermediaries (often located in a free-trade zone). They could then resell the oil on the world market for higher prices. According to WB economists, the cost of transfer pricing amounted to

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331 D. Lane, The political economy of Russian oil (Maryland 1999) p.131.
332 P. Jones Luong and E. Weinthal, ‘Contra coercion: Russian tax reform’, p. 141.
about $6-9 billion per year in 2002-2003. Another method of altering tax obligations was by negotiating tax breaks and privileges with the regions. As an illustration, Sibneft saved $450 million in taxes by basing operations in the Chukotka region where its CEO, Roman Abramovich, served as governor. Yet, according to Luong and Weinthal, fiscal compliance by the oligarchs increased towards the end of the 1990s. The authors suggest that a collaborative compromise was struck between the oligarchs and the state, as a response to the 1998 crash. Around that period a new Russian tax code was implemented, focussing on new taxes and taxpayer rights. Empirical evidence suggests though that the degree of compliance was short-lived. For, as late as 2002, Khodorkovsky successfully blocked a 2002 effort to raise oil excise taxes in the Duma. In light of this apparently unstable tax-regime, it was clear that some form of intervention was necessary to rein in on the tax evading practices of the oligarchs. Since the legal order and the state’s administrative and institutional regime still lacked sufficient authority, the temptation to use coercive methods was considerable.

4.4.2.2. Sustainable Production

As mentioned before, the oligarchs were not contributing to the long-term sustainability and renewal of Russia’s resource. With a highly uncertain property rights regime, their focus was bent upon short-term production. As such, they did not commit their resources to exploration, as the risk and high costs involved made it an unattractive venture. Putin did not believe that this strategy was in the best interest of Russia. It was clearly opposed to his own personal vision, in which “the stable development of the Russian economy […] needs to be based on the planned growth of its component parts, including in first place, the potential of its mineral resources”. The gap between these two policies provided an additional incentive to intervene in the sector. But it is questionable whether approbation of assets would be an optimal solution to this problem. A stricter control of development licenses or government-initiated incentives to back exploration would be equally effective.

4.4.2.3. Fulfilment of technological, infrastructural and capital requirements

Unlike the IOCs, the oligarchs had not been forced to commit large investments in infrastructure like the offshore projects in Sakhalin. This was mainly because the oligarchs had been blessed with existing infrastructure built in the Soviet era. In order to increase efficiency though, companies such as Yukos had employed Western technicians invested in enhanced extraction technologies, but these costs were pale in comparison to the sunk investments of the

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IOCs. With little innate technical expertise or know-how, it seems unlikely that this would form a driver for the Russian state to appropriate assets. Nevertheless, the value of the oligarchs’ assets had risen considerably thanks to successful management and solid financial performances, making them in any case a more interesting target for nationalization.

4.4.2.4. Domestic Political Utility

Nationalization of the oligarchs’ assets could serve two distinct objectives. First, it would benefit the popularity of President Putin. The domestic population, outraged by the loans-for-shares scheme, despised the oligarchs and their excessive wealth. In a 2003 poll 88% of all respondents believed that Russian big business had been formed by wholly or primarily dishonest means. Such was the unpopularity of the oligarchs that Putin even risked losing legitimacy if he failed to act against them. Second, it would allow Putin to consolidate state power. Under Yeltsin, the Russian state had become increasingly decentralized, allowing actors such as the oligarchs and regions to gradually fill up the huge void of economic and political power left behind by the collapse of the SU. The success of the oligarchs was visible in the amount of political positions they had held (Abramovich was governor of Chukotka, Khodorkovsky had been deputy Minister of Fuel and Energy). In addition, the oligarchs had control over a number of key sectors, such as the media. Under Putin, a minority (Khodorkovsky, Berezovsky and Gusinsky in particular) seemed intent on maintaining their grip on political power and were even openly funding opposition politicians and civic associations. This blatant challenge to his political power irritated Putin, who soon came to regard the oligarchs as nothing more than parasites feeding off the Russian state.

4.4.2.5. Geopolitical Objectives

With only a total 27% share of all Russian oil production and less than 40% of all exports, it remained difficult for Putin to coordinate Russia’s oil policy. In addition, some of the oligarchs were starting to venture onto forbidden turf: Russia’s export monopoly. Three key events took place evidencing this claim. First, Yukos willingly publicized a series of crude oil shipments to the Port of Houston in 2002. Second, the director’s of Russia's major private oil companies announced an agreement to construct a pipeline from oilfields in West Siberia (and high-potential fields elsewhere) to the arctic port of Murmansk on the Barents Sea. Third, in 2002 and 2003, Yukos proposed to construct a private pipeline from East Siberia directly into China. This was immediately rejected by state-owned Transneft that favoured a

longer Pacific-bound route. Notwithstanding this opposition, in May 2003 Yukos signed a 20-year delivery contract with China, “acting as if [it were] a sovereign power”. This of course infuriated the Russian government. A pipeline network owned and operated by private owners governed by transparent regulations and market competition would severely weaken the state’s use of the network as a political tool. The only solution would be to distance the oligarchs from the upstream activities through nationalization or at least ensure their compliance with state interests. The former, albeit coercive, would guarantee compliance, whereas the latter option would entail negotiations and persistent bargaining, prior to any form of joint action.

4.4.2.6. Development of National Industries

In his thesis Putin wrote: “The process of restructuring the national economy must have the goal of creating the most effective and competitive companies on both the domestic and world markets”. In order to achieve this he believed that the state should have the final say in these companies, who as state-supported national champions would be able to compete with IOCs and other NOCs on the long term. Pivotal to the success of this policy would be the promotion of state’s interests over profit maximization. Without state ownership, this would be difficult to realize. The oligarchs were hatching their own plans and were contemplating mergers and acquisitions to increase growth. In 2003 Yukos and Sibneft, for example, announced plans to merge, making it the biggest oil company in Russia, and the fourth largest world wide in terms of production. One of the reasons to merge was increased financial leverage, allowing it to be more successful in auctions for exploration licences. This caught the attention of the majors (Exxon and Chevron) who entered talks with Yukos in 2003 to potentially buy a 40% stake of the new supercompany. This flirtation with the West did not appeal to Putin, who became concerned that a foreign company could potentially hold an important stake in the Russian oil industry.

4.5. Recentralizing the State

Judging by the previous section, it seems that there was plenty of political and economic rationale to intervene on behalf of the state. Before examining the resulting bargain, we need to establish whether the Russian state was in a better bargaining position as Vernon’s paradigm suggests. We do so by analysing the political and economic context Putin operated in.

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4.5.1. Economic Outlook

When Putin took office in 2000, Russia had about $47 billion in foreign debt. Barely 6 years later, the country had repaid every penny. At the same time, its foreign currency and gold reserves had grown about seventeen-fold (see figure 15). This recovery was the result of a spectacular economic recovery, following the 1998 financial crisis. The crisis, precipitated by the ‘Asian Flu’ and a steep decline in oil prices in 1998, was caused by a multitude of factors too long to be extensively elaborated on in this paper. The bottom line was that Russia ran a chronic budget deficit between 1992 and 1998, not least due to its incapacity to collect tax revenues, and had simultaneously financed this same deficit with domestic and foreign currency-denominated loans. Inasmuch as the loans carried high interest rates (reflecting high risk), the debt burden quickly exceeded the means available to pay back the initial debts. The August Financial Crisis reached its apogee when the government, on 17 August 1998, was forced to devalue the rouble, default on domestic debt and declare a ninety-day moratorium on payments by Russian commercial banks to foreign creditors. As a result, the rouble’s nominal value was devalued by 70% against the US dollar, inflation and unemployment soared, and commercial banks went bankrupt. Fundamentally, the crisis exposed the deep flaws inherent to entire economic infrastructure of post-Soviet Russia. It also revealed the state’s susceptibility to fluctuations in the global market place, due to – among others - its over dependence on the oil sector for budgetary revenue.

Figure 15 Russian Foreign Exchange Reserves and Foreign Debt/GDP 1993-2008

Ultimately, it was the devaluation of the rouble and other measures forced on the Yeltsin government by the crisis that helped stimulate recovery. First, as mentioned before, the devaluation helped Russian exporters of raw material, on which the Russian economy depended.

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349 S. Pirani, Change in Putin’s Russia: Power, money and people (London 2010) p.44.
350 Along with the Asian countries, in mid-1997, Russia was subject to a currency crisis. After the onset of the East Asian Crisis, the rouble came under speculative attacks. In an attempt to defend the currency, the Russian Central Bank lost nearly $6 billion in foreign-exchange reserves.
352 P. Jones Luong and E. Weinthal, ‘Contra coercion’, p.145.
354 Source Economist Intelligence Unit.
Second, devaluation made imports relatively expensive, increasing the competitiveness of Russian goods on the domestic and world market. This paved the way for the recovery of Russia’s manufacturing industry. Third, the economy began to break away from the vicious circle of barter and non-payment of taxes that had paralysed the economy since the 1990s. According to the Moscow Times, out of the 70 million Russians that were supposed to pay taxes, in 2000, after a decade of market reform, only 3 million did so.\textsuperscript{356} In addition, Putin’s implementation of a 13% flat tax on income (one of the lowest in the world at the time) coincided with Russia’s industrial recovery culminating in increased corporate tax receipts.\textsuperscript{357} Finally, and most importantly of all, oil and gas revenues, as well as those of other Russian commodities (gas, oil and metals) rose substantially in the 2000s. However, it was only until Putin implemented additional tax reforms that the state could really benefit from these windfall profits.

\textit{Figure 16 Russian GDP Growth and Industrial Output Growth}\textsuperscript{358}

As demonstrated in figure 16, commencing in the early 2000s, Russia witnessed strong GDP growth, a stable currency and grew into a highly dynamic economy.\textsuperscript{359} This growth coincided with rising average living standards (average salaries more than doubled between 2000-06)\textsuperscript{360} and the restoration of Russia’s health, education and welfare systems. Despite its positive impact though, the dramatic turnaround, predominantly attributable to the higher oil prices, revealed once again how dependent the economic health of the state was on its energy resources.

4.5.2. Political Context

When he was hand picked by Boris Yeltsin and his corrupt entourage in August 1999 to become prime minister, Vladimir Putin was still an obscure ex-Committee for State Security (KGB) agent. Ordinary Russians seemed indifferent regarding his appointment, convinced that it was just another one of Yeltsin’s many ministerial shuffles (Putin was the 5\textsuperscript{th} prime minister to be appointed between March 1998 and August 1999).\textsuperscript{361} Yet, he quickly gained popularity and in a

\textsuperscript{356} Moscow Times May 8 2001.
\textsuperscript{358} Source Economist Intelligence Unit.
\textsuperscript{360} R.J. Hill and O. Cappelli, \textit{Putin and Putinism} (Oxon 2010) p.44.
matter of months was comfortably elected as president of the Russian Federation with 53% of the votes.

In his first term, Putin set out to reverse the erosion of state power under Yeltsin by taking a number of measures. First, he refashioned the state apparatus. Following his election, Putin surrounded himself with three groups: 1.) ‘silovki’, current and former security service officers; 2.) ‘St-Petersburg liberals’, market-reform economists and administrators from his time in St-Petersburg and; 3.) veterans of Yeltsin’s administration, who were gradually eased out during his first term. His political entourage had implications for his policy and even for its implementation. According to Appel, the rise of the silovki nurtured an atmosphere of fear, spurring greater compliance with laws. Second, coinciding with Russia’s economic growth, Putin rapidly assured himself a popular mandate. He conducted an intensive military offensive in late 1999 against the Chechens in response to their incursion in Dagestan and the Moscow apartment bombings, establishing himself as a tough, decisive and dynamic leader (approval ratings rose from 31% in August 1999 to 80% in November 1999). Through the war, Putin not only secured vast domestic support but also restored Russia’s nationalism and territorial integrity. Third, he reined in on the power of the regions. He did so by splitting Russia up into seven federal districts and appointing presidential representatives (mostly silovki) to bring the 83 subjects of the federation to heel. He also passed new legislation allowing him to dismiss regional governors who violated tax laws and federal statutes and allowing him to appoint governors, thus replacing direct elections. Finally, he sought to redefine the relationship between the state and the oligarchs. Despite that a number of oligarchs, including Berezovsky and Abramovich, had openly supported his election, Putin’s distaste for them soon became apparent, not least in his campaign pledges to “eliminate the oligarchs as a class” and to hold all businessmen “at an equal distance”.

An antithesis of Yeltsin in numerous areas, Putin was portrayed as a man who kept to himself, physically healthy, intelligent, honest and respected abroad. Thanks largely to Russia’s favourable economic performance he was able to sustain his popularity in subsequent years. Incidentally, he also enjoyed a great degree of support from both the public as well as from the Duma. The former resulted in a comfortable second term re-election with 71% of the votes, the latter (the Duma was substantially less polarized than under Yeltsin) assured him control

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366 S. Pirani, Change in Putin’s Russia: Power, money and people (London 2010) p.68.
370 P. Jones Luong and E. Weinthal, ‘Contra coercion’, p. 142.
over the legislature.\textsuperscript{371} With such strong public support, Putin had a stronger bargaining position and a larger degree of political manoeuvrability in pursuing his agenda than his predecessor.

4.5.3. National Identity
Like many members of Russia’s old elites, Putin still envisioned Russia as a great power. This was in stark contrast to Gorbachev and Yeltsin who had accepted a more reserved role for Russia in international affairs. Putin though, had a clear geo-economic and state-driven vision of how to restore Russia’s ‘great power status’.\textsuperscript{372} Desperate to once again be recognized as a coequal of the US, Putin hoped to quickly clear up the chaos Yeltsin had left behind, by strengthening the state and bringing back social order. In addition, he sought to redefine Russia’s relationship with its Soviet neighbours and near abroad.

4.6. The Obsolescing Bargain?
In the previous section we examined the potential drivers that may have played a role in the Russian state’s policy. We also demonstrated that through favourable economic and political circumstances, Putin enjoyed a stronger bargaining position to that of Yeltsin. This section analyses the resulting bargains. According to the OB-theory we should expect a different bargain, insofar the state’s bargain improved relative to that of the IOCs and the oligarchs.

4.6.1. IOCs
In his relation with the IOCs, Putin seemed to be pursuing contradictory objectives. On the one hand, aware of the long-term investment needs of the oil sector, he wished to restore Russia’s credibility concerning the state’s institutional reliability and its suitability for international capital.\textsuperscript{373} On the other hand, he was weary of foreign investment, as the presence of foreigners could have a destabilizing influence on his control over natural resources. Therefore, like Yeltsin he chose for a solution, wherein FDI would be tolerated so long as control remained in the hands of the state.

In his first term, Putin focussed on ensuring an attractive investment climate for foreign and domestic companies, whilst simultaneously setting out the rules that had to be adhered to.\textsuperscript{374} Investment in E&P was necessary to realize his ambitions of modernizing the economy and sustaining growth. In that period, the president personally blessed a merger between BP and TNK in August 2003.\textsuperscript{375} The British company acquired a 50% interest in the new entity for $8 billion, the largest-ever foreign investment in Russia. In addition, in 2004 ConocoPhilips

\textsuperscript{371} S. Pirani, \textit{Change in Putin’s Russia: Power, money and people} (London 2010) p.121.
\textsuperscript{372} A. P. Tsygankov, \textit{Russia’s foreign policy: Change and continuity in national identity} (Oxford 2006) p.171.
\textsuperscript{373} C. Locatelli, ‘The Russian oil industry between public and private governance’ p.1082.
bought a 20% share in LUKoil from the Russian government for a price of $1.9 bn. However, in the same year, the law on PSAs was changed implying that only fields which “no developers are prepared to develop under the usual licensing system, qualify for a production sharing agreement”. As a result, foreign companies were now compelled to operate in a Russian legislative framework, by either entering a JV with a domestic firm or by acquiring a (minority) stake in a Russian company.

Putin’s second term had more far-reaching consequences for the IOCs. Emboldened by his re-election and ‘petroconfidence’, Putin fought to claw back concessions (in particular that of Sakhalin-2) made to foreign oil companies under Yeltsin’s rule. In September 2006, Russia’s Natural Resource Ministry retracted its approval of Shell’s Sakhalin-2 permit. The consortium’s licence was revoked on environmental grounds barely a year after Shell had announced cost overruns totally $12 billion. To appease the government, the SEIC consortium reluctantly agreed to sell a 50.1% stake in the project to Gazprom for $7.65 billion and pay annual dividends of $100 million, whilst the government agreed to cover a share of the cost overruns. There were three main reasons for Russia’s renegotiation of the agreement. Firstly, the terms of the PSA were overly unfavourable to the Russian government – more so than the other PSA’s – since the government had to forego its share of revenues until the consortium had recouped costs. As such, every additional cost overrun gave the government more incentive to renege on its initial agreements. Nevertheless, a solution had been envisaged under the PSA for the eventuality of cost disputes. These could be settled under arbitration. Secondly, Gazprom in its ambition to become an international gas company was very eager to acquire LNG experience and expertise. By assuming ownership of the project, Gazprom enhanced the company’s position in the Asian LNG market and ensured access to Shell’s technological expertise. Finally, and perhaps most importantly, it was the only large-scale project that did not involve any Russian consortium partners, excluding the state from any control. The influence of local partnerships on the obsolescing fate of an IOC is an important factor and one that has been highlighted in other case studies (see Jenkin, Moran). Disputes erupted over the other two PSAs, with projects stalled, because of cost-overruns.

PSAs licensing oil and gas reserves for future exploitation were also scrapped. The Kirinsky and Ayashsky fields, part of Sakhalin 3, were initially licensed back in 1993 to respective consortia involving ExxonMobil, Rosneft and Texaco (Kirinsky) and ExxonMobil and Rosneft (Ayashsky). These licenses were cancelled in 2004. TNK-BP was also coerced to sell its stake

380 W. Partlett, “Enforcing Oil and Gas Contracts Without Courts”, p. 75.
in the giant Kovykta field in East Siberia to Gazprom. In 2008, the law on foreign investment in strategic enterprises established ‘default’ ceilings on foreign equity shares in oil fields with reserves of more than 70 million tons: any purchase of more than 10% of equity by a foreign private company or more than 5% by a foreign state-controlled company would require special permission. This was similar to Yeltsin’s decree in 1992 that permission was needed for foreigners to buy a 15% or higher stake in the oil sector.

Nevertheless, despite these negative events in that period, evidence shows that FDI increased throughout Putin’s second term (see figure 10). Minority stakes in state-champions Gazprom, Rosneft were even purchased. In addition, Total was awarded a new contract in the form of an equity partnership. The French company allocated a 25% stake in the development of Shtokman, in the Barents Sea. The other partners include Gazprom (51% majority share) and Norwegian StatoilHydro (24% stake). This is understood to be part of Gazprom’s current investment strategy: Ensuring the possibility to develop reserves on a condition of reciprocity in the market activities in the partner countries- or, in other words the guarantee that the national markets of the partnering companies will remain open to Russian gas and oil.

*Figure 17 Total Foreign Direct Investment in the Russian Oil Sector 1993-2008 (mln$)*

4.6.2. Oligarchs

Despite his determination to assert his authority over the oil and gas sector, Putin was aware that he needed to proceed with caution. A full frontal attack would lead to chaos, falling tax revenues and capital flight, endangering the economic recovery. Putin’s reassertion of state control over the oil industry began in 1999. In that year, as prime minister, he signed a decree, according to which energy directors could no longer be voting participants in the fuel and energy ministry. In 2000, he seized control of two national TV stations, of which one was the only remaining non-state television channel, and accused their owners Boris Berezovsky (who supported him in the elections) and Vladimir Gusinsky of embezzlement. Realizing the gravity of the accusations, they both fled to London shortly afterwards. In the same year Putin met with 21 of the country’s

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381 P. Hanson, ‘The resistible rise of state control in the Russian oil industry’, *Eurasian geography and economics* 50 (2009) 1 p.21.
383 Source: Rossiysikiy statisticheskiy yezhegodnik 2002, p. 585; Rosstat annual publications in years since.
top businessmen to attempt to come to a negotiated compromise. The bottom line was the promise of political restraint, legal obedience and timely fiscal payments in exchange for secure property rights. Putin pledged that there would be no campaign to overturn the privatisations but that he expected a change of behaviour on behalf of the oligarchs vis-à-vis the state.

Around the same time, Putin also initiated important tax reforms (the implementations hereof continued throughout his first and second term in office). Not only was new legislation introduced that closed many of the semi-legal tax loopholes related to transfer pricing in the energy sector, laws were also passed linking tax rates to world oil prices. More importantly though Putin succeeded in improving overall fiscal compliance, thanks to two factors. First, he implemented a number of practical measures concerning tax collection, such as the improved training of the tax administration and tax police. Second, relying on his increasingly centralized state power, he tackled uncooperative and non-compliant business elites, in such a way that it set a discouraging example for others to follow suit. This was made abundantly clear by the Berezovsky and Gusinsky cases, and later in 2003 by the Yukos affair. For Easter, the incident was to mark the turning point at which the “tax system was mobilized as a coercive instrument by which the central state reasserted its dominance over the corporate elite”.

The state-oligarch relationship finally collapsed though, when Khodorkovsky publicly accused the Kremlin of having unfairly helped Rosneft acquire the Russian company Severnaya Neft. This time Putin’s patience with Khodorkovsky ran out. In June 2003 government officials arrested one of Yukos’ senior officials. Three months later, Mikhail Khodorkovsky himself was arrested, marking the beginning of a new relationship between state and oligarchs. The pretext for his arrest was based upon a combination of discriminatory and retroactive tax assessments and privatization fraud. Within a year later, Khodorkovsky was sentenced to nine years in jail and Yukos’ main production subsidiary Yuganskneftegaz (which produced 11% of Russia’s total oil) was put up for sale by the ministry of justice to pay back fines equalling about $33 billion. Baikal, a nameplate company closely linked to the Kremlin, bought the subsidiary in an auction broadcasted live on television. Baikal, after having paid $9.35 billion (62% of the market valuation of the time), was subsequently bought up by Rosneft a few days afterwards. A year later, the state-owned company bought 34% of Selkupneftegaz and 51% of Udmurtneft, without any blatant abuse of state power. This took Rosneft a step closer to becoming the country’s largest oil producer.

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The dismantling of Russia’s most profitable company, Yukos, amplified the growing deference to state authority. At the same time, it also encouraged (coerced) the remaining oligarchs to pay back their tax arrears and take their fiscal obligations more seriously. In the spring of 2004, the government succeeded in implementing the indexation of the oil tax system in which the oil companies’ tax burden rose proportionally to the price of oil. This reform proved to be extremely important and highly advantageous to the federal budget since it allowed the Kremlin to capture a far larger share of the rents of subsequent energy price spikes. Beyond the capture of rent, fiscal non-compliance also gave the government a tool in pressuring the oligarchs to sell their assets. After a visit from the Russian tax collectors and claims of $1.4 billion in tax arrears, Sibneft majority shareholder Abramovich was pressured to sell his 72% stake to state-owned Gazprom for $13 billion. This contributed to Putin’s objective of creating ‘national champions’.

Ultimately, 2004 symbolized the end of the oligarchic model and the beginning of state capitalism. Private ownership in strategic sectors would be tolerated only insofar it was in agreement with broader political goals. Whilst in 1999 the state owned a mere 10% of the industry, by 2008 this figure had risen to just under 40% in 2008. The Kremlin pursued majority equity stakes in various companies and state monopoly over pipelines. The state-owned companies Gazprom, Rosneft and Transneft all respectively enjoyed a privileged position in the Russian economy. Other still private firms such as LUKoil, TKN/BP and Surgutneftegaz were quick to pre-emptively accommodate the interests of the state before they too would be put under pressure.

4.7. Was the Policy towards the oil industry Rational?
The previous section has analysed the resulting bargain between the Russian state and the IOCs and oligarchs (see appendix 2). The benefits of state intervention are clear. First, it allowed Russia to recuperate a considerable amount of the oil windfall. This was the case, with regards to the oligarchs, who were coerced to comply with fiscal legislation, and with the IOCs, who saw their PSAs and lucrative terms renegotiated. Had the oil prices not been as high, it is doubtful that these contracts would have been negotiated through. Second, state intervention permitted Russia to gain control over a greater deal of its upstream activities as reflected in the graph underneath. Nevertheless, Russia’s degree of ownership in the sector still remained pale in comparison to that of most oil-exporting countries. With more state control, the Kremlin

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391 A. Åslund, ‘Russia’s energy policy: a framing comment’, Eurasian geography and economics 46 (2005) 8 p.323
could pursue its geopolitical and sustainable natural resource objectives. Although this second advantage was mainly applicable to Putin’s intervention on the domestic market, the renegotiation of the PSAs succeeded in including Russian partners in the different consortia whilst seizing majority control. Third, intervention contributed to legitimizing Putin’s authoritarian rule over the country. Not only did Putin substantiate his rule in the eyes of ordinary citizens, he also reasserted control over the political system.

<table>
<thead>
<tr>
<th></th>
<th>Key Indicators</th>
<th>Degree of Importance (IOCs)</th>
<th>Degree of Importance (oligarchs)</th>
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<tr>
<td><strong>Economic Factors</strong></td>
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<tr>
<td>Maximization of rent capture</td>
<td>Higher oil price  Failing fiscal regime  Unfavourable PSA terms  Budget dependence</td>
<td>Very High</td>
<td>Very High</td>
</tr>
<tr>
<td>Sustainable development</td>
<td>Lack of long-term focus  Lack of investment in E&amp;P</td>
<td>Very Low</td>
<td>Average</td>
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<tr>
<td>Fulfilment of technological, infrastructural and capital requirements</td>
<td>Acquisition of technical expertise  Ability to orchestrate large-scale projects independently  Willingness to acquire sunk investments</td>
<td>Low</td>
<td>Very Low</td>
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<td><strong>Political Factors</strong></td>
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<tr>
<td>Domestic political objectives</td>
<td>Domestic discontent  Political interference  Nationalist sentiment</td>
<td>Average</td>
<td>Very High</td>
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<tr>
<td>Foreign objectives</td>
<td>Geopolitical strategy  Maximization of export monopoly  Expansion into new markets</td>
<td>Low</td>
<td>Very High</td>
</tr>
<tr>
<td>Development of national industries</td>
<td>Ownership transfers to state-owned companies  Inclusion of state-owned companies in consortia  Stimulation of technological transfers</td>
<td>High</td>
<td>High</td>
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*Scores: very high; high; average; low; very low*

*Figure 18 Russian Oil and Gas Rents 1970-2005 State’s Share in Oil Production 1994-2006 (% of total oil production)*

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Although the perceived benefits for the state were initially high, Putin’s policy also entailed a number of costs. First, state intervention provoked a political backlash from (primarily) Western and Russian critics. Putin was accused of undemocratic practices (and indeed many were true) such as the “politically motivated persecution of tax evaders” and the “elimination of institutional checks on authority”. Second, Russia’s refusal to uphold its long-term commitments has confirmed Russia’s disregard to strong property rights and the rule of law. Admittedly, this was not a new development as oil-producing countries worldwide were reneging on their contracts with IOCs. In that sense, Russia’s renegotiation of contracts merely confirmed the general downturn in bargaining power of the IOCs. Third, the expansion of state control gave way to a regime of higher taxes, and prolonged political and regulatory uncertainty. This caused a number of companies to invest less and to operate more conservatively – a development counter to the initial objectives of the state.

In sum, the long-term costs of intervention may exceed the short-term benefits. By appropriating resource rents that fuel corruption, Russia will only increase its vulnerability to the resource curse and will undermine diversity of its economy on the long run. Moreover, no guarantee exists that the governance of the oil sector by the state will be superior to that of the oil companies. To illustrate: Despite the states long-term strategic view, by 2010 the Kremlin had still not adequately addressed the structurally deficient exploration efforts that endangered the renewal of Russian resources in the long run. On the upside though, a price hike in the future may once again reward the state with windfall profits – a gamble which Moscow is prepared to take.

4.8 Conclusion
This chapter has analysed the intervention of the Russian state towards the oligarchs and the IOCs. This process has been assessed with the help of a rationality framework elaborated upon in the theoretical chapter (2.10) of this paper. This chapter has also presented empirical evidence, demonstrating that the dual bargains struck by the oligarchs and IOCs obsolesced, though to a different extent. This argument is supported by the stronger relative bargaining position of the Russian state and the resulting bargains between the Kremlin and these two actors. In order to summarize our findings it is useful to reiterate the research question of this chapter: “What were the drivers behind Russia’s re-nationalization policy in 2000-2008 and was this policy rational?”.

Similar to the privatization process, the state pursued different drivers in its policy towards the oligarchs and towards the IOCs. The story of the oligarchs, to begin with, has primarily been one of the Kremlin regaining political power that it lost in the 1990s. Admittedly, only a small number of the oligarchs actually witnessed a re-nationalization of their assets, with Khodorkovsky being the most obvious case. Putin eliminated the former Yukos owner as a potential political opponent and set an example for other non-state actors that dared to disobey. Yet, the expansion of state control did not necessarily mean that the state and oligarchs could not co-exist, it simply realigned the balance of power. In doing so, the Kremlin was able to substantially tighten its grip on political power, on the oil sector and on its rents.

The IOCs were less exposed to these political dynamics. The base for the renegotiation of the PSAs was founded on the maximization of rent capture by the state in a high oil price environment. Of course political factors also played an important role, including nationalist sentiment, the forced inclusion of state champions in consortia and the state’s geopolitical objectives all played a role. Interestingly, full-scale nationalizations, envisaged by the original paradigm, were not the order of the day. Instead, the majority of these contractual disputes were resolved through negotiated solutions, in which the IOCs (and oligarchs) accepted a minor role. The IOCs accepted this role for fear of losing out on the huge up-front investments that they had pledged and the potential payoffs of working in Russia on the long-term. In addition, Russia’s dependence on the IOCs for future cooperation and market access ensured that Russia did not damage its relationships with IOCs beyond repair.

In view of the resulting bargains in the oil sector, overall, short-term rationale seems to have overridden long-term objectives. The benefits of re-centralizing the state contributed to the restoration of Russia’s financial and political sovereignty. Through the large inflow of oil rents, Putin paid of international debt, accumulated foreign exchange reserves (at one point the third largest in the world), reinforced fiscal policy and revitalised Russia’s foreign policy assertiveness. Nevertheless, this did little to forward the long-term development of the state’s resources. On the contrary, Russia failed to create an institutional framework that ensured the protection of property rights or provide sufficient stability and protection to invest in E&P. Instead, Moscow began increasingly to take on the appearance of a ‘rentier state’, wherein the economy is subjugated to hydrocarbon rents and is therefore overly exposed to volatility in the sector.

To conclude, Russia’s form of re-nationalization towards the oligarchs diverges from the OB-theory’s traditional account, in which a shift in bargaining power occurs from investor to HC after investment costs have been sunk. Rather, the economic rationale for state intervention here was subordinate to political goals, designed to reassert the primacy of the state both in domestic and international affairs. Interestingly, this is primarily the result of political factors
dominating the initial privatisation process between the states and the oligarchs in the first place. Much of what Putin did simply restored the state to the functions a typical government would fulfil in most capitalist countries: collect taxes, stabilize the currency, cut out rent seekers, manage natural resources in a strategic fashion and so on. The renegotiated bargains between the IOCs and the state, though, did take on more forms of the OB-theory. Putin felt beguiled by unfavourable contracts signed by Yeltsin. The rise in oil prices along with the opaque cost overruns culminated in a determination to rectify the new situation. Therefore, Moscow, in a textbook OB-theory case, intervened to renegotiate the contracts, stopping short of expropriating any assets. Instead, the PSAs were modified (or even annulled) in order to accommodate state-owned companies as majority shareholders and controlling influences
Conclusion

“The state has the right to regulate the process of the acquisition and the use of natural resources, and particularly mineral resources, independent of whose property they are located; in this regard the state acts in the interest of society as a whole, as well as in the interest of private owners whose interest conflict and who need the help of the state organs of power to achieve a compromise”.

- 1999, Extract of Former President Vladimir Putin’s dissertation

This thesis has demonstrated that the OB-model is still a relevant tool in understanding bargaining situations in the petroleum industry. It has analysed whether the obsolescing bargain model can account for the rationale behind the state’s policy towards the IOCs and oligarchs. Before discussing our findings it is helpful to reiterate the main research question of this paper: “To what extent can the obsolescing bargain model account for the policy rationale of the Russian Federation towards IOCs and the Russian oligarchs in the oil sector since the fall of the Soviet Union till 2008?”. To understand the motives behind state intervention, concepts of rational choice were employed to evaluate the policy of both Yeltsin and Putin in their management of the oil sector.

The first chapter applied the economic rationale of the OB model, stating that a HC with relatively little bargaining power will give away investment related concessions to actors with relatively more leverage. Since this paper included a second actor, the oligarchs, the research question of this chapter was as follows: “What were the drivers behind Russia’s privatization policy in 1991-1999 and was this policy rational?”. The first part of this chapter highlighted the poor state of the oil sector and discussed the impact of the transition from a central-planed to a free-market economy on the oil sector. Empirical evidence suggested that the subsequent fall of Communism served to amplify these deficiencies, resulting in a production and demand collapse, supply disruptions, environmental issues and so on. In relation to these key issues, we identified the needs of the Russian state and the ability of the oligarchs and IOCs to respond to these requirements.

The second part of this chapter, established that the chaos of post-Soviet Russia, including institutional uncertainty, harsh market reforms and poor management, contributed to a catastrophic economic outlook. Predictably, this debilitated Yeltsin’s grip on political power. Not only did the harsh economic conditions lead to public discontent, his powerbase within the

Kremlin slowly eroded, as contending actors gradually entered the political realm. The combination of these factors culminated in the erosion of central state power and an extremely weak bargaining position.

To conclude, we established that both IOCs and oligarchs struck favourable deals with the Russian government, albeit very different in nature: The IOCs were confined to geologically complex areas with no existing infrastructure, whereas the oligarchs bought up existing assets at a fraction of their value. Based on our findings, the main driver of the Russian state towards the IOCs was founded on the Russian oil sector’s requirements for capital and technological. A rationale that can comfortably be explained for by the OB-theory. The main driver in Russia’s policy towards the oligarchs though, was not dictated by economic rationale but by political forces. In exchange for political and financial favours, the oligarchs took advantage of the free-for-all post-Soviet asset grab. A bargaining result that both our framework and the OB-theory were unable to account for.

The second chapter analysed the intervention of the Russian state towards the oligarchs and the IOCs, with the help of a rationality framework elaborated upon in the theoretical chapter (2.10) of this paper. The research question of this chapter was: “What were the drivers behind Russia’s re-nationalization policy in 2000-2008 and was this policy rational?”. Once again, the first part of this chapter was consigned to analysing the oil sector. We demonstrated that the sector was more profitable, thanks to a more favourable cost-revenue structure, providing incentive for more investment and production.

Consistent with the methodology of the paper, we then examined the possible drivers with regards to both actors behind state intervention in the oil sector and the resulting bargains. Our findings suggested that the bargaining power of both actors declined in favour of that of the state. The IOCs, operating on basis of the PSAs, were the subject of increasing scrutiny due a rise in oil prices along with opaque cost overruns, which prevented the state from capturing rent. This provided Putin an added incentive to claw back the concessions that had been given away in the Yeltsin era. The position of the oligarchs in Russia had also become unsustainable. Not only were they resented by the domestic population, they had also become an excessive counterweight in politics, an area that Putin believed to be confined to the authority of the state.

Concluding, Putin’s government intervened in order to rectify the chaotic situation left behind by Yeltsin. The oil sector was a key element in this process, as its control of its rents and that of its transportation network permitted the Kremlin to restore Russia’s financial and political sovereignty. Consequently, Putin reneged on the PSAs and subdued the oligarchs through coercive tactics. This shift answered the purpose of primarily short-term benefits,
including the maximization of rent capture, the reassertion of central state authority and the control of the oil sector to serve geopolitical and domestic ends.

So, can the obsolescing bargain model account for the policy rationale of the Russian Federation towards IOCs and the Russian oligarchs in the oil sector since the fall of the Soviet Union till 2008? The answer to this question is partly affirmative and partly negative. Russia witnessed two distinct, yet intertwined, bargains at the heart of the oil sector. Both of these obsolesced, but for contrasting purposes. With regards to the IOCs, the strong increase in oil prices was primarily at the basis of governmental intervention. This inflated the value of the PSAs in the eyes of the government, who increasingly resented the lack of economic rent. Incentives to renegotiate were heightened due to uncontrollable cost-overruns and perceived geopolitical benefits. As far as the oligarchs were concerned, intervention by the state was primarily motivated by the Russian state’s desire to consolidate its power over its own domestic political realm and over the ‘commanding heights’ of its economy — the oil (and gas) sector.

Concluding, two final points can be made with regards to the case. First, given the complexity of Russia’s post-Soviet transition, it is difficult to judge whether the obsolescing bargains of the IOCs and oligarchs are unique to the Russian state or were part of a broader trend that has precedence across the world. For, judging by recent state intervention in countries such as Venezuela, nationalizations seem part of a re-emerging 21st century policy model of the oil-producing countries, in which foreign companies are once again forbidden to be owners of the hydrocarbons they extract. This erosion of IOC bargaining power has been further exasperated by: 1.) Rising competition by established NOCs, 2.) the declining number of producing states that are willing to open their oil sectors for investment, and; 3.) increased involvement in areas with substantial below-and above ground complexities. In light of this trend, it would be interesting to compare the experience of IOCs in Russia with other Post-Soviet economies in which privatisation took place.

Second, a highly complex myriad of both exogenous and endogenous social, economic and political factors contributed to changes in the goals and priorities of the post-Soviet government in its relationship with the IOCs and the oligarchs. Based on the findings of this paper, the correlation between these variables and the state’s policy shift is impossible to pinpoint exactly. This would be an interesting avenue for future statistical research. In the meanwhile, this paper contends that it was the change in political leadership that was the largest catalysing factor to the obsolescence of the bargains. This claim is evidenced by the coinciding shift in leadership and shift in policy. All the same, it remains debatable whether this shift would have been as dramatic, if a rise in oil prices, and the ensuing economic upturn, had not occurred.
Looking ahead

Amidst the turmoil of the economic crisis, on the 26th of September 2009 prime minister Putin invited executives of a number of oil majors, including Exxon and Shell, to Salekhard in West Siberia. Barely a few years after compelling these very same companies to renegotiate PSAs they had signed with the Russian state, he asked them to contemplate investing in the development of the Yamal Peninsula, promising contracts founded on ‘stability’ and ‘transparency’. So, is this the start of a new bargain between the IOCs and the state? Initially Gazprom had boldly announced ambitious plans to develop the field, but the company was forced to withdraw following financial problems due to the economic crisis and to a contraction in gas demand. With insufficient capital available, the IOCs once again became attractive alternatives.

The request came at a time when oil prices still had not fully recovered from a steep, but short, drop at the end of 2008. Even worse, the oil prices, lingering under the $40 mark, were dangerously close to the break-even production costs of some fields in Russia. With the illusion of indefinitely elevated oil prices shattered, it is highly likely that the state will be dependent on the involvement of IOCs in the future. Four factors support this claim. First, geographical and geological conditions are likely to become more complex as easy-to-reach oil runs out. As a result, Russian oil will originate increasingly from higher cost, more capital-intensive areas such as Timan-Pechora oil province, the Arctic region, Eastern Siberia and Sakhalin in the future. Second and closely linked to the first factor, production costs in Russia remain relatively high and will undoubtedly increase in the future. Third, Russia’s economy is excessively dependent on the flow of oil and gas rents, and has failed over the years to diversify its economy from this sector. This is not likely to change overnight and Russia is therefore coerced to maintain production in order to mitigate its exposure to the volatility of the oil markets. Finally, under Yeltsin and Putin, policies related to the exploration and production of the resource base have been consistently lacking. This is particularly worrying when considering the reserve-to-production period of around 10-15 years in Russia and the discrepancy between the proved reserve and production growth.

The question remains whether these ambitions will result in new agreements between the IOCs and the state. It will also be equally interesting to see how IOCs can avoid a new obsolescing cycle. It is the opinion of this paper that three factors could help IOCs mitigate this

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404 Ibidem.
405 A. Moe and V. Kryukov, ‘Oil exploration in Russia: Prospects for reforming a crucial sector’, Eurasian geography and economics 51(2010)3 p.312
risk. First, IOCs should increase cooperation and coordination with each other and their home
governments to increase their collective bargaining power towards oil-producing states. In
practice, IOC-home government cooperation is already the order of the day. Yet, it is the
opinion of this author that a common policy on HC approbation is possible - though the risk of
free-riding could endanger the feasibility of this option. Second, as the Deepwater Horizon
crisis has demonstrated, industrial accidents are conducive to a swift erosion of IOC bargaining
power. Given the decline in their access to conventional oil reserves, IOCs are becoming
involved in increasingly hazardous areas, amounting to huge exposures to risk. Therefore,
governments and IOCs must make transparent and public agreements concerning the
environmental, financial and safety risks that they are willing to bear in their quest for hard-to-
reach reserves. Third, the IOCs should review the forms of cooperation with oil producing
countries and national oil companies. Clearly, unfair IOC-HC contracts provide a breeding
ground to obsolescing bargains. Therefore, increased cooperation in the form of hybrid shared
ownership agreements between IOCs (minority share) and state-owned companies (majority
share) can be an attractive alternative. This provides a vehicle for close cooperation, based on
aligned interests and reduced agency costs.
Appendices

Appendix 1: Bargaining Result under Yeltsin

Appendix 2: Bargaining Result under Putin
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