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The Russian Energy State: An Economic and Legal Assessment

At a meeting of the General Council of the public organization Delovaia Rossiia (Business Russia) in October 2010, Russian Prime Minister Vladimir Putin noted that the kind of fresh, innovative business environment that Russia needs could be achieved through a partnership between effective government and an honest business community. Calling for business people to “abandon shadowy schemes” and “abide by the law,” Putin made it clear that for business to flourish, reform must be based on “a two-way street.”¹ Despite this professed commitment to modernization and government reform, Russia’s economic ambitions are still not free from prying state hands two decades after the fall of communism. Government corruption and malfeasance, combined with an inadequate legal and financial infrastructure, has carried over into post-communist Russia. These factors have created a stratum of problems that affect state-building, business, law, and foreign policy. Using the energy sector as a case study of how industry can serve as the perfect playground for collusion between politicians and businessmen, this qualitative analysis will discuss the political and economic difficulties of the post-communist transition, particularly how they have impeded development of a transparent business and legal environment.

The nineteenth-century Russian poet Fedor Tiutchev famously declared that “Russia

cannot be understood through reason alone.” Many investors would probably see a similarity between Tiutchev’s words and Russia’s current business practices. Analysts note that the shock therapy reforms spearheaded by the Yeltsin administration in the 1990’s were ill-advised and rushed; as a result, the effects of price liberalization from two decades ago are still evident today.

It is important to note, however, that there was not a sufficient time frame to have allowed a “comprehensive legal framework” to take root alongside the market changes. It was precisely the weak state regulation of financial and business operations that left the door ajar for ambitious Russian oligarchs. With links to state officials, the oligarchs were able to cash in on the undervalued assets in various sectors, and were later suspected of mass swindling by Kremlin officials. Limited state-initiated reorganization in this aspect guaranteed that legal protection would remain weak. This was not too far from what the situation had been in Russia a few years prior to the Soviet Union’s collapse, only now it was a state that had inherited a mentality characterized by “little interest in promulgating legal rules that could create the basis for … accountability.” Business during the Soviet era did adhere to the rule of law; society was governed by a byzantine bureaucracy where people effectively cheated the system by using blat—connections to people with access to goods or favors. Such societal mechanisms did not simply fade away when a new form of government materialized; instead they endured as ingrained

4 Richard N. Dean, “Corporate Governance and Rule of Law,” in ibid., 320.
barriers. But Russia’s government has been reportedly fighting them, first during Vladimir Putin’s presidency and now during Dmitry Medvedev’s presidency.

During the early 1990s, while the international community focused on ways to invest in important sectors of the Russian market, at the local level relationships were strengthening between regional figureheads and local business interests. Businesses in the various oblasts (provinces), especially those in key sectors such as foodstuffs, energy, and manufacturing, were doing what would seem to go against the very philosophy of a capitalist system—forging ties with state authority as a way to “ensure the perpetuation of the property regime … that favored them (by limiting competition and entry into their markets, preserving their rent-seeking opportunities, and protecting them from central state regulation and taxation).” Unprepared for the challenges of a market economy, business managers sought to limit their competition by ingratiating themselves with those in power who would “favor the status quo.” Regional authorities, who were now accountable to a constituency (in other words, pressured to gain voter support), realized that they were to be “tightly bound up with the success and failures of enterprises.” The atmosphere of legal bespredel (no limits) in the early 1990s continued the legal norms of the Soviet state. Once again, “enforceable contracts and inviolable property rights” held no weight in an economic sphere dominated by “personal networks and mutual obligation.”

However, corrupt business practices were not the only obstacle to streamlining central and regional authority during the Yeltsin administration. As Kathryn Stoner-Weiss points out,

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7 Ibid., 39.
8 Ibid.
9 Ibid., 41.
center-periphery conflict often took the form of economic sabotage and manipulation. As the Kremlin fought to unify various, diverging laws, oblast administrations took matters into their own hands, introducing laws that outright contradicted or flouted federal ones. Stoner-Weiss writes that “economic policy was the focus of noncompliance in regions over time,” as was evidenced by regions “usurping federal taxation privileges,” and “[imposing] illegal internal tariffs” among a myriad of other legal violations (not solely limited to the economic sphere, either). Moscow became caught in a struggle with regional governments, which impeded political development and economic growth. Richard N. Dean adds that the “weakness of institutions” prevented “good corporate governance.” The central state, weakened by the constant infringement of its regional units, was effectively paralyzed by extensive state/industry networks. Early in his presidency, Putin initiated an aggressive plan of attack to reform the inconsistencies that permeated the center-periphery legal system. He anointed representatives to oversee a major smoothing-out of the regions’ contradictory laws and statutes, but Taylor has noted that “these victories are limited and perhaps temporary” in light of what he sees as continuing “influence of non-state actors on law enforcement.”

Evidently, the state was weak at protecting its own economic interests both during the Yeltsin and Putin years. Equally important was its failure to provide adequate security structures and legal remedies in the form of an honest police force and an independent judiciary. Again, the Soviet legacy of a relentless police state and a completely subordinate legal system endured through Russia’s transition stage without reprimand. In the midst of market confusion and

10 Ibid., 4, 65.
11 Dean, “Corporate Governance,” 320.
13 Ibid.
societal destitution was an even more incomprehensible world of intricate, often duplicative, and insufficient laws. The result was a “low reliance on state justice,” and in order to solve the problem of commercial transaction issues (e.g. observing contracts, payment of debts, etc.), many turned to private criminal groups, often comprised of ex-athletes and military personnel who were ready with weapons and manpower to offer their services.\textsuperscript{14} According to Vadim Volkov, it makes sense that businesses in need of arbitration would turn to private protection groups since their services were more “cost-efficient,” and since “the actions of the state bureaucracy and of law enforcement remain arbitrary.”\textsuperscript{15} Paradoxically, this situation is a prime example of market efficiency in a nascent capitalist society where such a concept was barely understood. Such anecdotal evidence reminds us that overall, government and society at the time were both ill aware of the changes necessary to create a business culture that would have protected property rights and fostered competition.

Laws, while at times confusing and cumbersome, do not constitute an entire legal system. They are used and implemented by the courts and police, and in this area too, Russia was to see various forms of degradation of the system. A Russian study by researchers at the Academy of Sciences Institute for the Socio-Economic Problems of Society between 2000 and 2002 revealed the many kinds of services that police personnel could provide in exchange for cash or benefits, including the closing of a criminal case, the release of a criminal, or the sharing of documents with private individuals and companies.\textsuperscript{16} Surprisingly, just like their counterparts in private protection companies, they could also provide business with a so-called \textit{krysha} (roof)—which

\textsuperscript{15} Ibid., 19.
\textsuperscript{16} Ibid., 97.
protected them from harassment by other racketeering groups and state inspectors.\(^{17}\) Partly due to low salaries, police have been known to have illegal jobs on the side in which they provide these services.

Judges on the high bench suffered their own problems. First, their salaries were low, and monetary aid to assist courtrooms across the country was inadequate. Judges could be bribed, but more interesting is the fact that business “sponsorships” were allocated to some courts in the form of subsidies.\(^{18}\) The issue of court financing needs is illuminated by an anecdote recounted by Federico Varese:

Court bailiffs, many of whom were middle-aged females, were called upon at times to collect property (e.g. heavy items) in a judgment without the support of proper administrative aid (i.e. a government vehicle).\(^{19}\)

A strict policy of court reform within Russia’s administrative units was implemented in 2001; Putin wanted to “[sever] the dependency of courts on regional governments,” raise the standards of the system, and simply create a more centralized corpus from all of the contradictory regional and federal laws.\(^{20}\) Despite the commitment to change, and the idealization that courts would act in accordance with the rule of law and not governmental ambitions, Putin managed to use “the procurator-general against two ‘oppositional’ oligarchs with large media interests, Vladimir Gusinsky and Berezovsky, in his first year in power.”\(^{21}\) After him, President Medvedev, a lawyer by profession, made public claims that he was committed to the spirit of the law, yet remained...

\(^{17}\) Ibid., 17.
\(^{20}\) Trochev and Solomon, “Courts and Federalism,” 91.
\(^{21}\) Taylor, “The Dynamics of Russian Politics,” 65.
somewhat neutral during the highly criticized second conviction of energy mogul Mikhail Khodorkovsky in 2010.

A generally weak legal infrastructure affects the petty shopkeeper as much as it does a multinational corporation; neither can sufficiently remedy legal disputes if the courts do a poor job of ensuring their judgments. Richard Dean notes that the key to fostering a safe, productive, and efficient business culture is a strong legal foundation that will actively afford justice and ensure that court decisions are followed through. If, however, there exists a poorly trained and poorly paid judiciary, and the whole process is relegated to a mass of confusing laws, what will result is a “judicial process vulnerable to incorrect decisions, endless appeals in a maze of courts, and bribery.”

Overseas businesses looking to invest in Russia face legal issues that cannot easily be solved by the country’s legal system. The lack of rule of law, however, is but one structural deficiency in the Russian business world.

Here, it is necessary to make a salient distinction between the accepted business norms of Western, industrialized nations and those of Russia and other emerging economies. In countries which previously had planned economies, typical practices such as training business managers and providing transparent accounting records were never developed. Because of this, Western companies entering Russia at the start of the post-Soviet transition inevitably clashed with the organizational style of former Soviet managers, who had a stronghold on formerly state-owned firms. In order to provide a point of reference for the current state of business in Russia today, let us consider data provided by the Doing Business project, a series of reports compiled annually by the World Bank Group. Russia is categorized as an upper middle-income country, and in terms of engaging in business, Russia placed 123rd out of 183 economies for the year 2011.

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22 Dean, “Corporate Governance,” 310.
(down seven spots from the previous year). Although it should be noted that this project looks specifically at domestic small and medium sized companies, it is safe to extrapolate the rankings to larger sized firms, as the indicators used in the calculations are universal to business operations. Several points of interest in the data stand out (the figures are ranked on a scale of one to ten). In terms of “strength of legal rights” pertaining to acquiring credit, Russia had a score of three (in comparison to Hungary with a score of seven). In terms of “extent of director liability” pertaining to protecting investors, Russia earned a two, and in the case of “strength of investor protection,” it received a five. In addition to this, country specific figures were calculated for the time and costs associated with constructing a warehouse. Findings for Russia shall be compared to those of Hungary, a post-communist nation, which in contrast has fared relatively well in the last two decades. On average, “It requires 53 procedures, takes 540 days, and costs 4,141.00% GNI per capita to build a warehouse in Russia” versus Hungary’s average of “31 procedures, …189 days, and 9.81% GNI per capita.”

Hooking up a phone line would take thirty days to complete in Russia, and cost 176.54 USD, while in Hungary this same basic task would take fourteen days and cost 153.24 USD.

Capricious governmental organs and an ever-evolving legal code provide the slack that allows businesses to perpetuate questionable practices. In the spirit of collusion with regional

24 Ibid.

leaders, managers in the past have taken advantage of manipulating “bankruptcy procedures to avoid federal taxes and debt repayments to creditors outside the region,” as a way to stay in business, keep people employed, and provide a steady source of bribes.\textsuperscript{28} Furthermore, regional authorities could help insolvent firms by helping to circumvent bankruptcy in exchange for extracting rents. It is clear that businesspeople who forge ties to the well-connected and influential can be more or less shielded from interference by the government or non-governmental entities. However, those who fail to take the necessary steps to protect their interests may be subjected to “arbitrary audits, the bureaucracy’s power to freeze assets” and the “shut[ting] down of business operations without a clear legal basis,” all of which again “undermine investor confidence.”\textsuperscript{29}

Apart from daily inconveniences and possible interference from the bureaucracy, the banking sector in Russia suffers from several serious setbacks. The concept of credit is relatively new, and many citizens fear saving their money in banks, preferring to keep it in a safe place at home. Loans, if needed, are often provided not by banks, but rather by family members and close friends. Businesses also avoid borrowing money from banks due to the high cost of loans, and in relation to this, banks report that “risks are too high and solvent customers too hard to come by.”\textsuperscript{30} At the same time, however, the banking sector suffers from a “persistent lack of financing of private investment,” which was evident when the state accounted for one third of the total banking sector’s assets in October 2001.\textsuperscript{31} Indeed, when Putin met with business leaders in

\textsuperscript{28} Stoner-Weiss, \textit{Resisting the State}, 108-109.
\textsuperscript{29} Dean, “Corporate Governance,” 321.
\textsuperscript{31} Ibid.
October 2010 to discuss the country’s business climate, Boris Iurevich Titov, chairman of Delovaia Rossiia, admitted the following:32

The state will tell us to raise our profitability, to modernize. But, unfortunately this cannot always happen easily because at the moment interest rates are still sufficiently high. For our firms, which for the most part are medium-sized, 11–12 percent is the norm. But if we talk about long-term credit, as in the case of a financing project for example, then my firm recently managed to get 16.8 percent. We deal with wine, and because of that we received subsidized rates from Krasnodar Krai [a federal territory], which is why we pay two times less. That is already a big help, but in the meantime rates are still sufficiently high.33

Interestingly enough, Titov managed to shed light on the country’s manufacturing sector as well, noting that, “The share of the manufacturing sector in our economy is still not high—13.7 percent, and during the crisis that percentage went down almost 2 percent.”34 It is not only the Duma (the Russian parliament) that has pondered the diversification of its nation’s economy. Economic researchers have hypothesized that Russia’s dependence on natural resources and its lack of domestic investment may lead to “Dutch disease,” a phenomenon wherein the manufacturing sector experiences stunted growth in light of “surging commodity prices” triggered by export revenues.35

Realizing the high financial stakes associated with controlling natural resources, the Russian government has taken almost full control of the energy sector. Several top government officials have taken management roles in the country’s largest corporations, such as Deputy Prime Minister Igor Sechin for Rosneft, and Deputy Minister of Energy Alexei Miller for

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32 “Predsedatel’ Pravitel’stva Rossiiskoi Federatsii V.V. Putin prinjal uchastie v zasedanii general’nogo soveta Obshcherossiiskoi obshchestvennoi organizatsii ‘Delovaia Rossiia.’” [the leader of Russia took part in a session of the general council of the Russia-wide public organization ‘Business Russia’].
33 Ibid.
34 Ibid.
Gazprom. Although government control of certain industries was a noticeable trend during Putin’s presidency, many point to the Yeltsin administration as the foundation for this questionable practice. Through majority ownership of so-called holding companies, which in turn owned subsidiaries (also majority-owned), the Kremlin was able to practically monopolize control over key industries. Russia has continually tried to implement this strategy through government ventures with the operations of Western energy giants such as ExxonMobil, Royal Dutch Shell, and more recently British Petroleum (BP). The federal budget relies significantly “on the value of its shares in the oil companies and taxes generated by oil production.” Even the Minister of Finance Aleksei Kudrin announced in February 2011 that, “the Ministry of Finance constantly presents new scenarios of budget growth—its profits and expenses … in relation to its [budget’s] dependence on the price of oil,” as was publicized in an article that discussed the potential of Russia’s 2011 budget deficit dropping to zero in light of mid-year prices at $115 per barrel of oil.

It should therefore be expected that Moscow is actively involved in the business concerns of both domestic and international energy firms. Tiumen Petroleum Company TNK, headed by the Russian billionaire consortium of Alfa Group, Access, and Renova (AAR), and British energy giant BP, together forming TNK-BP, is one of several corporate partnerships whose façade has been marred in the past few years due to infighting and intrigue. The press revealed that BP experienced difficulties carrying out operations not only because of pressure from its


38 Ibid.
Russian partners, but also from intimidation by the Russian government. WikiLeaks, an online source of confidential diplomatic media, has published numerous reports leaked from the American embassy in Moscow in regard to various schemes designed to undermine the stability of TNK-BP’s operations in Russia. In 2008, the reports revealed that TNK-BP’s headquarters had been raided; numerous guesses as to who had orchestrated these raids were discussed at length in reports that were dated several months apart.

In a document from 28 March 2008, diplomatic sources revealed three possible reasons for why the raids may have been devised. First, the Russian side of the partnership wanted to exert more power and extract greater profit. Second, Gazprom, the government-controlled gas entity, wanted to buy out the Russians, but first needed to drive the purchase price down. Third, Rosneft, the state-controlled gas firm, purposefully disrupted dealings between its competitor, Gazprom, and BP. Regarding the first hypothesis, one western TNK-BP official noted that the Russians, especially German Khan (one of the founders of Alfa Group Consortium, an investment group), were not open to the business practices used by their foreign counterparts—“accountable corporate governance, transparency, and fiscal discipline.”

The Britons were not particularly fond of Khan’s plans for expansion, which included drilling in rogue states such as Burma, Cuba, and Sudan. Such plans were aligned with Khan’s general manner of decision making, which included coming to dinner armed with a chrome-plated pistol and planning high-


stake deals in smoke-filled rooms within a matter of hours. Managerial clashes clearly existed, but the actual culprits in the matter could only be guessed.41

Diplomatic cables and the press revealed the issues between the Russian and British management of TNK-BP. One major problem that arose in the partnership was high tension between the two groups, resulting from what CEO Robert Dudley called “managerial violations” on the Russian side; this included “deliberately understat[ing] to the GOR [government of Russia]” how many visas were needed for expatriate staff, thereby crucially jeopardizing company operations.42 Another document dated from May of the same year expounds the theories surrounding the raids; BP was ready to expose the harmful acts of its Russian partners to the press, while the Russian billionaires were intent on undermining their foreign partners. All the while, Gazprom had a stake in the disputes, since it wanted to “buy out the Russian half of TNK-BP and pursue a global partnership with BP” in order to further push the energy giant into state hands.43 A Russian method of business was evident on the side of the AAR shareholders who used their wealth and connections in government, utilizing state agencies and the courts to undermine BP while concurrently battling Gazprom; the prospect that they may be forced to sell their share of the joint venture pushed their determination “to get the best price they [could].”44

42 “TNK-BP Internal Fight Goes Public; Both Sides.”
43 Ibid.
For the most part, this was a three-pronged struggle. On the state’s side, however, there existed another player on the field—Rosneft. A diplomatic leak from 2007 included statements from the CEO of Rosneft, Sergei Bogdanchikov, who claimed that the company at the time was “not interested in buying the ‘Russian half’ of TNK-BP” due to its “production inefficiencies and assets.” As such, this particular investment would make no sense. A year later, the tables had turned. Gazprom CEO Aleksei Miller reportedly failed to engage the AAR partners in a buy-out scheme as a way to form a partnership with BP. Deputy Prime Minister Igor Sechin, who headed Rosneft, saw this as an opportunity to promote his company in light of the unfruitful negotiations, and consequently “moved to block the [Gazprom] takeover,” which would have proven a challenge to Rosneft’s position as “Russia’s national champion for oil.” Deputy Chairman Robert Foresman of Renaissance Capital, BP’s business consulting firm, predicted in 2008 that the most likely outcome was a Rosneft buy-out of AAR partners. Indeed, news reports in early 2011 confirmed that Rosneft had forged a joint venture agreement with BP, leading its Russian partners to file an injunction in London to block the $16 billion deal. One news analyst, James Herron, doubted that the injunction would be effective, given that the BP-Rosneft deal was strongly backed by both Prime Minister Putin and his deputy Igor Sechin. Numerous times in the WikiLeaks documents from 2008, American and other officials mentioned that Russia’s government apparently did not understand the ramifications of the AAR consortium

46 Ibid.
47 “Insider Views of TNK-BP Dispute.”
49 Ibid.
relying on state institutions to fight its personal battles, something that contradicted President Medvedev’s statements regarding the reduction of official corruption both at home and abroad.

Although the Russian government pretends to be unaware of corporate intrigue, it assumes a frontline position on energy matters. Because of its abundant natural resources, Russia is able to wield immense influence and pressure on Europe and Central Asia in terms of extraction, transport, and supply. For the European Union (EU), oil constitutes thirty percent of imports, while natural gas constitutes fifty percent.\textsuperscript{50} At a June 1994 briefing in Washington, D.C. on trade in the NIS (Newly Independent States), one of three panel members was the director of international affairs for Chevron Overseas Petroleum. Sharing his experiences working for Chevron in Kazakhstan, he observed that under Soviet rule “all the logistical systems for oil and gas went through the Russian Republic,” and that there is still “no independent way of getting oil to western markets” from Central Asia without first going through Russia.\textsuperscript{51} Moreover the situation has not dramatically changed to this day. Zeyno Baran notes that Russia’s stranglehold over the current European energy market is aided in part by supplies funneled from Kazakhstan, Turkmenistan, and Uzbekistan.\textsuperscript{52}

Baran launches several criticisms of EU energy reliance. First, state-owned Gazprom has been heavily networking with several domestic gas distribution networks in Italy, Germany, Austria, and elsewhere. This leads to the concern that Russia can use “foreign energy executives to exert pressure on foreign governments” as a way to obtain favorable negotiating terms.\textsuperscript{53} The

\textsuperscript{51} Ibid.
energy-producing countries in Central Asia depend on Russian exports, making them vulnerable to two major risks — political manipulation and economic extortion.\textsuperscript{54} Several solutions exist; the West should focus on “establishing direct, diversified transport routes to access Caspian gas,” and the EU should actively implement anti-monopoly statutes to break Russia’s dominant grip on the market.\textsuperscript{55} The problem lies in the fact that the Russian government actively works as a lobbying force, pursuing energy transport deals with countries like Bulgaria and Hungary and pushing the Central Asian nations closer to its sphere of power.\textsuperscript{56} Yet others find themselves trapped by Russian energy terms, simply because the country is “the European Union’s primary oil and gas provider,” and therefore, the EU is the dependent party.\textsuperscript{57} Clearly, the Russian energy complex is a government vehicle that has been for some time in the business of implementing pivotal foreign policy and successfully influencing billion-dollar business deals.

After the collapse of the Soviet Union, Russia was no longer the superpower the world once feared. Economic troubles, ethnic movements, and mass emigration dictated Russia’s political and business landscape for the next two decades. Several side effects of the transition to capitalism were the rise of the protection industry, widespread corruption in law enforcement, and mass center-periphery divergence. Reforms made during the Putin administration centered on the consolidation of power within the country’s administrative units, simultaneously transforming various energy firms into a state-controlled operation. These factors created roadblocks for creating a transparent business environment and stable legal framework, and continue to do so today. The immense tension surrounding BP operations within Russia has

\textsuperscript{54} Baran, “EU Energy Security,” 133.
\textsuperscript{55} Ibid., 143.
\textsuperscript{56} Ibid., 137.
\textsuperscript{57} Ibid., 131.
further highlighted the institutional weaknesses that limit Russia’s potential to build a more democratic society.
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“Predsedatel’ Pravitel’stva Rossiiskoi Federatsii V.V. Putin prinial uchastie v zasedanii general’novo soveta Obshcherossiiskoi obshchestvennoi organizatsii ‘Delovaia Rossia.’”


Kathryn Stoner-Weiss, Resisting the State: Reform and Retrenchment in Post-Soviet Russia (New York: Cambridge University Press, 2006), 38.


