The dramatic arrest 18 months ago of Mikhail Khodorkovsky is turning into modern Russia’s equivalent of the Dreyfus affair – a scandal that briefly illuminates and brings to a head normally half-hidden contests over power and principle. The indefinite detention of Khodorkovsky, formerly Russia’s richest man, and the effective renationalization without compensation of the bulk of his Yukos oil company – worth nearly US$ 40bn at its peak in mid-2003 – marks the ascendancy of the former secret police or “siloviki,” whom President Putin has appointed to jobs throughout the government. They believe that regaining state control over the country’s vast natural resources to create a stronger central state is a prize big enough to justify destroying Russia’s most efficient private oil company and damaging the country’s reputation with western investors. In the minds of the siloviki, oil has replaced military power as Russia’s most powerful foreign policy instrument – “super-Gazprom,” the planned state holding company for oil and gas assets, is, in effect, the new Red army.

Not even the most reactionary silovik wants a return to the autarkic economic policy of Soviet times. Their aim is limited to control over what the British Labour party used to call “the commanding heights of the economy.” But Yuri Trutnev, the natural resources minister, has made clear that this means not just oil and its infrastructure but also other minerals and natural resources. Shortly after Trutnev’s statement in February, the French company Total announced that it was rethinking its oil investment plans and BHP Billiton, one of the world’s largest mining companies, declared that Russia was “immature” as a place in which to invest safely.

Natural resources remain the bedrock of the Russian economy. The risk is that scaring foreigners off from big energy and resource investments will not only cut the growth potential and efficiency of the oil, gas, and extractive industries, but also deter investment in other sectors (retail banking, property development, and consumer goods) – investment which is important to diversify the economy and create jobs.

Some Kremlin officials have tried to reassure western business leaders that Yukos is a special case. But at a minimum, the lesson of Yukos is that western oil and mining companies can no longer take controlling stakes in Russian resource companies, or even create further joint ventures such as TNK-BP, the 50-50 joint venture between BP and the Tyumen Oil Company in which BP invested over US$ 7bn two years ago. But if western companies are not happy buying powerless minority stakes, such as ConocoPhillips’ recent US$ 1.98bn payment for the government’s 7.6 per cent stake in Lukoil, so be it, say the siloviki. State-owned oil companies in India, China, and elsewhere are clamouring
to secure Russian oil and reduce dependence on the Middle East, and will invest on Russian terms.

To prove the point, China’s national oil company recently agreed to pay US$ 6bn in advance for 48m tonnes of oil to be delivered over the next five years, while in February the Indian energy minister was in Moscow for talks about acquiring minority equity stakes in Russian oil companies.

What happens next depends on the ability of the siloviki to restrain their rivalries and pursue their policies in the face of mounting western concern and, more importantly, growing signs of domestic unrest.

Vladimir Putin has never disguised his intention to build a modified version of the authoritarian, centralized Russian state under which Russians have been governed, mostly badly, for six centuries. Nor has he ever tried to deny his impeccably Soviet credentials as the grandson of Lenin’s and Stalin’s trusted cook and as a loyal, albeit junior, former KGB officer and party member.

When the Soviet Union collapsed and the Communist party with it, Putin did not try to defend them. He merely took off his uniform and put his party card back in the drawer. He admits that the Soviet system did not work, but still calls its collapse a tragedy. He is probably closer to the thoughts and feelings of ordinary people than any other Russian leader in history. He has touched a deep chord by refusing to reject a Soviet past whose horrors and triumphs were shared by four generations.

He has accompanied the partial resurrection of the Soviet era with the selective embrace of older symbols from czarist times. He has restored the stirring Soviet anthem, albeit with different words, and has returned the red flag, minus hammer and sickle, to the Russian army. But he also attends major religious services at the side of the patriarch, restoring earlier links between the state and the Orthodox church. And has recreated something like the czarist system of appointing governors-general in the provinces.

Putin’s strategy for rebuilding Russia, restoring national pride, and ending the excesses of the chaotic transition years has been popular and successful, and ensured his huge re-election majority in 2004. His first term brought an end to bitter years of poverty and humiliation for millions of people. Ordinary Russians had been bewildered by the collapse of old certainties as the Soviet welfare state ran out of funds and the ubiquitous military factories shut their gates. A few oligarchs became super-rich and a new middle class grew up – but millions died of drink and despair or slipped into humiliating poverty.

The lowest point was in mid-August 1998 when the post-Soviet bubble burst: the government was forced to default on billions of dollars of foreign debt, the banks closed their doors, and the rouble lost 70 per cent of its value in a few weeks. But it is always darkest before the dawn. Painful as it was, devaluation turned out to be a blessing. Imports became unaffordable overnight, and business responded by investing in domestic manufacturing – from mineral water and fruit juices to office furniture and fridges. Soviet car plants received a new lease of life as customers flocked back to cheap Fiat Ladas, face-lifted Volgas, and Kamaz trucks.
As real wages fell, so did production costs – including the costs of mining ores and producing oil and gas. And at precisely this moment, world energy prices, stimulated by rapid economic growth in China and India, began the steady increase that has transformed the prospects and tax revenues of oil producers around the world. None benefited so spectacularly as Russia, where a great deal of spare capacity was available to bring into production.

The combination of low costs and rising export prices spurred frantic restructuring and heavy investment by Yukos and the other private companies which had gained control over Russia’s potentially most lucrative oilfields in the controversial “loans for shares” privatization of 1995-96 and subsequent privatization auctions. Companies such as Yukos, Lukoil, Sibneft, and Surgutneftegaz hired western contractors, who applied western technology and management methods to cut waste and pollution. Production started to rise after a decade of decline.

Oil was not the only beneficiary of higher world prices. Gas prices linked to oil also rose, along with those of other raw materials and semi-processed products, such as steel, titanium, nickel, gold, and platinum. As world-class suppliers of all these products, Russia has been the main beneficiary from the spectacular shift in the terms of trade of the past seven years.

It was Vladimir Putin’s good fortune to win the presidency for the first time in March 2000, just as the Russian economy was beginning a powerful recovery. With his quintessentially Russian looks, virile image, and domestic policies finely attuned to the values of Ivan Ivanovich, the Russian man in the street, Putin’s popularity soared. For the first time in years, millions of state employees and pensioners received the money they were owed. It was a welcome contrast to the Yeltsin years when a bankrupt state was unable to pay its workers while the “novi Russki” swished past in imported limousines and caroused in restaurants and nightclubs.

In his first term, Putin was cautious. As Yegor Gaidar, prime minister and main economic guru of the early transition, recently explained in London, this was partly because Russian policymakers were desperate not to make any more mistakes after the 1998 fiasco. During this period Kremlin power was also subject to several restraints. Putin had to accommodate powerful, elected regional governors and big city mayors. The Duma was still lively and political debate fairly open, despite obsequious television news coverage. And foreign creditors and international financial institutions such as the IMF and the EBRD kept a close eye on economic policy. This is no longer the case now that Russia is flush with foreign reserves and has paid back all its IMF loans. Most of the other checks and balances have also been weakened.

In retrospect, “Khodor’s” arrest marked the end of the first, largely positive phase of the Putin regime and the beginning of a new phase in which fear returned to Russian politics. The significance of the change was underlined by the resignation of Alexander Voloshin in protest against Khodorkovsky’s arrest and the aggressively nationalist policy turn.

Voloshin was a wily strategist who ran the Kremlin administration – which has replaced the communist politburo as the top policymaking and coordinating body. After Voloshin’s departure, Putin took the opportunity to replace several other competent and
experienced figures from the Yeltsin era and replace them with men personally loyal to him, often from St. Petersburg, his home town, and usually with a similar KGB background and little experience of either business or the world beyond Russia’s borders.

Along with Voloshin, another senior “holdover” was Mikhail Kasyanov, the fluent English-speaking former foreign debt negotiator who was made prime minister when Putin became president. Under Kasyanov, significant tax and other reforms were pushed through and higher tax revenues and rising foreign currency income were prudently used to repay foreign debt and build up reserves. The stock exchange watchdog was given sharper teeth to attack insider trading, judges were trained better and paid more to discourage corruption, and corporate governance improved – following the example set by big companies like Yukos.

Churchill described Kremlin politics as a dogfight under a carpet. In this case Dmitri Medvedev, a Putin loyalist from St. Petersburg, emerged as the winner to replace Voloshin. And in February 2004, three weeks before the presidential election, Kasyanov was replaced as prime minister by Mikhail Fradkov, a colourless apparatchik.

The Yukos saga revealed the limited experience and provincial outlook of the people appointed by Putin. In a bitter outburst which revealed deep divisions within the political elite, Andrei Illarionov, Putin’s main economic adviser before he fell foul of Kremlin palace intrigue, expressed the contempt that the professionals, reformers, and democrats felt for the siloviki. The Bolsheviks were back in charge, Illarionov raged at the end of last year. They were undermining confidence in the rule of law and the protection of property rights and returning Russia to the third world, he said. He went on to denounce the “monstrously unqualified and unprofessional people” who were destroying Yukos and replacing efficient private oil companies with a giant state-controlled oil and gas corporation.

But this was more about politics than inexperience. To Putin, the oligarchs represented an uncomfortable new pluralism and their financial independence made them a potential threat to the Kremlin.

There is no question that the early post-Soviet privatizations were carried out in a very opaque and often violent manner or that Yukos, in common with most other Russian companies, pulled every trick in the book to minimize tax payments, including buying Duma deputies and judges to influence legislation or judgements.

No one ever claimed that Khodorkovsky was a saint, least of all Khodorkovsky himself. But there is no evidence that he behaved worse than any other beneficiary of the sale of state-owned assets. This process took place on an unprecedented scale, at unheard-of speed, amid political and legal confusion. It was bound to be messy.

Khodorkovsky was the third oligarch to be crushed by Putin (after Vladimir Gusinsky and Boris Berezovsky). His offence was to criticize Putin to his face on live, nationwide television, and to finance political groups and parties. He even talked about becoming a politician himself.
Khodorkovsky was jailed not because he was rich, not even for the way he became rich – although his wealth was of course envied by many - but because of the way he declared his intention to use the power and independence which wealth gave him. By mid-2003, this promised to become even greater on completion of a planned merger with Sibneft, the oil company formerly controlled by Berezovsky and subsequently passed to Roman Abramovich.

Once the YukSib merger was consummated, Khodorkovsky intended to sell a minority stake in the merged company to a US-based oil major. He was negotiating with ExxonMobil and ChevronTexaco at the time of his arrest. The prospect of an independently wealthy Khodorkovsky – with powerful minority shareholders in Houston and direct access to politicians and power brokers in Washington – alarmed Putin and the siloviki.

Such a man would have been able to offer Russians an alternative to the strong state offered by Putin, whose “guided democracy” respects the form but ignores much of the substance of representative government: multiple power centres, free press, and the rule of law. This is not to say that Putin is a tyrant in the Stalin mode. Russia needed a period of consolidation after the Yeltsin years of semi-anarchy, and for most Russians everyday life has improved.

But the arrest of Khodorkovsky, and the manner in which Yukos shareholders were robbed of their assets – over alleged tax irregularities – in a campaign orchestrated by the top of the Kremlin power structure, has sent a message right through Russian society. In particular it has sent exactly the wrong signal to a bureaucracy only too ready to use the Kremlin’s example to bend rules in its own interest.

In the Yukos case, the state itself not only violated the property rights of shareholders, but acted contrary to international rules and practice enshrined in agreements signed by the government. These acts call into question Russia’s suitability for G8 membership and could even threaten its stated aim of joining the World Trade Organization. Although at the recent Bratislava summit, President Bush accompanied clear criticism of Putin’s democracy deficit with continuing support for WTO membership: it is still seen by the US as a means of tying an unpredictable Russia into a web of international agreements.

One of the most disturbing elements of the whole Yukos affair is that it has been accompanied by a barrage of lies from senior officials, including Putin himself, who for 18 months denied any intention of bankrupting Yukos. When he did finally comment, during a visit to Germany, he airily dismissed further questions by saying that what had happened was legal in Russia, and moreover an internal affair. Quite so, murmured his host Gerhard Schröder, the German chancellor, who had just sold him 60 shiny new high-speed trains for use on the Moscow-St. Petersburg line.

The Kremlin’s plan for a “super-Gazprom,” incorporating the Yukos oil assets, is central to its “commanding heights” strategy. It reflects close study of the way other oil-rich states such as Saudi Arabia, Malaysia, and even Kazakhstan have retained national ownership of natural resources and imposed increasingly onerous terms on foreign oil companies. The Kremlin’s plan for a huge, bureaucratic state oil and gas corporation is far removed from Khodorkovsky’s vision of Yukos as a world-class, transparent, publicly quoted oil company, working for profit, and willing and able to forge close links with the global oil
The Kremlin’s original plan for a powerful state oil and gas corporation involved merging Gazprom, the world’s biggest gas company, with Rosneft, a relatively small state-owned oil company. This asset swap would raise the state’s stake in Gazprom from 38 to a controlling 50 per cent plus one share. At that point Putin promised foreign investors he would abolish restrictions on foreigners buying shares in it.

But this plan was complicated by the state’s confiscation of Yuganskneftegaz, or “Yugansk,” the main Yukos subsidiary, which produces well over 1m barrels of oil a day. (State-owned Rosneft bought Baikal finance group in December 2004, which in turn had bought Yugansk in an enforced auction.) Alexey Miller, whom Putin installed as head of Gazprom four years ago to clean up the corrupt and inefficient company, planned to absorb Yugansk and Rosneft into a new Gazprom-owned oil subsidiary, Gazpromneft. But this plan was stymied before Christmas when Yukos filed for bankruptcy protection in a court in Houston, Texas, and threatened lawsuits against anyone who tried to profit from what its lawyers called “stolen assets.”

The Houston case created panic in the Kremlin, which subsided at the end of February when the US court ruled that a solution had to be found which involved the Russian government and courts. But the relief was short-lived, because the ruling sparked off open warfare between Gazprom and Rosneft over division of the Yukos spoils: Gazprom wanted to acquire the Yukos assets, Rosneft wanted to hang on to them. A few days after the dismissal of the Yukos case, Miller appeared on television to announce the merger between Gazprom and Rosneft. But the next day, senior Rosneft officials denied a deal had been done and made clear their intention to retain control of Rosneft’s assets which, with Yugansk, would become Russia’s third biggest oil company.

In this way the dogfight moved from under the Kremlin carpet to the public gaze, an embarrassment for Putin who was exposed as being unable to control a power struggle between two rival groups of siloviki – one headed by Dmitri Medvedev, Kremlin chief of staff, who also chairs Gazprom; the other led by Igor Sechin, the deputy chief of staff who doubles as the chairman of Rosneft.

The Kremlin had no need to renationalize Yukos in order to control it or, indeed, to benefit from its efficiency. Thanks to the private companies, Russian oil production has risen nearly 50 per cent since 1999, reversing a decade of decline. In addition, the windfall oil tax allows the state to take 90 per cent of export revenues over $25 a barrel. Yukos was certainly far more efficient than Gazprom, which is a byword for corruption, insider dealing, and poor management despite Putin’s efforts to replace many of the former Soviet managers.

Forecasts of slower oil production growth show that it is no longer safe to assume, as the EU and to a lesser extent the US government have done, that the Russian energy sector will continue to deliver rapid and reliable increases in oil and gas production in the years ahead. This is not good news for Britain, which is planning to replace declining North sea oil and gas production partly with Russian sources. The EU is already heavily dependent on Russian energy and is planning new pipelines which will increase that dependency. A more prudent policy might be to press ahead with other energy projects, including the
proposed Nabucco gas pipeline from the Caspian Sea region through Turkey and Bulgaria and the projected Burgas-Vlore oil pipeline. Both projects take advantage of EU expansion to the Balkans and provide new outlets for both Russian and Caspian oil, which do not cross Russian territory.

Before his arrest, Khodorkovsky talked about helping to build a more modern Russia with greater emphasis on private property rights, the rule of law, a free press, and a dynamic civic society. In practice, the Khodorkovsky state would have been concerned in part with making Russia safe for oligarchs. But he proposed to take Russia in a much more promising direction than it has been heading over the last 18 months.

Russia’s Dreyfus affair has not yet reached its conclusion and it is not clear how deep or lasting the damage will be. Economically, there is some evidence that the commercial rule of law is becoming more rather than less secure at local level, away from the “commanding heights.” That was at least true before the Yukos affair contaminated the atmosphere. But even since Yukos there have been some big international deals that suggest that natural resources might, indeed, be a special case. Earlier this year Sistema, a leading Russian telecommunications company, raised US$ 1.6bn on the London stock exchange. It was the largest public offering in London for three years. It went ahead, despite the Yukos experience, because Sistema was able to present clear and transparent accounts and proof of adherence to world-class corporate governance standards. Jean Lemierre, president of the EBRD, noted recently in an interview with the Herald Tribune that: “The Yukos case has not discouraged investors from investing, but it has made them very sensitive to the risk.”

Politically, too, the situation may be becoming more fluid. Recent months have seen growing signs that the Kremlin has provoked a new spirit of resistance to creeping authoritarianism, through its rough handling of Yukos, its botched introduction of welfare reforms, the bloody outcome of the Beslan school siege, the clampdown on civil and political liberties, the mendacity of the electronic media, and the humiliating outcome of interference in the Ukrainian presidential elections. Having gathered so much power into their own hands, Putin and his friends are now being blamed for almost everything that goes wrong. The latest signs of open warfare in the Kremlin over control of the Yugansk assets indicate that the future course of Russian politics is more open than it seemed even three months ago.

Opposition politicians and other critics are again starting to raise their heads above the parapet. Mikhail Kasyanov is being talked about as a possible challenger in the 2008 presidential election. And civil society is also starting to stir. Russia is not Ukraine, but 13 years after the collapse of the Soviet Union it is no longer an inert mass either. Russians have wider experience of the outside world and a new middle class is emerging. The combination of Yukos and Ukraine might be the spark needed to overcome the recent climate of fear and reawaken a more open debate over the future of Russia’s society and economy. A bumpy, unpredictable ride lies ahead.

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