

# Executive Memorandum

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## Russian Oil After YUKOS: Implications for the United States

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The Russian oil and gas sector's new paradigm can be summarized in two words: "state domination." The free-market paradigm has been abandoned. In December 2004, the tax authorities bankrupted YUKOS, a major oil company, for alleged tax arrears and sold its main production unit, Yuganskneftegaz, to the state-owned oil company Rosneft, using a straw company as an intermediary. Chinese state banks apparently financed the purchase with \$6 billion in loans. To top it off, Rosneft is merging with state-owned Gazprom, the largest natural gas company in the world.

The Bush Administration and U.S. oil companies need to recognize that the Russian energy sector is now operating on a new model of state domination and control. Successful U.S.–Russian energy cooperation depends on the U.S. and Russia arriving at a framework agreement during President George W. Bush's visit to Russia in May to celebrate the 60th anniversary of the Allies' victory in Europe. Washington should condition U.S. agreement to Russia's entry into the World Trade Organization (WTO) on the creation of transparent rules and investment protection for U.S. companies that invest in Russia. President Bush should specifically request that U.S. companies participate in construction of the Murmansk pipeline and the Shtokman natural gas projects in the Barents Sea.

The Kremlin, not the private sector, has become the key decision maker in licensing oil fields, determining the location of pipelines, and approving consortia for production and transportation. The biggest problems in the post-YUKOS Russian oil sector are the intrusive role of the state, overregulation, the violation of property rights, opaque transactions, and xenophobia toward foreign investors.

Exxon and Total, a French firm, recently announced that they would scale down involvement in Russia's oil markets, and capital flight from Russia has increased from \$2.9 billion in 2003 to \$9 billion–\$12 billion in 2004.

Vladimir Putin's economic adviser Andrey Illarionov called the sale of Yuganskneftegaz the "swindle of the year" and warned that Russia is on its way to joining the Third World economically. While Illarionov was demoted for his candor, he was not fired. Clearly, the Russian elite is deeply divided over energy policy.

**Global Ambitions.** The Kremlin wants to play a major role in Russia's domestic and global energy markets while keeping foreign investors at bay. The

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  - The combined Gazpromneft will be a major global company that will also become an instrument of Russian foreign policy in the region and around the world.
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government-owned Gazpromneft (the combined Gazprom and Rosneft) will be a major global company, bigger than Petroleas de Venezuela (PVDSA) and comparable to Saudi Arabia's Aramco (both state monopolies), and will become an instrument of Russian foreign policy throughout the region and around the world.

With anti-Americanism on the rise in Moscow, Russia wants to use its energy muscle to develop a more robust presence in the Commonwealth of Independent States, Europe, and Asia. It is buying up strategic infrastructure companies, such as pipelines, refineries, electric grids, and ports in Georgia, Hungary, and Ukraine. Russian officials have implied that 20 percent of Yuganskneftegaz would be sold to China. Moscow is enticing Japan to pay for the Nakhodka pipeline—cooperation that could create competition between China and Japan in the Far East. There are hopes in some quarters that Russia's energy, supplemented by Iran and Venezuela, can power a global coalition with China and the Muslim world to offset U.S. hegemony.

After September 11, 2001, it was hoped that Russia and Eurasia could provide a welcome addition, if not an alternative, to Middle East oil, but this hope seems to have been premature. Russia's real challenges, beyond government renationalization, are the antiquated pipeline network, which is a government monopoly, and high production and transportation costs. In December 2004, the Russian government committed to building the Taishet–Nakhodka pipeline, a gargantuan 4,300 kilometer project that will cost \$12 billion and is designed to provide 80 million tons of oil per year to the Asian Pacific market, including up to 30 million tons to China. The Russian government seems to have lost interest in the pipeline from Western Siberia to Murmansk—the easiest way to export oil to the United States.

**The U.S. Response.** The Bush Administration and U.S. companies need to push energy cooperation issues at the highest level, beginning at the Bush–Putin Summits in Moscow in May and following up at the G–8 Summit in Scotland in July. Specifically, the Administration should:

- **Recognize** that the Russian energy sector is operating on a new model predicated on total

state domination and control. All future dealings in Russia must receive full Kremlin blessings. If the U.S. wishes to maintain an interest in Russian oil, the U.S. government must become a participant in assuring the viability of future deals.

- **Arrive** at a framework agreement on U.S.–Russian energy cooperation. The U.S. should insist that such a framework include a key role for the private sector in developing Russian energy resources and infrastructure. Investment stability and recognition of Western investors' property rights need to be acknowledged at the highest level.
- **Condition** U.S. agreement to Russia's entry into the WTO on the creation of transparent rules and investment protection for U.S. companies that invest in Russia.
- **Request** that U.S. companies participate in construction of the Murmansk pipeline and the Shtokman natural gas projects in the Barents Sea.

**Conclusion.** U.S. and Russia are still “energy compatible.” One is an importer and the other, an exporter. But recent events, by diminishing the attractiveness of Russia's energy investment opportunities, will adversely affect the country's economic development in the medium and long terms. In addition, Russia's decision-making elite is split between those who view the takedown of YUKOS as a heavy-handed operation that caused unacceptable collateral damage and those who believe that the end justified the means. Statism and opacity conceal corruption; and nationalist rhetoric covers up protectionism, backwardness, greed, and graft. As a WTO candidate and G–8 member, Russia cannot afford any of these.

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