Mutual Predators: An Examination of Russia’s Oil, Gas, and Nuclear Sectors in the Post-Soviet Era

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Mutual Predators:
An Examination of Russia’s Oil, Gas, and Nuclear Sectors in the Post-Soviet Era

by

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Abstract

Russia’s energy sector has changed dramatically over the past three decades and this study examines this change within the oil, gas, and nuclear sectors. Having inherited a state capitalist system after the fall of the Soviet Union, Russia’s bureaucracy now presides over an incredibly rich and deeply problematic energy economy. At its core, this is a study on institutionalized corruption and the behaviour of corrupt elites. More specifically, it examines whether Russia can succeed within this context and what this may teach us on the nature of corrupt states and institutions.
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Dedication

For Paulina
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“There who fight corruption must be crystal clean themselves, otherwise they just engage in political self-promotion”

– Vladimir Putin, April 25, 2013
Chapter One: Introduction

1.1 Introductory Remarks

Corruption and economic development can coexist: emerging economies like China, Indonesia, South Korea, and Brazil have all demonstrated this reality. Whether by accident or design, the political-economic fabric of many successful states has been such that tremendous growth has occurred in spite of the multitude of those who make careers out of what essentially amounts to theft. However, there are many other states in the world where corruption has been a significant factor in their economic undoing. Unfortunately, the Russian Federation falls into this latter category. With immense human, technological, and mineral resources available, Russia’s tremendously important energy export sector is failing despite these advantages. This study asks why this is happening, and argues that pervasive corruption, and the relationship between the energy sector and the state bureaucracy, provide important answers to this question.

In 2009 Russia’s economy contracted by 7.9% as a result of the global financial crisis (Bogetec, March 30, 2010) and since then, growth has been quite slow. As of March 2014, the World Bank is projecting that Russia’s economy could even contract once more, by 1.8%, citing among other issues ongoing tensions with the West over Ukraine (Deutsche Welle, March 26, 2014). In September 2013 Standard and Poor also made poor economic growth projections, citing low global demand and deep structural problems within the hydrocarbon sectors as key factors (Standard and Poor, September 25, 2013). With the country heavily dependent on oil and gas exports for growth and budgetary expenditures, the prospects are grim for Russia overcoming this economic slowdown after a decade of sustained economic growth.

Though Russia is certainly a major supplier in the world energy market, it is much more dependent on the world than vice versa. According to the United States Energy Information
Administration, revenue from the oil and gas industries accounts for 70% of the country’s $515 billion export revenue and 52% of the annual budget (Hargreaves, March 3, 2014). Furthermore, commodity prices have not rebounded from the 2008-2009 global financial crisis and this has put a tremendous strain on the federal budget: according to a recent report, the federal budget will face a shortfall of roughly $302.5 billion to finance budgetary commitments in the period 2017-2020 (Ria Novosti, May 12, 2013). Though Russia has a low sovereign debt and nearly $500 billion in foreign currency reserves, the aforementioned systemic issues will weigh heavily on Russia’s federal expenditures and economy over time (Kliment, March 31, 2014). These factors, combined with a regime dependent on the support of a public that is heavily reliant on increased social benefits, could be costly to the stability of the Federation as a whole.

While prospects for oil and gas appear grim in the short term, it appears the state is now turning to export of nuclear technology and the possible export of electricity generated from future domestic production as alternatives. The potential for such an endeavour could certainly be lucrative, if executed correctly. After years of stagnation in the post-Soviet era, Russia is now re-emerging as a major supplier of nuclear technology to the global market. In 2011 the state-owned nuclear conglomerate, Rosatom, saw orders rise by 30%, and in 2012 reported that it signed orders amounting to $66.5 billion over a ten-year period, aiming for an increase to $72 billion in 2013 (Tanter, 2013). The reach of Rosatom is extensive. With deals signed with countries like Turkey, Iran, Vietnam, India, and the People’s Republic of China, and many more states expressing interest, Russia is poised to become perhaps the most important player in the global sale of nuclear technology. However, there are serious doubts as to whether Rosatom can meet the technological, regulatory, safety, and transparency requirements of a post-Fukashima world. Furthermore, there is evidence that suggests that the culture of corruption and
inefficiency: if true, these startling claims could lead to Rosatom’s endeavours costing more than they are worth in terms of financial and potentially human losses.

Russia’s economic faltering could have serious consequences for the global community. When one considers that Russia is currently the world’s largest exporter of oil and gas, yet is now struggling to derive profit from these industries, there are conceivable threats to the global supply chain in this regard. Furthermore, as Russia emerges as a dominant exporter of nuclear energy technology, a number of disturbing reports regarding the safety of the equipment and materiel involved indicates the real threat of radioactive contamination in many places around the world. Finally, there are some who argue that, as the Putin regime faces economic hardship, it will turn increasingly toward an aggressive foreign policy to shore up support among its people. Writing for Foreign Affairs, Alexander Kliment argues that “the president has abandoned economic justifications for his rule and adopted reactionary conservatism” (Kliment, March 31, 2014). Surgei Guriev, a Russian economist and himself a victim of repressive behaviour from the Kremlin, argues that corruption is the primary destructive force in Russia’s economy. He further argues that a long economic downturn will result in a more repressive state and “a more aggressive foreign policy to which Western leaders are now struggling to respond” (Guriev, April 2, 2014). With a large military force, repressive state apparatus, and increasingly aggressive foreign policy positions, Russia’s future role in global politics should be cause for alarm. When one considers that Russia’s energy exports and economic faltering may be key drivers of this change, the topic of this study is of great interest to many.

1.2 Argument of the Study

Over time, similar patterns of corruption and inefficiency have evolved in the oil, gas, and nuclear sectors and this has, and will continue to have, a strong effect on Russia’s politics, economy, and foreign policy. It is the argument of this study that actors within Russia’s
bureaucracy have effectively ‘colonized’ the energy sector and are now profiting greatly at the expense of their state owned corporations and the state itself. This is unique in that they are technically in the employ of the state and their own power has stemmed from the use of state power; however, it is also clear that they act with a high degree of autonomy, and evidence suggests the widespread abuse of this power. With these cases we find a move from the state being the primary predator on the business sector to the state-owned corporations acting with autonomy and preying on the state. In this sense, these actors are comprised of elements of both the state and business sectors, and the ultimate outcome is one that is far from optimal economically.

This possible underlying factors behind this ‘colonization’ are beyond the scope of this study; however, it is possible that the Putin government played a significant role in this process. Because these actors function with relative autonomy, it can be said that for all intents and purposes, they constitute a ‘business sector’. I argue this is because the Putin reforms simply supplanted some of the old elite from the 1990s while empowering new ones to seek high rents from these industries, in numerous forms, to the detriment of optimal overall economic output. Furthermore, by supplanting the so-called ‘oligarchs’ in the oil industry, Putin’s reforms have come at the expense of developing any kind of situation wherein economic optimization is even possible under the current conditions.

I intend to demonstrate that Russia’s current economic system leads to the accumulation of personal wealth for state and business leaders in the oil and gas sectors at the expense of the investment in efficiency and productivity needed to meet the challenge of sustaining and growing Russia’s oil and gas export volume. With regard to the nuclear sector, I intend to demonstrate that Rosatom functions in a way that is very much akin to firms in the hydrocarbon
sector: seeking rents with impunity at the expense of efficiency and profitability. I also argue that while this may be a source of export revenue for the firm itself, the costs associated with this revenue for the state will be a heavy burden for the foreseeable future and the risks are considerably high. Moreover, I argue that a culture of corruption and a near-complete lack of oversight within Rosatom could potentially have disastrous results with regard to safety both domestically and among its many projects around the world. Thus with significant potential for disaster and a high cost to the state, the future of Russia’s nuclear export sector is precarious at best.

1.3 Organization of the Study

Following this introductory section, the theoretical framework and methodology employed will be outlined in the following chapter. I do this to familiarize readers with these concepts as a frame of reference to consider throughout the study.

In order to offer the reader the best understanding of the subject matter, the second and third chapters will be devoted to a deep contextual analysis of the sectors in question. Though it would perhaps have been possible to integrate the analysis into these chapters, I have left it distinct in order to allow readers to process this information relative to the concepts introduced in chapter one. This will allow them to follow the narrative in a way that mimics my own analysis of the subject matter in a more critical manner, allowing for their own perceptions of outcomes to be conjured before reading the final chapter of analysis. The final portion of this study will be my own personal conclusions on the subject matter.
Chapter Two: Theoretical Framework and Methodology

The primary theory employed in this study is David Kang’s “Four Types of Corruption”. In *Crony Capitalism: Corruption and Development in South Korea and the Philippines*, he offers a theory that is very useful in analyzing economic outlooks for developing states where corruption is a primary aspect of the political-economic structure. It is a safe assumption, as the contextual chapters will demonstrate that Russia, despite its former Soviet status, very much fits the profile of a “crony capitalist” state. This is not to say that Russia falls perfectly within Kang’s matrix: as we will see, developments in Russia over the past three decades offer new insights into the nature of crony capitalism. The framework for Kang’s theory is best summarized in Figure 1:
2.1 Definition and Contextualization of Terms

The differences between terms used in the study require necessary distinction. Before delving into specific definitions, it is necessary to demonstrate the subtle and frequently interconnected relationship between the terms ‘corruption’ and ‘rent seeking’: the former being technically illegal and the latter being often illegal, but sometimes legal in spite of the unnecessary reaping of wealth by individual actors. In this sense, rent-seeking behaviour may be openly engaged in, while corruption itself tends to be hidden from the public.

---

1 Prisoner’s Dilemma
An example of this subtle but often interconnected difference would be the gross overpayment of a construction firm for a project of questionable value. The firm that receives the payment is engaging in rent seeking that is technically legal whereas the executive that ordered the project who received a ‘kickback’ (payment) from the firm in exchange for ordering the project is engaging in rent seeking that is illegal, which is then corruption. In this case, both actors have engaged in rent seeking, but the corrupt rent seeking is hidden from the public whereas the overpayment itself is conducted openly. Most importantly, however, both examples are damaging to the viability of the firm from which the rents are being taken.

2.2 Crony Capitalism

‘Crony capitalism’ can be reasonably defined as those in positions of power within the state giving preferential treatment in the form of capital assets or money to friends and/or associates, regardless of their qualifications or managerial acumen in what is at least nominally a market economy. This understanding will be employed later when examining the evolution of Russia’s political economy during the Soviet and Post-Soviet eras.

I argue that the Russian economic system, as a successor the Soviet Union, very much lends itself to cronyism. The roots of this, which will be explored in greater depth in the following chapters, are found in Lenin’s post-revolutionary ‘New Economic Policy’. The objective of the system was to harness the industrial power of capitalism and apply it to a socialist context, essentially to expedite the capitalist stage of Marxist theory. In order to achieve this, the state economy would be managed by a powerful bureaucracy that would essentially serve a role akin to that of industrial magnates in the West, albeit under the direct purview of the state and functioning (at least nominally) in the interests of the working class. He explicitly refers to this system as “state capitalism” (Lenin, 1921) and, as we will see, the placement of
individuals in highly-coveted bureaucratic positions that hold sway over substantial portions of the economy tends to lend itself to patronage and cronyism.

Corruption

Kang writes, “At the heart of this model is the idea that those with excessive power tend to abuse it”. Terry Lynn Karl notes that

Though often used interchangeably with rent seeking, corruption is more narrowly defined as the misuse of public power or resources for private gain, and it is generally illegal (Karl, 2004, p. 661).

Kang further writes, “Were there no government distributing rents, there would be no corruption, and thus a key issue is how to model the government-business relationship.” Kang’s model offers a scenario wherein the misuse of power or resources through rent seeking need not necessarily detract from economic development.

2.3 Rent and Rent-Seeking Behaviour

Rent-seeking behaviour is the central component of Kang’s theoretical model. The diagram notes that though rent-seeking behaviour is found in each of the four categories, it is those states in which rents are large that prove to be at the greatest disadvantage in terms of economic development. For this reason, it is necessary to define a ‘rent’.

Adam Smith’s classical definition of rent, which in 1776 referred primarily to land use, is:

Whatever part of the produce, or, what is the same thing, whatever part of its price is over and above this share, he (the landowner) naturally endeavours to reserve to himself the rent of his land, which is evidently the highest the tenant can afford to pay in the actual circumstances of the land (Smith 1:3, my emphasis)
It is from this early understanding that we conceptualize rent as that which is paid above market value. Kang draws on James Buchanan’s *Towards a theory of the Rent-Seeking Society*, who more broadly defines “rent-seeking” as “that part of the payment to an owner of resources over and above that which those resource could command in any alternative use.” Terry Lynn Karl describes this behaviour as “the efforts, both legal and illegal, to acquire access to or control over opportunities for earning rents” (Karl, 2004, p. 661). Kang adds to the definition by stating:

Rents are created when an actor manipulates prices and causes them to diverge from competitive levels, and the existence of rents can lead to corruption by various actors attempting to gain access to the rents. By manipulating prices, the actor himself, or some other actor on whose behalf the price manipulator is acting as an agent is able to reap ‘excess profits’ (Kang, 2000, p. 12)

Kang also notes that the primary way in which rents are created is through state intervention. He argues that “the distribution and volume of rents are thus a function of the relative strengths of the state and business sector” (Kang, 2000, pp. 12-13). An example of this that relates to this study is tariff prices on oil and gas pipelines, the prices of which are set by the state and collected by the firms that control the pipelines. For the purposes of this study these three definitions of ‘rent-seeking’ will be synthesized and understood as follows:

The efforts of individual actors to access the ability to extract payment (rent) from a transaction that is over and above its market value, primarily for the purposes of personal gain. This is primarily achieved through access to state power.

In figure 1.1, the instances where rents are at their highest occur when either the state or the business sector has primacy over the other. In cell II, labeled “Rent-Seeking”, a strong business sector is able to exact large rents from the state. The example Kang offers is the
democratic post-independence era in the Philippines. In this instance he argues that powerful business elites effectively “colonized” the state structure, demanding large rents at the expense of the efficiency of their own business, as long-term investment in their productivity would detract from the money earned in the short term that was gained by doing very little (rents). Cell III, labeled “Predatory State,” offers an alternative instance in which rents may be large: where a powerful state has primacy over a weak and dispersed business sector. Kang uses the Philippines under the Marcos era to exemplify this scenario: the power of the state was employed to damage or even destroy rival families, and allowed state actors to demand large sums of money from the business sector. Thus money that could have been used by businesses to invest in their efficiency and productivity was alternatively used to enrich Marcos loyalists, as well as adding to Imelda Marcos’ substantial shoe collection. In each of the two scenarios, the development and prosperity of the country as a whole suffers.

Cells IV and I offer scenarios in which rents are reduced by the relative equality of power between the state and business sectors. In cell IV, Kang argues that corruption and rent seeking are at their lowest when the power of the state and of business interests are equally weak. In this instance neither set of actors has the power to demand much from the other, and thus rents are “all but eliminated”. He further claims that many of the advanced industrial economies of the world “approximate this situation” (Kang, 2000, p. 17). With the evidence that I will provide in the following chapters, we can reasonably exclude Russia from falling into this category.

Kang argues that the situation found in Cell I, titled “Mutual Hostages,” is the ideal scenario for economic optimization under the circumstances of crony capitalism. In this instance, the state and business sector are equally powerful, and thus a ‘prisoner’s dilemma’ arises wherein each group has the equal ability to harm the other. Here, he states “although in the short
run either actor may be better off by defecting and gaining all the rents, the other actor retains the ability to punish defection over time, and thus a grudging cooperation may ensue” (Kang, 2002, p. 18). The rents exacted in this scenario are medium in size as the power of the actors involved gives them a limited ability to harm the other, thus necessitating a compromise. Because rents are neither eliminated (as in in cell IV) nor maximized (as in cells II and III), it is in the interest of all parties involved to increase the amount of attention paid to economic development as this ensures a more frequent occurrence of transactions from which one side may exact rent from the other.

2.4 Methodological Approach

The focus of this study is not simply on Russia’s oil, gas, and nuclear sectors individually, but rather how they fit into a system as a whole. More specifically, though it is known that the Russian political economy exists within the context of institutionalized corruption, the question is whether this is necessarily a hindrance to economic performance. Oil and gas are of primary importance to the Russian economy as it provides much of the revenue the state requires for the annual budget expenditures that have partially led the public to support the Putin administration. Furthermore with revenues from oil and gas down, the state’s ability to capitalize on the emerging nuclear energy market is one of the modes in which this lost revenue my be recovered. Most importantly, each sector functions within the prevailing political and economic trends of the time and the parallels and differences ascertained from examining them separately will offer a stronger understanding of the Russian state as a whole.

Though Kang’s matrix offers an excellent framework in examining how the state interacts with economic institutions, it falls short with regard to how these institutions function internally. For this reason, it is also necessary to draw on additional literature on corruption as a complement to Kang’s theoretical framework.
Kang admits that there is a polarity to his model and that it “necessarily abstracts from a rich reality” (Kang, 2002, p. 13). Because this study examines not the business sector as a whole, but rather sub-sectors within, it is possible that the relative power of the state may be strong in relation to one sub-sector while weak in relative to another. For this reason, it is necessary to examine the state-business dynamic with each of the sub-sectors in question in order to fully grasp the situation as a whole.

Testing these relationships will require the examination of two factors:

I) Are the state institutions, relative to the sub-sector in question, coherent and strong or fragmented and weak?

II) Is the business sub-sector in question one that is relatively strong (concentrated) or weak (dispersed)?

Testing these two factors first requires examining the contextual overview of the sub-sectors in question. Determining the state’s goals is a fairly simple in that there have been numerous pronouncements from the political elite on the matter. Furthermore, there is a considerable amount of peer-reviewed literature that provides considerable insight into Vladimir Putin’s economic philosophy and goals for the country based on excerpts from his PhD thesis and subsequent article concerning management of the state’s mineral resources. From these sources, we will be able to derive an understanding of the state’s goals in relation to the focus areas of this study.

For the purposes of this study, the business sector may be purely characterized as those firms and actors that compromise the private sector: that which is not owned by the state. With regard to state-owned corporations, the definition becomes somewhat more difficult. Though they are considered arms of the state for the purposes of this study, it is important to note that they have
adopted a corporate structure, comprise a very large portion of Russia’s economy, and are run with varying degrees of autonomy. Thus they will be considered part of the state, but the fact they comprise a kind of quasi-business sector is also worth noting.

There is much literature offering strong evidence of the state’s ability to enforce its goals relative to the performance potential of each sub-sector. An institution that flouts state goals in the pursuit of other interests (especially in the pursuit of rents) is a strong indicator that that institution has an advantageous position over the state. Conversely, if an institution has rents exacted from it by the state, possibly at the expense of its productivity, which is indicative of an advantageous position of the state in this regard.

An indicator of state coherence is the ability of its actors to function toward a specified goal. To put this more simply for the purposes of this study, a state wherein political and economic elites within state institutions do not act toward common goals is a strong indicator of state incoherence. Kang argues that for the business sector, the power of associations capable of lobbying for collective interests is a key to determining its cohesion (Kang, 2002 p. 137). For the purposes of this study, we will examine both the formal and informal ways in which the private business sector associates to articulate and lobby for its interests.

The second criterion to test is the state of investment in relation to the firms involved, as this is a primary way in which rents are reaped. Though Kang’s work does an excellent job of examining money politics and state institutions, his work does little to examine rent seeking behaviour from the side of corporations and state-owned corporations. Given that these institutions play a key role in Russian corruption, they must be given a substantial amount of attention for the purposes of this study. Terry Lynn Karl notes a common aspect of rent-seeking behaviour within economic institutions is through “megaprojects in which payoffs can be more
easily hidden and the collection of bribes is easier, whereas productive long-term investment remains undersupplied.” (Karl, 2007, p. 19) She also notes that these kinds of projects typically come at the expense of basic infrastructure development and maintenance: these latter have fewer prospects for conferring rents as they utilize large sums of money in multiple small projects over time (Karl, 2004, p. 667).

In the case of the subsectors, an example of this could be continued state investment in new large projects while existing infrastructure is left poorly maintained, or the quality of new projects suffers as a result of the use of inferior quality materials and/or labour. Though it is virtually impossible show direct rent payments to individual actors for such projects in most cases, Karl notes that the opacity of financial practices surrounding these projects is usually a strong indicator of corruption (Ibid.). The kind of fraudulent investment associated with these practices is known as ‘value destruction’ to economists and can result in firms’ loss of large amounts of money that is used to line the pockets of associates over time. Because investing in multiple small projects that increase productivity and efficiency while working to meet state goals could pursue small- to medium-sized rents, the systemic neglect of infrastructure maintenance at the expense of large-scale investment projects is a strong indicator that large rents are being conferred and compromises are not being reached between political and business sector actors. In Kang’s example, small- to medium-sized rents based on compromise are characteristic of the optimal ‘mutual hostages’ scenario whereas large rents are indicative of the less optimal “predatory state” and “rent seeking” scenarios.

A final gap in Kang’s matrix that must be examined for the purposes of this study is a tool for examining the opportunities for and size of the rents being conferred within institutions. Though Kang offers the notion of rents being reduced when both parties have the mutual
opportunity to harm the other (Kang, 2002, p. 17), this study requires more in analyzing the behaviour of specific actors and institutions. Alberto Ades and Rafael Di Tella found in examining a number of developing states in the 1980s and 1990s that “natural rents, as in the case of oil, and rents induced by a lack of product market competition foster corruption” (Ades and Di Tella, 1999, p. 183). They further found that in state-owned corporations “less competition means bureaucrats can extract more rents from the firms they control, but it also means that it is more valuable for the public to avoid corruption and, thus, is more likely to control the bureaucrat” (Ibid, p. 991). They argue that this is because less competition results in higher rents, resulting in actors having “higher incentives to engage in malfeasant behavior” (Ibid, p. 982). Thus for Russia, in determining the opportunities for and likely size of the rents being conferred, we must examine two things: 1) the amount of money being put toward projects with a high likelihood of ‘value destruction’ as identified by Karl, and 2) the level of competition in the market that would limit size. Utilizing these tools will not only offer further insight into the cases in question, but will also assist in approximating where Russia may be categorized in Kang’s matrix.

Finally, much of the evidence presented in this study indicates that Russia is experiencing the symptoms of what is known as “the resource curse” and this may help explain the situation in which Russia finds itself today. The volume of work produced on this phenomenon spans over the course of five decades and incorporates a plethora of qualitative, quantitative, and normative research methods. In a 1997 review of *The Paradox of Plenty: Oil Booms and Petro States* by Terry-Lynn Karl, *Natural Resource Abundance and Economic Growth* by Jeffrey Sachs and Andrew M. Warner, and *Winners and Losers: How Sectors Shape the Developmental Prospects of States* by D. Michael Shafer, Michael Ross offers an excellent overview of the work on this
topic from its origins in the 1950s to the late 1990s. The resource curse as a phenomenon and the full depth of its implications are beyond the scope of this study. However, since its inception as an area of study, a number of prominent symptoms have been identified and agreed upon by most scholars in the area. By identifying whether Russia is experiencing these symptoms, coupled by where it falls within Kang’s matrix, this study opens further possibilities for research.

Ross notes that after the Second World War, most economists believed that the resource rich countries of Africa would outperform the resource poor countries of East Asia (Ross, 2012, p. 1); however, history has shown that the opposite has been true. Ross goes on to identify Raul Prebisch and Hans Singer as the first to theorize “that primary commodity exporters would suffer from a decline in the terms of trade, which would widen the gap between the rich industrialized states and the poor resource-exporting states” (Ross, 1997, p. 301). From this seminal moment in understanding, one can see that Russia, a former industrial power moving away from a manufacturing economy to one which is resource based could begin to have issues with regard to development and economic stability.

Ross identifies Hussein Mahdavy as having first identifying that which we know as the “rentier state”, or put more simply a state whose expenditures are heavily reliant on rents levied from resources. Mahdavy notes that elites in these states tend to “devote the greater part of their resources to jealously guarding the status quo” (Ross, 2012, p. 199). Karl writes that a partial determinant as to whether a resource producer becomes a rentier state is institutions. She argues, “if pre-existing institutions are weak or the state only partially formed, the influx of rents from petroleum tends to produce a rentier state”. Upon examination, this study will determine whether Russia fits the profile of such a category.
Institutions are at the focus of this study and there is much from the body of literature on the resource curse phenomenon to offer insight here. The primary contention found within this subfield is whether oil rents do, in fact, weaken state institutions; however, the nuance suggests an agreement on principal. Ross argues that, “in theory, resource wealth should strengthen the state’s leverage over societal actors by giving the state a nontax revenue cushion that can insulate it from interest-group pressures and finance payoffs to government opponents” (Ross, 1997, p. 311). However, Karl notes that this superficial strengthening produces a rather brittle structure, arguing that this state expansion primarily favours privileged elites resulting in institutions that “look(s) powerful but (are) hollow” (Karl, 2007, p. 25). On the point of the role of elites, Ross and Karl agree, with Ross noting multiple examples of elites using national oil wealth for their own purposes, free of institutional constraints on their behaviour (Ross, 2012, p. 60). Thus, for the purposes of this study, we will examine whether Russia’s government expansion over the past decade and a half has led to a robust set of institutions that constrain elite corruption, or whether these are merely ‘hollow’ tools at their disposal. As mentioned previously, these criteria are meant not so much to examine every specific aspect of Russia relative to theories on “resource curse”, but rather to invite further study into the matter.

Many of my sources come from the English-language versions of a number of Russian media outlets including, but not limited to The Moscow Times, The St. Petersburg Times, and the state-media outlets Ria Novosti, Itar-Tass, and Russia Today. In addition to the aforementioned English language Russian news sources, keeping track of developments over time necessitates the use of other international news sources. These include, but are not limited to Reuters, BBC, The New York Times, The Washington Post, and The Guardian. When possible, I have relied on
these due to their resources that permit them the ability to conduct investigations within Russia. This list is by no means exhaustive and I have utilized additional news sources when necessary.

When possible, I rely on sources with extensive experience in Russia and utilize their peer-reviewed work when it is available. This study draws heavily on Anders Aslund’s book, *Russia’s Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed*, wherein he covers developments in the country throughout the Soviet and Post Soviet eras. Aslund is an economist and Senior Fellow at the Peterson Institute. He has served as an advisor to governments in Russia and Ukraine in the 1990s and has had extensive contact with a number of officials and journalists in both countries. Additionally, Aslund publishes regularly with the Peterson Institute and is a regular contributor to a number of publications; this study draws on his work in *The Washington Post* and *The Moscow Times*. In addition to Aslund, I draw on Daniel Treisman as a source on the Russian political economy. His 2010 article, “Loans for Shares Revisited”, in *Post Soviet Affairs* offers insight into the often derided affair that has changed my perceptions on it and sparked further research into the news sources of the time for the purposes of this study.

Marshall Goldman has studied Russia and the Soviet Union for more than five decades, having received his Phd. in Russian Studies from Harvard University in 1961. His book, *Petro State: Oil Power and the New Russia*, is an invaluable resource as it draws heavily on his own experiences in the country including information from interviews with former officials and journalists from the past three decades.

In addition to Goldman, I draw on sources by other Russian speakers that offer insight into the Putin government through their own experience. These include Harley Balzer, Martha Brill-Olcott, and Andrew Jack. These sources offer insights not only into the regime itself, but
also into Vladimir Putin’s thesis at the St. Petersburg Mining Institute, which has since been made unavailable to the public.

This study has required a significant amount of research on Russia’s nuclear energy sector, the literature on which has been largely separate from that of the oil and gas sectors. Much of the information in this area has been derived from the Bellona Institute, an international environmental research non-governmental organization with an office in Murmansk, Russia (bellona.org) and whose local economic expert, Leonid Andreev, has done much to illuminate the behaviour of the state nuclear conglomerate, Rosatom. Additionally, I draw on *World Nuclear News*, a subsidiary of the World Nuclear Association, which uses contacts in industry, academia, research institutes, and intergovernmental agencies to examine the global nuclear sector (world-nuclear-news.org). I additionally draw from a number of articles in peer-reviewed journals including *History and Technology: An International Journal*, *Slavic Review*, and *Asian Perspective*. Finally, due to the necessity to track recent developments, I have drawn on the aforementioned English language news sources, both Russian and international.
Chapter Three: The Soviet and Yeltsin Periods

This chapter will cover the Soviet and immediate post-Soviet periods relevant to the scope of this study and will necessarily demonstrate the events and patterns that have led to the state of the oil, gas, and nuclear sectors at present.

Throughout most of Russia’s history, the state has taken primacy in the management of the country’s vast resources. Though manifested in different forms, this remains the fundamental reality of the system in place today. Bureaucratic elites have exerted extraordinary influence. However, the benefits afforded to these elites, especially in regard to rent-seeking behaviour, have increased dramatically in recent decades.

Though the Russian bureaucracy finds its roots in the 18th Century, its primacy over Russia’s entire political economy is rooted in the Russian Revolution and Lenin’s ‘New Economic Policy’. A quote found in Lenin’s works is particularly illustrative of a system that has heavily influenced the one in place today:

The state capitalism, which is one of the principal aspects of the New Economic Policy, is, under Soviet power, a form of capitalism that is deliberately permitted and restricted by the working class. Our state capitalism differs essentially from the state capitalism in countries that have bourgeois governments in that the state with us is represented not by the bourgeoisie, but by the proletariat, who has succeeded in winning the full confidence of the peasantry. (Lenin, 1921)

History has shown us that Lenin’s notion of the working class permitting and restricting capitalist enterprise would result in a powerful state bureaucracy assuming that function. Revolutionary idealists who deviated from this model were purged ruthlessly in the years following the Bolsheviks’ consolidation of power. Though Lenin’s version of state capitalism
differs from that found in Kang’s analysis, and indeed in Russia today, the creation of a powerful bureaucratic elite to hold sway over the economy has profoundly influenced the behaviour of Russia’s economic stakeholders at present. In order to demonstrate this connection in the coming pages, it is first important to examine its origins under the Soviet system.

In *Russian Bureaucracy: Power and Pathology*, Karl W. Ryavec argues that a general “over-bureaucratization” of the Soviet system was, with other things, a major cause of economic stagnation, unsustainable environmental degradation, and a lack of technological innovation. He offers examples of bureaucrats having to be “placated and bribed at every level” and a culture of hubris that permitted a system in which the government spent as much on “cars and drivers for bureaucrats as it did on all public transport” (Ryavec, 2003, pp. 102-103). In 1977 John Kramer also noted that Soviet bureaucrats systematically abused their access to consumer goods, and perhaps most importantly, higher education, the means with which one attained coveted positions the bureaucracy itself (Kramer, 1977, p. 219). So widespread was this corruption and elite nepotism that it was noted by a plenary session of the USSR Supreme Court, which stated that it “represented a major social danger and required decisive measures to eradicate” (Ibid. p. 214). By allowing a bloated state bureaucracy to manage all economic activity in the country, corruption and cronyism were arguably natural by-products. Though certainly authoritarian, the coherence of the Soviet state began to dissipate as multiple actors pursued separate agendas within its structure. It is from this system that we find the seeds of a culture of cronyism that persists today with little remnant of the constraints on excess found in the Soviet authoritarian model.

By the mid 1970s the Soviet bureaucratic-driven economic model began to deteriorate and the economy had become largely anaemic. Ryavec (2010) writes “although bureaucracy
cannot directly be blamed for the end of the USSR, Gorbachev’s destabilization of the Soviet system was closely related to his attempt to solve its rigidity and ‘stagnation’ (Zastoi) to cope with the overall problem bequeathed to him by Brezhnev, a ‘swollen state and spent society’” (Ryavec, 2010, p. 102). It was through the process of Gorbachev’s reforms that the large Soviet bureaucracy, with its deep culture of rent seeking and cronyism, was almost completely disjointed from the state political establishment. With its leaders removed and replaced by largely inexperienced new ones, the bureaucracy that remained was able to take advantage of economic reforms that were ironically put in place in order to limit their influence and breathe new life into the economy through liberalization.

“Perestroika” or “restructuring” was meant to invigorate the Soviet economy through incentives created by market liberalization; however, this did not work in practice. Inflation rose as much as 140% and those in positions of power turned to alternative means of attaining wealth as the value of their salaries diminished drastically. Writing just before his country’s collapse, Victor Layanenov, a Soviet mathematician, made notes on what was occurring at the time. In 1992 John Majewski and Kenneth Solokoff of the University of California, Los Angeles Department of Economics, incorporated Layanenov’s commentary into a working paper. Concerning bureaucratic corruption he wrote:

With decreasing labour productivity and the emergence of shortages, having power insures having all the benefits unavailable to the subordinate class… the lawless nature of this power is related to the fact that under a bureaucratic regime power can only be inherited through an old boy network. It follows that the bureaucratic class is not interested in producing goods per se, but in expanding and bolstering its power (Layanenov et. al, 1992, p. 11, my italics)
Though corruption had always run rampant through the Soviet bureaucracy, there were restrictions that placed some limitation on it. For example, a bureaucrat could generally accumulate wealth through rents with impunity, but was only permitted to own one car and have a house no larger than two stories unless his position came with an official residence. Because the Soviet rouble was only used for internal trade, bureaucrats were also prevented from moving money overseas and stripping assets for real cash. Once these restrictions were removed, those bureaucrats who had accumulated enough power were also able to accumulate an increasing amount of wealth as state institutions fell into decay. It was during this time that Soviet bureaucracy pursued what Ryavec terms ‘nomenklatura privatization’ by working to “get their hands on whatever (state) assets they could”. He further notes: “by late 1993 it became harder to tell the gangsters apart from the bureaucrats” (Ryavec, 2010, p. 182). At the highest level these corrupt elites rose into the ruling class of secessionist republics like Turkmenistan, where the decadent and backward totalitarianism of the Niyazov era persists today with his successor, Gurbanguly Berdimuhamedow. Those who did not take advantage of such opportunities often found themselves in poverty by the time of their country’s collapse.

The Perestroika era also served to enrich a new class that rose in tandem with the bureaucratic or ‘nomenklatura’ elite. With permission to start private banks and take their black market activities into the emerging private sector, new entrepreneurs were able to secure loans from foreign banks and take full advantage of the perestroika reforms. Their emergence would also have a profound effect on the Russian state and society in the decade after the fall of the Soviet Union.

3.1 Hydrocarbons in the Soviet Era

In 2010 Dmitry Travin and Otar Marganiya examined the Soviet bureaucracy’s management of the oil sector. They argue “increasing labour productivity, reducing expenses, or
developing new production was not considered to be an achievement of the enterprise if it did
not fulfill the directive plan on volume production” (Dmitry Travin and Otar Marganiya, 2010, p.
28). This is somewhat indicative of the example of a state hindering development found in
Kang’s “predatory state” category. However, the fact that this development was not severely
hindered by rent seeking and general corruption demonstrates that Kang’s model does not
conform completely when applied to a state-capitalist context.

One of the largest problems faced by the oil sector both today and during the Soviet era
was the lack of foreign technology available to maximize production. Lenin identified this issue
more broadly as early as 1922:

Unfortunately, the introduction of state capitalism with us is not proceeding as quickly as
we would like it. For example, so far we have not had a single important concession, and
without foreign capital to help develop our economy, the latter’s quick rehabilitation is
inconceivable. (Lenin, 1922)

The Soviet Union overcame this problem with some success through years of borrowing
foreign technology to further its hydrocarbon sectors. In the 1920s and 1930s, American
industrialists played a key role in the development of the Soviet oil sector through their resources
in technology and technical expertise (Bailes, 1981, pp. 29-30). This trend continued in spite of
Cold War tensions: Saudi Arabia, the Soviet Union’s and later Russia’s perennial competitor for
oil exports, identified this challenge to their own global market share by noting the country’s
vigorous purchasing campaigns of foreign technology in the early 1960s (Saudi-Aramco World,
1962). A report from the United States Library of Congress noted “in 1979, the Soviet Union
devoted approximately 22 percent of its trade with its major Western trading partners (some $3.4
billion) to energy-related technology and equipment” (Chase et. al., 1981).
As the state’s industrial economy began to collapse, the Soviet state became increasingly dependent on oil and gas output. However, there were major challenges to the success of these industries. Firstly, Cold War tensions limited the state’s ability to procure pipeline material from producers like West Germany, and the country’s oil and gas midstream infrastructure began decaying in the 1980s as a result. Secondly, the American government placed an embargo on the Soviet import of American oil- and gas-related technology, and out-dated extraction methods using water caused flooding, severely limiting oil well productivity. Thirdly, by awarding funds to research institutes as opposed to specific projects, bureaucrats squandered the resources and manpower that could have been better used in the development of new innovations that would lessen the hydrocarbon sectors’ dependence on foreign technology (Technology and Soviet Energy Availability, 1981). Finally, all of these factors contributed to the under-utilization of existing fields and lack of exploration for new ones: a 1977 CIA document entitled “The Impending Soviet Oil Crisis” predicted that the Soviet Union would hit peak oil “no later than the early 1980s” (Reynolds and Kolodziej, 2008, p. 277).

Though there were numerous challenges to obtaining foreign technology and maintaining a crumbling infrastructure during this period, the Soviet Union managed to become the world’s largest producer of crude oil, at a peak of 11.8 billion barrels per day in 1988, and the largest producer of natural gas at 28.8 trillion cubic feet per year in 1990, with the vast majority of the production of each occurring in the Russian Soviet Federated Socialist Republic (RSFSR).

Because oil and gas were such a substantial portion of the Soviet state and economy, particularly in regard to budget revenue and the acquisition of foreign currency needed for consumer goods and other imports, Gail Tverberg argues that the decline of oil prices in the 1980s was a primary factor in the Soviet collapse in 1991 (Tverberg, 2011). It would be nearly a
decade after the fall of the Soviet Union before the global price of crude would rebound, resulting in a new influx of revenue.

3.2 The Post-Soviet Oil Industry

The fall of the Soviet Union brought about dramatic changes in the Russian economy, the effects of which altered the decision-making structure of the oil industry. From 1992 to 1994, in an initial effort to equally distribute the wealth of the country, 98% of the population received vouchers equivalent to shares in much of the country’s economy. These vouchers could then be used to purchase shares in newly privatized industries, a model that had previously been successfully adopted in Czechoslovakia prior to the Velvet Revolution of 1989. However, as the Russian population faced the economic hardships associated with hyperinflation and the collapse of their industrial economy, most were forced to sell their vouchers/shares to make some semblance of ends meet. The effect of this was the opposite of its initial intent: most vouchers wound up in the privileged hands of former bureaucratic elites and, later, an emerging business class that had been previously empowered by the perestroika-era reforms. In this new era, these actors were free to personally profit from their positions of power and influence. As Anders Aslund points out: “Soviet society had been a lawless kleptocracy kept in check by a ruthless police state kept in check by the CPSU (Communist Party of the Soviet Union). When the CPSU was prohibited, the repressive organs lost their authority and crime skyrocketed” (Aslund, 2007, p. 130).

This reality hit the oil industry especially hard: low prices and Soviet-era managers’ preoccupation corruption caused production to fall substantially. In 1990 the Russian Republic within the USSR produced almost 524,000 kilotons (metric) of crude oil; by 1995 that had fallen to just over 305,000 kilotons (ibid.). To remedy this, the Yeltsin administration sought to inject new management into the industry through reforms aimed at privatization.
Privatization of the oil sector was accelerated through a process known as ‘loans for shares’. In an effort to attain much-needed capital to solve budget shortfalls and combat hyperinflation, the Yeltsin government offered large tranches of shares in 12 large state-owned corporations to certain businessmen in exchange for loans to the federal government totalling roughly $800 million. Competition at auctions was kept to a minimum through rigging and a general lack of transparency (Treisman, 2010, p. 210). Furthermore, if the government did not repay the loans by September 1996, the businessmen would be permitted to auction off their tranches and keep 30% of any profit made in the transaction with the tacit understanding that they could then sell the shares to themselves at a discounted rate (Guriev and Rachinsky, 2005, p. 138). This near-flawless example of state-initiated rent provision has often been used to exemplify the corruption of the Yeltsin era, with oil as its primary sector of impact.

It was through this program that we find the highly publicized and oft politicized rise of the private ‘oligarchs’ in the Russian oil sector. Treisman (2002) argues that though conventional wisdom says it was the relatively young actors from the private sector who took most of the spoils from these rigged auctions, it was indeed actors from the Soviet-era bureaucracy who also made substantial gains (Treisman, 2002, p. 209). The following table shows the oil companies in which a controlling interest was auctioned and the ultimate winners.
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<td>Yukos</td>
<td>45</td>
<td>159</td>
<td>290.5</td>
<td>298.4</td>
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<td>Sibneft</td>
<td>51</td>
<td>100.1</td>
<td>128.1</td>
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<td>Sidanko</td>
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<td><em>Won by company management</em></td>
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<td>‘Red Directors’</td>
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<td>Lukoil</td>
<td>5</td>
<td>35.01</td>
<td>383</td>
<td>339.7</td>
<td>89</td>
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<tr>
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<td>40</td>
<td>88.3</td>
<td>288.3</td>
<td>795.2</td>
<td>69</td>
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<tr>
<td>NaftaMoskva</td>
<td>15</td>
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Table 3.1 The sale of oil firms in loans for shares auctions

The first thing one notices here is that the portion of shares purchased by the “oligarchs” is significantly larger than that purchased by company management. Daniel Treisman notes that there were considerable risks for outsiders investing in these firms. Firstly, at the time of the
auctions the Communist Party was widely expected to win the 1996 election and it was anticipated that its candidate, Gennady Zuganov, would most likely annul the loans for shares deals-and likely without compensation. For this reason, most foreign investors avoided the offering, forcing oligarch-investors to take the entirety of the risk themselves. Though his investment in Sibneft paid off substantially in the long-term, Boris Berezovsky was unable to attract a single foreign partner at the time: he was rejected by his contacts at Daimler, Daewoo and investment banking firms in New York. When he tried to persuade George Soros, one of the world’s most successful investors, to invest in the deal an aide told him that “the package is worth nothing” (Treisman, 2010, pp. 203-204). Treisman (2010) further notes that the “oligarchs” would have to wrest control of their firms from entrenched bureaucrats with their contacts in local law enforcement and even organized crime. Additionally, the oligarch winners could also face minority shareholders who could block restructuring in the hope of being bought out at exorbitant prices in a scheme known as ‘greenmail’. Finally, the liabilities for which the owner would become responsible were staggeringly high. One Sibneft subsidiary owed $2 billion: nearly twenty times what Berezovsky and his associates paid for the acquisition loan (Ibid.). Thus the risks for these new actors were substantial; however, those who already managed the firms were not subjected to such liabilities. This perhaps also explains why the oligarchs purchased more shares than their bureaucratic counterparts: it is possible that the existing management did not want to take on the burden of dealing with minority shareholders and the aforementioned liabilities as it was not necessary for them, as the existing management, to do so at the time.

The existing company managers already comprised the decision making structure of their firms and would not be forced to face the aforementioned barriers to control. Secondly, the
financial liabilities were much lower for bidders from company management. Lukoil’s General Director, Vagit Alekripov, spent most of the Perestroika era consolidating as much assets under his company as possible: when he used his banking connections to acquire a mere 5% of the firm he did so at an 89% discount and could continue to reap rents from extensive asset stripping by maintaining his position within the company (Dixon, 2008, p. 125). Surgutneftgaz boss Vladimir Bogdanov used his company’s pension fund to acquire a 40% interest at a 69% discounted rate, making himself, as its sole manager, the de facto owner (Maugeri, 2006, p. 158). It is notable that Bogdanov continues to run Surgutneftgaz and recent estimates put his current personal net worth at $3.2 billion (Forbes, April 27, 2013).

In addition to the risks they took by acquiring their shares in the first place, the discounts the oligarchs received at their rigged auctions were not nearly as large as those afforded to their bureaucratic counterparts. Mikhail Khodorkovsky of Yukos received a discount of 45%, and Boris Berezovsky and his partner Roman Abramovich of Sibneft received one of only 16%. Finally, the interests of the ‘red directors’ were protected by the state to a much higher degree: Prime Minister Viktor Chernomyrdin (the former director of the gas monopoly, Gazprom) was actively protecting the managers of state-owned firms and ‘red director’ owners (Treisman, 2010, p. 217).

If bureaucratic elites had the upper hand in acquiring assets, why then were the oligarchs involved at all? The simple answer to this question is politics. The Yeltsin administration’s liberal economic advisors were eager to inject new management into major firms, especially in the country’s oil sector: the current management of these state-owned firms were running up large debts, diverting assets for personal gain and not paying their workers. Treisman notes that dislodging the corrupt and largely incompetent state managers would be much harder if the
communists increased their share of the seats in the state Duma in the December 1995 elections. Yeltsin’s First Deputy Prime Minister and top economic advisor, Anatoly Chubais, communicated to an IMF representative that the loans for shares program, by offering stewardship over shares and not technically instituting privatization at the time, meant the government was able to circumvent the Duma’s ban on privatizing oil companies (Treisman, 2010, p. 14). He further argues:

With the presidential election around the corner, winning the support of the new private business elite was thought to be crucial to Yeltsin’s re-election. The two-stage set-up of the program – with loans made before the election, but the auction of the shares only after it – gave the participants a strong interest in preventing a Zyuganov victory (Ibid, p. 14)

Though oil had the highest level of privatization in terms of new management of the three sectors examined in this study, half of the companies that became private remained in the hands of entrenched Soviet-era bureaucrats. It is also important to note that the country’s largest oil producer at the time, Rosneft, other producers Tatneft, and Bashneft, and the pipeline monopoly Transneft (on which all producers relied for transport) remained under state control while their management extensively diverted and stripped capital assets.

But despite the fact that the nomenklatura appeared to have the upper hand in the oil industry, the new business elites gained access to political power. The Yeltsin administration became known for what is called the “Kremlin Family”, a handful of oligarchs that heavily influenced the decision-making structure of the executive branch. Among the two most powerful of these oligarchs were the oil barons enriched by the loans for shares program, Mikhail Khodorkovsky of Yukos and Boris Berezovsky of Sibneft (whose diversified portfolio extended well beyond the oil sector). David Hoffman notes that they, among other oligarchs, actually
profited by offering their financial backing to Yeltsin’s beleaguered 1996 presidential campaign through low-cost government bonds (Hoffman, 2003, pp. 348-351). If Anders Aslund is correct in his account of one oligarch telling him they had put up a combined sum of more than $600 million to finance the campaign, this was a substantial amount of money for a government in the midst of a debt crisis (Aslund, 2007, p. 167). Former Prime Minister Yegor Gaidar commented that, had Yeltsin not received the oligarchs’ backing, “Zyuganov’s chances of winning the elections would have been substantially better, and maybe he would have been unbeatable” (Hoffman, 2003, pp. 312-313). Finally, those who took part in the loans for shares program were blessed by the government’s failure to repay its loans by August 1996. This allowed them to sell their assets to themselves at another series of rigged auctions.

It is unknown why the government did not repay its loans to the oligarchs and bureaucrat-owners. Had it managed to raise the necessary $800 million to do so it would have reacquired assets worth substantially more on the market at the time of their auction, primarily due to the discounted prices at which they were sold. Additionally, some of the firms had more than doubled in market value in the ten to eleven months since their transfer. Just from the available information gathered on the oil sector alone, the government’s shares would have been worth over 1.6 billion, more than double the value of all the loans combined.

Though we cannot know why the government did not take action, Treisman speculates that it was due to fears among reformers that Yeltsin’s ill health could encourage his recent electoral backers to put their support elsewhere and undermine the regime (Treisman, 2010, p. 223). However, other factors are also worth consideration. By offering favours in the form of substantial rents (in this instance by conferring capital at prices below market value), the Yeltsin government gained newly empowered friends. In 2005 Sergei Guriev and Andrei Rachinsky
wrote that the oligarchs were the “only currently feasible counterweight to the predatory and corrupt Russian bureaucracy”. Indeed they had become close with leading reformers in the Yeltsin administration like Anatoly Chubais (Aslund, 2007, pp. 161-162); however, the oligarchs’ alliance with the Yeltsin government quickly became a precarious one. According to former Prime Minister Yegor Gaidan,

in my opinion, the major motive at the moment was a political one, connected with providing stability and not allowing the return of the communists to power…without any doubt, we were naïve (Gaidan, 2000).

This naiveté would have long lasting consequences for the Russian state and society; however, external conditions soon paved the way for a decade-long oil boom and would provide those in the business sector with a motive for maximizing production and profit over pilfering assets. With the oligarchs less dependent on rents and moving toward a profit-seeking model, they would be even more empowered to make greater demands of the state.

As mentioned previously, the early to mid 1990s were a period of general stagnation in Russia’s oil production, caused by a number of factors. Perhaps most important, as Fiona Hill and Florence Fee noted in 2002, was the fact that the global price of crude oil was generally quite low during this time. They specifically point to the dramatic fall in demand within the former Soviet Union and the carryover of high production levels from OPEC states in the 1980s as causing a near two-decade-long glut in the global oil market, leading to a low price per barrel that created low incentives for Russian producers (Hill and Fee, 2002, p. 5). During this time, instead of investing in and developing their new holdings, both the ‘red directors’ and the new oligarchs largely prioritized tax evasion, stripping cash from assets, moving money offshore, and eviscerating minority shareholders’ rights by diluting shares as much as 240 per cent (Ibid, pp.
As Treisman noted previously, diminishing the power of minority shareholders was not irrational, as it removed their ability to block progress through rent seeking; however, it also served as a deterrent to foreign investors (Treisman, 2010, p. 224; Willingham, 2000, p. 8).

One of the greatest constraints on production lay not in the production sector, but rather in transport. Transneft, the state-owned pipeline conglomerate functioned more as a hindrance to rather than a facilitator of oil production in the 1990s. Hill and Fee note that the pipeline network, while flowing at capacity, was incapable of meeting the industry’s output needs (Hill and Fee, 2002, p. 5). In 1997 Dylan Cors argued that though it made sense for the state to maintain a monopoly over pipelines in order to manage production and export during times of uncertainty, the state’s mismanagement of Transneft was, overall, damaging to the oil sector. Specifically he pointed to Moscow’s failure to cooperate with regional governments, infighting and rent seeking within Transneft’s corporate structure, and an unclear regulatory policy that permitted local rent-seeking authorities to skim profits as factors of constraint. Reinvestment in the ailing pipeline infrastructure was not among Transneft’s top priorities, which further deterred foreign investors who were rightly cautious of losing their money to corrupt parties (Cors, 1997, pp. 604 – 610). This is consistent with Karl’s noting that corrupt firms tend to prioritize rent seeking behaviour over maintaining infrastructure, due to the latter offering relatively small-sized rents. Because all of Russia’s oil producers were dependent on Transneft for export, asset stripping became a logical choice to recover investments and seek profits in a time when export was constrained by low global demand and a problematic pipeline system. However, Treisman argues that this asset stripping actually served a purpose for the oligarchs: in addition to ridding their firms of inefficient and unprofitable assets, it also freed up capital for future investment (Treisman, 2010, p. 224).
The incentive to increase oil production and export began in 1998-1999 as the global price began to rise in the fallout of the Asian Financial Crisis. The figure below shows an average global crude price from 1998 to 2001.

![Graph showing average global crude price from 1998 to 2001. Source: IndexMundi]

**Source: IndexMundi**

**Figure 3.1 Average global price of crude 1998-2001**

This rise in prices at the end of 1998 encouraged production for the oligarchs. When prices rose, the oligarchs moved away from asset-stripping and were actively investing in the growth of their firms: between 1998 and 2003, Yukos and Sibneft’s annual “upstream” (production) investment increased by roughly 140 percent (Treisman, 2010, p. 223).

But when the new oligarchs (Khodorkovsky of Yukos and Berezovsky/ Abramavich of Sibneft) acquired their firms, they also faced serious challenges that further constrained their initial ability to produce. They quickly moved to consolidate their control. Private security companies had been legalized in 1992 and with little oversight from local authorities or the Kremlin, large private armies and intelligence specialists, drawn from the ranks of unemployed...
military and KGB personnel, were employed to intimidate minority shareholders and combat
criminal organizations, racketeers, and old management within the firms (Aslund, 2007, p. 164).
Though controversial, these measures were effective in that the oligarchs were able to gain full
control of their firms prior to the 1998-99 rise in the price of crude oil. The ‘red directors’ and
state-owned managers did not have to undertake such drastic of measures as the oligarchs to gain
control of their firms because they were already entrenched in the management structures as
former state bureaucrats. Though this benefitted them at first, they also had less incentive to curb
the rent seeking within their enterprises that cut into profitability, productivity, and limited their
ability to attract investment.

Production growth was uneven between those firms controlled by the oligarchs versus
those in the hands of former management or under state control. While output from oligarch-
owned firms (Yukos, Sibneft, and Sidanco) increased at a combined average of 69% between
1999 and 2003, the output of firms controlled by ‘red directors’ (Lukoil and Surgutnefegaz) only
increased by 46%, and the state-owned firms (Rosneft, Tatneft, and Bashneft) rose at a
comparatively dismal 15% (Treisman, 2010, p. 223).

The oligarchs also proved successful in combating the age-old problem of attaining
foreign technology and expertise, which no doubt aided in their production growth. Yukos and
Sibneft used international auditors to sort out their financial departments, struck deals with the
American rig service companies Halliburton and Schlumberger, hired foreign executives, and
brought in management consultant firms (Aslund, 2007, p. 164). In 1998 the prominent Moscow
Journal called Yukos the worst run oil company in the country (King and Treskow, 2006 p. 81);
however, by 2001 it and Sinbneft were praised for having sought transparency and good
Though the oligarchs were performing quite well from a production perspective, their public behaviour was beginning to make them quite vulnerable to forces that would mobilize against them in coming years. Though economically successful, they failed to reach a level of organization among themselves that would enable them to defend themselves against the onslaught of state power in the decade to come. Similarly, Kang cites the lack of organization among Filipino business families as a key factor in their falling prey to Marcos’ “predatory state” (Kang, 2002, p. 137).

Infighting among the oligarchs and reformers in the Yeltsin administration erupted in 1997 over, among other things, forcing the oligarchs and their enterprises to pay taxes that had not previously been enforced (though the actual reasons are much more complex and strongly related to finance and privatization of other industries). Berezovsky and his media-holding counterpart Vladimir Gusinsky launched a vicious assault on the Yeltsin government and even collaborated with the Communist Party in the State Duma to block legislation. On August 18, Anatoly Chubais’ chief ally in St. Petersburg was assassinated by sniper fire on the city’s busy main street. Shocked, Chubais took the murder as a warning: though it was never proven, Boris Berezovsky was widely suspected of ordering the hit and he received a relative ‘slap on the wrist’ by being sacked from the state Security Council on November 5 (Aslund, 2007, p. 171).

The so-called ‘banker war’ would result in a splitting of those oligarchs with interests in mineral resources and those who had made their wealth in finance, each vying for influence within the Yeltsin government. The oil barons Berezovsky, Abramovich, and Khodorkovsky joined with the ‘red directors’ to ensure that former Prime Minister Viktor Chernomyrdin would be reappointed to his post (Hoffman, August, 1998). This was an alliance that brought Russia’s new oil barons into the same faction as the traditional establishment that would eventually
acquire their interests. Despite his known and suspected treachery, Berezovsky along with his new ally, Chernomyrdin, were successful in leading a group of fellow oil barons to take advantage of the 1998 financial crisis by petitioning the government to devalue the rouble. Because their assets were held in foreign currency, devaluation of Russia’s currency by 70% would significantly lower their production costs without damaging their cash holdings. It was a drastic measure and though there were some economic benefits, it forced most banks into bankruptcy and eviscerated the savings of millions of ordinary Russians. Despite both the government and oligarchs knowing this would be the outcome, the policy was pursued regardless (Ibid, p. 180). The outcome of the devaluation severely diminished the standing the Yeltsin administration in the eyes of an already sceptical public. If the oligarchs, having openly defied the government in numerous ways, could convince it to take an action that undermined its credibility, we have a strong sense of who had the upper hand. What Berezovsky and other oligarchs perhaps did not realize was that they also had become objects of public ire.

By the late 1990s Russia’s oligarchs, especially those in the oil sector were outperforming their bureaucratic counterparts and reaping enormous profits. Though they often resorted to unscrupulous means to achieve this, they clearly understood that rent seeking was unsustainable in the long term and were much more effective in introducing new ideas and investment to increase the productivity of their firms. This new class, outside of the traditional Soviet bureaucracy, was able to have enormous sway over the state. However, their ‘red director’ and state-owned managerial counterparts also became wealthy and wielded power more from the shadows. Though less business savvy, the bureaucrats were a class educated in the art of survival through inconspicuousness and quiet opportunism. The oligarchs did not seem to appreciate this subtlety and were everything the bureaucrats were not: conspicuous, arrogant, and ostentatious,
and most importantly lacking in coherence. This is in stark contrast to the bureaucratic actors being actively protected by Chernomyrdin in the Duma, who as we will see, were able to wield power effectively and coherently in the pursuit of their own interests.

3.3 Natural Gas and the Ascent of Gazprom

Russia’s modern natural gas industry primarily finds its origins in the 1965 creation of the Soviet Ministry of Gas, as the state decided to put considerable resources into the commodity’s production and export. In 1989, under the directorship of Viktor Chernomyrdin, the Ministry changed its name to Gazprom. It was privatized as a joint-stock company in 1993 and the state’s shares eventually fell to 38% (Goldman, 2008, p. 5). However, unlike the oil sector Gazprom remained a single vertically integrated gas monopoly and remained in the hands of state management.

When the Soviet Union fell, Chernomyrdin entered the political realm as Yeltsin’s First Deputy Prime Minister in May 1992, and then became Prime Minister in December of that year. During his time in office, he took the opportunity to ensure that Gazprom remained intact and under state control (Rosner, 2005, p. 12). Though the state retained only a 38% minority controlling interest, the trading of Gazprom shares was highly regulated: foreign ownership was limited to no more than 9% of total shares and the remaining shares were mostly distributed among nearly 750,000 members of the Russian public, mostly in exchange for vouchers (Goldman, 2008, p. 5). However, it should be noted that these shares were not distributed equally: company managers, employees, and senior officials were offered substantial amounts of shares at discounted prices unavailable to the general public (Aslund, 2007, p. 141). During the 1993-1994 privatization, it is rumoured that Chernomyrdin acquired a personal 5% stake in Gazprom: if this is true, his shares would have been worth roughly $13.5 billion in 2007 (Ibid, p.
Like most of the ‘red directors’, Chernomyrdin’s personal net worth has never been disclosed publicly; however, his profile on the Russian state media website ‘Russia Today’ simply described him as “one of the richest men in Russia” at the time of his death in 2010 (RT, 2010). Though Chernomyrdin’s personal net worth is difficult to ascertain, there is strong evidence of widespread rent seeking within the firm he fought so hard to keep away from public oversight.

Unlike the oil oligarchs, Chernomyrdin wielded his substantial influence as Prime Minister in a relatively inconspicuous manner. He put forth an omnibus decree in 1992 that, among other things, exempted Russia’s wealthiest company from virtually all taxation – a savings that amounted to 1 to 2 percent of Russia’s entire GDP in 1993 (Aslund, 2007, p. 141). Though Yeltsin made many contradictory presidential decrees with an aim of reforming Gazprom, Chernomyrdin used his post to ensure they were easily changed, forgotten, or simply not respected (Ibid, p. 131). Though others in the power elite seemingly ignored Chernomyrdin’s apparent corruption, it was not lost on the Russian public. His party, “Our Home Russia,” was often derided as “Our Home Gazprom” and it captured a mere 10% of seats in the 1995 State Duma elections (Cornell and Nilsson, 2008, p. 60). Despite mild public scorning, Chernomyrdin was able to manage the levers of power in favour of Gazprom relatively quietly. In contrast, new oil barons like Berezovsky and Khodorkovsky were forced to employ violent mercenaries to consolidate control over their own interests and were openly defying the state through their media holdings during this time.

Gazprom’s influence within the Kremlin grew immensely during Chernomyrdin’s tenure in office, and he fought diligently to keep the company, with all its inefficiencies, as an opaque nominally state-controlled conglomerate. Gazprom became virtually exempt from state
regulation. Chernomyrdin was famous for being appreciative of the concept of “investment without the investor,” once convincing an investor to sink some $15 million into a project, only to have it transferred to Gazprom control shortly thereafter in a classic example of predatory rent-seeking (Rosner, 2005, p. 13). If reformers of the time argued “that which is not privatized will be stolen”, it was perhaps most applicable to Gazprom.

Anders Aslund describes Gazprom in the 1990s as “Russia’s foremost rent-seeking machine” (Aslund, 2007, p. 142). Over the course of the decade, Gazprom was selling gas to the private broker, Itera for $4 per 1000 cubic meters (mcm), which was in turn sold to Ukraine for $42 per mcm at a time when the actual price was about $80 per mcm, generating billions in annual rent profits to Itera at Gazprom’s expense (Aslund, 2007, p. 142). Given the negative effect this bleeding of immense wealth would have on Gazprom’s profitability and overall share price, it seemed likely that Gazprom’s management had something to gain from these deals. For instance: in the mid 1990s the state extended more than $600 million in loan guarantees to Gazprom, which some analysts and minority shareholders believed to have been used by Gazprom’s leadership to enrich themselves and their families through these transactions (Tavernise, March 27, 2002).

Following his dismissal as Prime Minister in 1998, Chernomyrdin returned to chair Gazprom and, taking advantage of the lack of oversight he himself instituted, engaged in massive asset-stripping and tax evasion, parceling off much the firm’s holdings to the management, the board, and their friends and relatives (Goldman, 2008 p. 61). In 2002 an American investor uncovered seven dubious transactions that saw more than $5.8 billion worth of Gazprom assets sold to Itera for a total of $325 million between 1997 and 2001. In dumping these assets, Gazprom lost roughly 10% of its total gas reserves, an amount comparable at the time to Exxon-
Mobil’s entire gas reserves worldwide (Carnegie Endowment, 2002). By comparison, the oil firms controlled by oligarchs were investing heavily in upstream production and embracing transparency at this time. While Gazprom was paying virtually no tax and diverting billions in profits to intermediaries, the Russian government was perpetually strapped for cash and in the midst of a crippling debt crisis.

Likely because of such asset stripping, Gazprom did little to invest in production or transport infrastructure. The figure below shows Russia’s natural gas export balance from 1990-2001.

![Natural Gas Exports Balance](image)

**Source: OECD**

**Figure 3.2 Russia's natural gas exports balance 1990-2001**

Unlike oil, we see that gas export growth was quite slow from the mid-late 1990s. However, like oil prices gas prices also rose in Europe (with the exception of 1998-1999 as a result of the Asian Financial Crisis) during this time.
If Gazprom were interested in profitability during this time, one would think that exports would rise in 2000-2001, given the historically high price during these years. The fact that the volume actually declined during this time is indicative of the aforementioned systemic problems.

Gazprom’s iron-fisted monopoly is also responsible for the massive wasting of resources annually. By prohibiting domestic oil companies from using their pipelines, Russia’s oil companies were forced to flare roughly 20 billion cubic meters of gas each year during this time (Aslund, 2007, p. 141). When one considers that production was falling and gas was being diverted for enormous profit, this appears to just be gross incompetence and mismanagement on the part of Gazprom’s leadership.

Similar to the oil industry, Gazprom lacked, and continues to lack, the ability to attract the investment needed to maintain its massive pipeline network. Much of this can be attributed to the corruption that is endemic in the firm’s structure, causing foreign investors to shy away from the largest producer and exporter of natural gas in the world (Goldman, 2008, p. 77). Furthermore, upon its founding as a joint-stock company, the firm inherited a significant amount of holdings that distracted it from its core business of producing and transporting gas. Instead of
ridding itself of these unnecessary assets to invest in production, Gazprom continued to purchase everything from media holdings to farms that were sold by the state at heavily discounted prices (Rosner, 2005, p. 13).

By the end of the 1990s, Russia’s single largest corporation was a financial disaster; however, it was seldom viewed as such. Aslund notes that this was primarily because Gazprom’s production for the domestic market remained constant and it was Russia’s single largest exporter (Aslund, 2007, p. 142). Perhaps because it was comprised mainly of Soviet-era bureaucrats, Gazprom’s management seemed to understand that they must pay nominal fealty to the concept of social responsibility if they were to continue in their privileged positions. By ensuring ordinary Russians did not suffer long winters with chronic gas shortages, Gazprom did not draw the same public ire as the oligarchs. Simultaneously, the firm remained an oasis of relative peace while the shootouts over the control of other enterprises were widespread throughout the country. Finally, the company’s substantial media holdings ensured that a steady stream of pro-Gazprom propaganda made its way into the public’s consciousness. During this time Aslund describes Gazprom as “an idyllic Soviet theme park with wonderful holiday homes and social benefits” (Ibid). This combined with the quiet yet powerful influence of those who, like Chernomyrdin, made Gazprom a force that was virtually unassailable by the end of the decade, regardless of its capacity for productivity or profitability.

3.4 Atomic Energy Development and Technology Export

After a period of considerable stagnation, Moscow renewed its interest in nuclear energy in the early 2000s. In 2005 President Putin appointed Sergei Kirienko as head of the Federal Nuclear Agency, Rosatom. Since then, Kirienko has enjoyed a growing profile particularly in relation to the export of nuclear technology, and is known to join Putin on numerous state visits to discuss, among other things, the development of civilian nuclear technology. Though Russia is
poised to once again emerge as a major exporter of nuclear technology and energy, there are also substantial opportunities for rent seeking found within this endeavour.

Unlike hydrocarbons, the Soviet atomic energy sector was completely self-sufficient in terms of technological development (excluding early espionage efforts in the United States) and remains so to this day. During the Soviet era, the world’s first nuclear power plant began functioning at the Obninsk facility in 1954, less than four years after testing the country’s first nuclear warhead. It was the world’s first nuclear energy reactor for civilian use.

Beginning in the 1950s the Soviet Union made the training of physicists one of its top educational priorities, and the study of atomic and nuclear physics was required of all physics students at the University level (Akhmatov, 1963, pp. 11-14). By the time of the fall of the Soviet Union, the RSFSR possessed more than 60 operational non-military research and test reactors used, among other things, for the training of technical experts (World Nuclear News, October, 2012). In little over a decade, the Soviet Union became a world leader in the training of professionals to work in the nuclear industry. However, as the Soviet empire crumbled, so too did its standing as a world leader in nuclear energy: following the Chernobyl disaster of 1986, the design and safety of Soviet nuclear facilities came into question. This, coupled with the financial hardships associated with the country’s collapse in 1991, led to a period of relative dormancy in the Soviet/Russian civilian nuclear sector for more than a decade.

The extensive training of nuclear specialists in the Soviet Union was also a key element in the export of their technology abroad. In 1955 the Soviet Union assisted China in the development of heavy water reactors, enriched uranium, and offered the assistance of technical experts. By the early 1970s, they began to emerge as a major global supplier of civilian nuclear technology and by 1985 had civilian nuclear cooperation agreements involving the production of
reactors, the sale and enrichment of uranium, and the provision of technical experts with over two dozen countries, many of which were outside the Socialist Bloc (Potter, 1985, p. 472). By this point, the civilian nuclear energy sector had proven lucrative from a foreign trade perspective.

However, the two decades after the fall of the Soviet Union have decimated Russia’s number of trained professionals. This is one of the greatest challenges to Russia’s renewed interest in the export and sale of atomic energy: a need for trained professionals at present. While the Soviet Union was a world leader in this training, education suffered tremendously in Russia during the 1990s and saw a systemic fall in the prestige of and living standards in the scientific field. In addition to discouraging young people from entering the sciences, this also contributed to a significant brain drain, which some estimate caused 50 percent of the most prominent physicists to leave the country (Khirpunov and Katsva, 2002, pp. 53-55). Coupled with aging existing professionals, this poses a serious problem for an industry in which highly skilled and educated people are perhaps the most important factor in maintenance and further development.

As with the oil and gas sectors, historical corruption within Russia’s civilian nuclear sector cannot be understated. During the 1990s, Minatom (the Ministry of Atomic Energy, later reorganized as Rosatom) was noted as having a “loss of control” over its nuclear facilities in a number of regions and that internal corruption had a serious impact on non-proliferation cooperation with the United States (Moltz et. al., 2004). In 2013, Richard Tanter noted that there were “systemic weaknesses that Russian and foreign observers had identified in the Russian nuclear industry for some time”. They include widespread rent seeking in the procurement process, bribery, direct theft, a weak regulatory regime, and a general consensus among Russian and foreign businesses that corruption in the sector is increasing (Tanter, 2013, pp. 485-486).
Moreover, Andrei Ozharvosky claims that, during the Soviet era, the nuclear industry functioned as a “state within a state” and in addition to being powerful and secretive, had an almost limitless access to government funds with “no accountability to either the state or the public” (Ozharvosky, 2011) and this does not appear to have abated. As we will see in the following chapter, the nuclear sector’s access to funds and opacity have increased substantially in the past decade.
Chapter Four: The Putin Period

On December 31, 1999 President Boris Yeltsin abruptly resigned in favour of his then-Prime Minister, Vladimir Putin. Over the course of his presidency, Putin ensured that the state would obtain nominal ownership of the vast majority of Russia’s energy industry. This chapter will examine these developments and the results thereof.

The essence of this chapter is to demonstrate the effects of Russia’s renationalization of oil assets while continuing to allow the general opacity of its state-owned gas and nuclear enterprises: most importantly, it will focus on how the bureaucracy has managed this change. This is to examine not only developments over time, but to allude to the patterns that will be discussed in the following chapter.

4.1 The Putin Thesis: A Model for Reform

While working in the office of the Mayor of St. Petersburg Vladimir Putin, as a young former KGB operative, enrolled in a doctoral program at the St. Petersburg Mining Institute. Unfortunately his thesis has since been made unavailable to the public: in one instance, David Hoffman reported having a summary of it “snatched away” from him in the Institute’s Library in 2000 (Balzer, 2005, p. 214). For this reason, we are limited to the accounts of the few who have seen it.

Andrew Jack provides a summary of an article published by Putin in 1999 that was based on his original thesis:

“He (the author) says there is a need to create competitive and effective companies, to reduce taxes while increasing the ‘rent’ levy on natural resources, and to support social stability. He also emphasizes the need to create conditions for investment, including from
foreign companies in appropriate circumstances. The elements are a blueprint for his subsequent economic policy.” (Jack, 2004, p. 78)

However, Harley Balzer claims that this brief summary omits some of the most important information contained in Putin’s article. He notes that in saying “short term” (Balzer, 2005, p. 214), the article is stressing that this should be the economic foundation for the Russian economy for at least the next 50 years. He further notes that Putin advocates achieving this end through the creation of vertically integrated financial and industrial groups to compete with Western multinationals (Ibid). Goldman writes that these firms would function as what Putin termed “National Champions,” promoting the interests of the state over profit maximization. This was by no means a new idea: Charles de Gaulle of France advocated something similar during his presidency in the 1950s (Goldman, 2005, p. 99). Goldman further notes:

Regardless of who is the legal owner of the country’s natural resources and in particular the mineral resources, the state has the right to regulate the process of their development and use. The state should act in the interests of society as a whole and individual property owners, when their interests come into conflict with each other and when they need the help of state organs of power to reach compromises when their interests conflict (Goldman, 2008, p. 98, my italics)

This quote is illuminating in that it harks back to Lenin’s quote from the previous chapter. In both Lenin’s and Putin’s philosophies of state economic management, bureaucrats are empowered to act as stewards of a market economy regulated by their policy prerogative, and indeed Jack notes that Putin himself admits he “fancies himself more of a bureaucrat than a politician” (Jack, 2005 p. 45). As Martha Brill-Olcott wrote in 2004 in regard to the state’s
mineral resources: “this Russian president is not willing to give up control of such lucrative and potential authoritative instruments of power” (Brill-Olcott, 2004, p. 223).

Despite the radical nature of Putin’s proposals in relation their potential damage to Russia’s ruling elite of the time, he was nonetheless selected to succeed the physically- and politically-ailing Boris Yeltsin as president in 1999. Most experts on Putin believe that he himself could not have expected such a rapid ascent to power: his relative anonymity at the time is perhaps best reflected in the title of the biographical chapter on Putin in Andrew Jack’s 2005 book: “The Man from Nowhere”. Nevertheless, as an experienced technocrat who had risen from the ranks of the KGB, Putin understood the most important aspects of Russian political culture: loyalty in one’s patron-client relationships. Marshall Goldman argues that, despite his views differing from those of Yeltsin, a primary reason he was chosen as a successor was out of the president’s own political interest:

Putin apparently was more amenable to ensuring that he (Yeltsin) and his ambitious daughters would be *guaranteed immunity* from any future investigation into contract kickbacks. From all reports, they needed such protection (Goldman, 2008, p. 94, my emphasis).

Indeed, despite his many his criticisms of the old administration, Putin held up his end of the bargain with regard to his predecessor. Despite numerous allegations of egregious corruption, the former president was never charged with any wrongdoing following his resignation and he died an old and wealthy man in 2007. In this sense, the political culture in which Putin finds himself today differs little from that of the Soviet Union: the primary difference with regard to the economy is the expansion of personal privilege.
By introducing the concept of “national champions”, Putin explicitly sought to limit competition in the Russian energy economy. As Ades and Di Tella note, this tends to increase corruption overall as rents are increased due to larger portions of the market share (Ades and Di Tella, 1999, p. 982). Thus for Russia to reach the economic optimization identified in Kang’s “mutual hostages” scenario, it is necessary that the state take an active role in limiting corruption within these empowered institutions.

4.2 Reforms and Outcomes in the Oil Sector:

One of the most important reforms that dramatically increased Russian exports under Putin’s tenure was initiated through a deal struck by oil producers and Russia’s state-owned pipeline monopoly, Transneft. The Baltic Pipeline System greatly improved Russia’s transport capacity, and upon its completion in 2001 Russia’s oil exports increased dramatically.

Source: OECD

Figure 4.1 Russia's oil export 1999-2005
Regarding this surge in Russian oil exports, Marshall Goldman writes:

Because of the increase in oil prices, Russia’s rebounding economy would make whoever was in power at the time look like an economic genius. To his credit, Putin did nothing to hamper economic growth (Goldman, 2008, p. 96).

When Putin came into office Rosneft, Russia’s state-owned oil producer was barely functional. Despite being the country’s largest oil company when it was formed in 1993, its share of production output fell to only 4% by 1998 as a result of many of its assets being auctioned off, as well as those which were stripped internally. By 2006, Rosneft was Russia’s largest oil company both in terms of production and market capitalization (Henderson, 2012, p. 1). The way in which this was achieved would have a profound impact on the industry as a whole in Russia.

On July 18, 2000 President Putin called a meeting of twenty-one of Russia’s newly rich (non-nomenklatura) oligarchs – the habitual upstarts Berezovsky and the media baron Vladimir Gusinsky were not invited. His message was clear: stay out of politics and he would reward them by not inquiring into how they had acquired their wealth so quickly (Goldman, September 26, 2006).

Berezovsky and Gusinsky each used their media holdings to criticize Putin publicly – particularly in response to Russia’s actions in the Second Chechen War that had begun the year prior. It was Berezovsky’s last mistake on Russian soil: upon hearing rumours of his upcoming arrest, he ceded his shares in Sibneft and most of his other holdings to his junior partner, Roman Abramovich, and fled the country.

After his acquisition of Sibneft, Abramovich attempted to merge it with Yukos. The Yukos CEO, Mikhail Khodorkovsky, had paid $3 billion for a 26 percent share in Sibneft. However, when Yukos became the subject of a scandal in 2005, Abramovich put the merger on
hold and later neglected to refund the $3 billion after Khodorkovsky’s arrest in 2005.

Abramavich later considered selling half of his shares in Sibneft to a foreign company, accepting bids from Chevron-Texaco, Shell, and Total. However, this did not conform to Putin’s plans for reforming the oil sector. In 2005 Sibneft received multiple visits from Russian tax authorities and the company was ‘found’ to owe some $1.4 billion in tax arrears. In September 2005, Abramavich agreed instead to sell his 72 percent stake in Sibneft to Gazprom for $13 billion. This acquisition alone brought the state’s share of oil production from 16 to 30 percent and signalled Gazprom’s emergence as a major oil producer. Through compliance with Putin, Abramavich did well for himself. Following the sale of Sibneft, his net worth soared to $18 billion dollars, making him the wealthiest man in Russia at the time.

Mikhail Khodorkovsky’s Bank Menatpep had acquired Yukos in the highly unpopular and much derided ‘Loans for Shares’ auctions in 1995 and formally gained control after the government defaulted on its loan the following year. Though not as openly ostentatious as some of his contemporaries, Khodorkovsky was seen by many as a Kremlin insider who became very wealthy through state patronage at a time when Russian living standards fell dramatically. During the 1990s the Russian GDP shrank by 40-50%, pensions were eviscerated through hyperinflation and currency devaluation, and more than one third of the population fell below the poverty line (Goldman, 2008, p. 107). It did not matter that more embedded insiders from the Soviet era got rich at the same time: Khodorkovsky, like Berezovsky and Gusinsky before him was an easy target.

Like virtually all of the other oligarchs, Khodorkovsky carried a substantial amount of dirty laundry. In 1998 Bank Menatap closed its doors in the wake of the Russian financial crisis, and its depositors and foreign creditors lost all of their money. To make matters worse,
Khodorkovsky transferred the bank’s assets to an independent subsidiary in St. Petersburg, called Menatep St. Petersburg. Furthermore, though many deny Khodorkovsky’s personal involvement, Yukos’ now infamous head of security, Alexei Pichugin, is alleged to have carried out a number of assassinations on high profile individuals as late as 2003. These practices were conducted in a context where violence, extortion, racketeering, and rent-seeking were the norm. The now-Kremlin darling, Roman Abramovich, is well known to have taken part in Siberia’s bloody ‘Aluminum Wars’ over control of valuable smelters (Szelenyi, 2010, p. 20). Furthermore, nearly all of the important figures of the time, including Boris Yeltsin, deployed private armies of violent mercenaries in the pursuit of their interests.

Despite this baggage, Khodorkovsky embraced transparency and good corporate governance in 1999. Foreign talent was brought in, production increased at an average of 12 percent annually, the company was listed on the London Stock Exchange in 2000, and oil tankers were sent to Houston in 2004, opening the possibility of Russia becoming a major oil supplier to the United States. Yukos was on its way to becoming exactly what Putin wanted in a ‘national champion’: a vertically integrated and globally competitive producer of natural resources. However, Yukos did not conform to the most important element in Putin’s master plan: submission to the state.

The catalyst for Khodorkovsky’s dramatic downfall came when he and the owners of Russia’s top five oil producers announced a project in 2003 wherein a pipeline would connect Siberian oil fields to a seaport a Murmansk, allowing easy access for deep water tankers as early as 2007 (The St. Petersburg Times, September, 2003). Furthermore, Yukos signed a twenty-year oil delivery contract with China that committed it to deliver 20 million tonnes of crude annually by 2005 and 30 million tonnes by 2010. As Goldman notes: “it was as if Khodorkovsky and
Yukos were acting as sovereign powers” (Goldman, 2008, p. 111) In addition to the fact that Yukos was behaving as a policymaker, this was a direct challenge to Transneft’s pipeline monopoly.

There was also the matter of Yukos’ ownership: Khodorkovsky had expressed an interest in selling off a substantial portion of Yukos to either Chevron or ExxonMobil – foreign corporations. This was not unprecedented: that same year a group of smaller private producers had merged to form TNK and were in talks to enter into a 50/50 partnership arrangement with British Petroleum (BP). However, by circumventing Transneft, partnering with a major foreign producer, and moving toward acquiring Sibneft, Yukos was expanding to a point that it could challenge state authority in the oil sector.

Exxon Mobil CEO, Lee Raymond had met with Putin twice in 2003 to discuss the acquisition of at least a 40% stake in Yukos. In an interview with Goldman, Raymond said that he was under the impression that the Russian government would not object. However, just three weeks after the signing of a protocol of understanding that this purchase would take effect, Khodorkovsky was arrested in October 2003, effectively scuttling the deal.

Nevertheless, Khodorkovsky appeared to be under the impression that he lived under more favourable circumstances. Putin’s tacit agreement with the oligarchs was one predicated on a mutual understanding: the state remained deeply corrupt and was inching closer to authoritarianism, while the oligarchs had become wealthy through dubious means (Goldman, September 22, 2006). However, this was not a predication for a ‘mutual hostages’ scenario: the state had its bureaucratic elite, police, intelligence, and judiciary as tools it inherited from the Soviet era. Conversely, the oligarchs had an enormous amount of money and relatively small private security forces to protect it.
Khodorkovsky and other Yukos executives began backing opposition parties and had ‘purchased’ as many as 100 members of the 450 seat State Duma, effectively blocking two of Putin’s attempts to increase taxes and environmental regulations on oil companies. Furthermore, Khodorkovsky criticized the alleged rent-seeking activities within the state-owned oil producer Rosneft and even went so far as to address Putin directly by telling him “your bureaucracy is made up of bribe-takers and thieves” (Goldman, 2008, p. 114). Though there was certainly merit to his words, Khodorkovsky had challenged not only the government but also the post-Soviet bureaucratic-industrial elite: Sergei Bogdanichov of Rosneft was caught on tape remarking “three days in Butyrke Prison and (the Yukos leaders) will understand who is king of the forest” (Ibid, p. 115).

In June 2003, Yukos security chief Alexey Pichugin was arrested on the charges of murder and attempted murder and subsequently received a life sentence in prison (Radio Free Europe, October 23, 2013). Another senior executive, Platon Lebedev, was imprisoned the following month for a breach of contract with a fertilizer company. He served more than ten years and was just released in January, 2014 (The Moscow Times, January 27, 2014). Khodorkovsky did not appear concerned with these developments publically: Goldman notes he travelled to the United States to meet with then-Vice President Dick Cheney the following month to discuss Exxon Mobil’s impending purchase of Yukos shares (Goldman, 2003, p. 115).

Khodorkovsky was arrested on October 25, 2003 after masked policemen armed with submachine guns stormed his private jet on the tarmac in Novosibirsk. He was charged with tax evasion, grand theft, fraud, forgery, embezzlement, and extortion and sentenced to eight years in a remote Siberian prison. After receiving a number of additional charges, he was not released until December, 2013 (BBC, January 5, 2014). Russia’s Prosecutor General not only targeted
Yukos executives, but also anyone associated with them, including lawyers and junior staff (Goldman, 2008, p. 116). In total, more than two-dozen Yukos staff and associates were either forced into exile or were arrested (Ibid, p. 117-118). Though many of the charges, especially those levelled against top executives, likely had some merit, these developments also signalled the plunder of Russia’s most profitable and transparent oil producer. Having been charged with tax evasion, Yukos was accused of failing to pay $33 billion in back taxes. Goldman notes that for some years the total arrears assessed amounted to more than total revenue earned (Goldman, 2008, p. 120). Additionally, Paul Stephan also estimates Yukos’ entire market capitalization to be $43 billion, meaning that the final tax bill equalled roughly 75% of Yukos’ total assets. With the courts having frozen its liquid assets, Yukos was forbidden to sell or transfer any of its assets in order to pay the tax bill. In July 2004 the government announced its intention to forcibly auction off Yukos’ most valuable asset, the oil producer Yuganskneftgaz. Paul Stephan estimates Yuganskneftgaz’s total value to have been in the range of $15-$20 billion. It was ultimately sold to the illusive Baikal Financial Group for a mere $9.35 billion at a rigged auction. It has since become known that Baikal was a dummy corporation acting on behalf of the state-owned Rosneft Company (Stephan, 2012, p. 30). The main reason for using a dummy corporation, Goldman argues, was due to a group of American investors working for Yukos who had sought Chapter 11 bankruptcy protection in a Texas Federal Bankruptcy court. By using a front, Rosneft could purchase the valuable asset without any liability should the issue be pursued in a European or American court (Goldman, 2008, p. 120).

In early 2005, Rosneft filed several suits against what was left of Yukos for non-payment of oil purchases and tax liabilities. Bankruptcy proceedings began in March 2006. After Rosneft
and the Tax Ministry’s rejection of a proposal for restructuring, the final liquidation of Yukos assets occurred in the fall of 2007, with most assets being purchased by Rosneft through additional shell corporations at rigged auctions. Stephan also notes that “remarkably, once the liquidation got underway, YNG’s tax liabilities somehow disappeared” and that the assets of Russia’s largest oil producer “passed into the hands of a state-owned oil company without any compensation to its owners or any outlay (spending) by the Russian state” (Stephan, 2012, p. 30). The opaque manner in which Yukos’ assets were sold was described by Putin’s economic advisor, Andrei Illarionov as “the scam of the year” and he was then sacked for this comment; Aslund estimates the value of these assets to have been roughly $100 billion (Aslund, December, 12 2007).

Though Yukos’s practices were every bit as unsavoury as those of its competition, it had become Russia’s most transparent energy producer by the late 1990s. In so doing it was forced to embrace reforms to Russia’s tax code that had begun to take shape in the late 1990s. By 2004 Putin had managed to pass legislation in the Duma that completely eliminated Russia’s domestic tax havens (Stephan, 2012, p. 20). Thus Yukos was begrudgingly being brought into tax compliance; however, by this time Yukos’ dismantling was already underway.

With Yukos and Sibneft being acquired by the state-owned Rosneft and Gazprom, respectively, the Russian state took on a much larger role in oil production. By 2012, Russia’s largest oil producers were Rosneft, Lukoil, Surgutneftgaz, and TNK-BP, with each producing roughly 2 million barrels per day (Aslund, October 23, 2012), and Gazprom Neft (formerly Sibneft) producing just over 1 million barrels per day (Gazprom Neft Official Website). Following this, Rosneft acquired TNK BP from BP in exchange for $12.5 billion and a 19.75% minority stake in the parent company (Reed, March 21, 2013). The state now controls 69.5% of
Rosneft (now including TNKBP) and has maintained its 100% ownership in Transneft, which accounts for 93% of all crude shipments within the Russian Federation. The following chart illustrates this dramatic shift from private to state ownership in the past decade.

<table>
<thead>
<tr>
<th>Major Producers</th>
<th>Status 2004</th>
<th>Status 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rosneft</strong></td>
<td>State-Controlled</td>
<td>State controlled</td>
</tr>
<tr>
<td><strong>Sibneft</strong></td>
<td>Acquired by outside interests (1995)</td>
<td>Nationalized 2005</td>
</tr>
<tr>
<td><strong>Lukoil</strong></td>
<td>Acquired by company management (1993)</td>
<td>Unchanged</td>
</tr>
<tr>
<td><strong>Surgutneftgaz</strong></td>
<td>Acquired by company management (1995)</td>
<td>Unchanged</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Major Producers 2014</th>
<th>State-Owned Production Output (BPD)</th>
<th>Private Owned Production Output (BPD)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rosneft</strong></td>
<td>4 million</td>
<td></td>
</tr>
<tr>
<td><strong>Gazprom Neft</strong></td>
<td>1 million</td>
<td></td>
</tr>
</tbody>
</table>
Lukoil | 2 million
---|---
Surgutneftgaz | 2 million
| Total: 5 million (56%) | Total Private Output (bpd): 4 million (44%)

**Table 4.1 Control and output among top producers 2004-2014**

Despite his predecessor’s actions to the contrary, Dmitry Medvedev’s term as president was marked by the first major calls for privatization in the energy sector since Yeltsin. In 2011 the president stated that the economic status quo in Russia was “dangerous for the future,” and some anticipated that the state might cut its stake in Rosneft to below 50 percent (Bloomberg, June 17, 2011). However, as of February 2014 nearly 70% of the company remains under nominal state control, and now that it has acquired TNK BP it controls nearly half of Russia’s total production (*Washington Post*, February 7, 2014). Since resuming his place in the Presidency, Vladimir Putin has also expressed “mixed feelings” over the state’s increased role in Russia’s oil industry following Rosneft’s TNK-BP purchase, but he nonetheless gave his tacit approval to the BP-Rosneft deal (Reuters, October 25 2012). Since the purchase, now-Prime Minister Medvedev has also offered his approval, stating that it is merely an “exception” to the state’s plans for privatization (*Dow Jones Newswires*, November 26, 2012).

Though now somewhat begrudgingly, the Russian state has asserted itself as the dominant player in the oil industry. However, a number of questions have arisen as to whether this is a positive development. The first consideration is the choice of Igor Sechin as the CEO of Rosneft in 2010. Sechin had worked alongside Putin in the St. Petersburg Mayor’s office, has alleged ties to the KGB, and is thought to have had an important influence on the President’s economic policies. Upon his appointment, Sechin had no prior experience running a large
corporation, or even in the oil industry itself other than previously serving as chair of Rosneft from 2004 to 2011. However, documentary filmmaker Igor Shadkhan argues that the decision was based more on personal ties to Putin. Regarding their previous dealings he claims “Putin chose Sechin because he wasn’t talkative and could be trusted with any information” (Reznik et al., January 30, 2014). According to Anders Aslund, Sechin’s micromanaging style harks back to the Soviet era: he writes “(Sechin) wants full control, which limits his ability to benefit from the knowledge of others” (Aslund, June 21, 2013).

Like Yukos before it, TNK BP had been praised for its transparency, ability to attract foreign capital and talent, and for leading in exploration and production efficiency. Robert Dudley, who ran TNK BP from 2003 to 2008, is widely touted as having turned TNK BP into Russia’s best-run energy company in terms of operations and finance (White and Huffstutter, July 26, 2010). However, the company faced a number of hardships before its sale was finalized in 2013. After enduring raids on his offices and increased bureaucratic barriers, Dudley was eventually denied a work visa and forced to leave Russia in 2008 after his contract expired, leading some at the time to suspect that BP would be forced out of the venture entirely (Kramer, July 25, 2008). Dudley’s Russian business partners had been calling for his ouster for years, and when the Rosneft takeover deal was finalized the shares of the four partners were purchased for $28 billion in cash (Reuters, October 25, 2012). At the time Dudley was forced out of the country, it was widely suspected by analysts that the partners had colluded with the Russian authorities to achieve this end (Kramer, July 25, 2008). Upon news of Rosneft’s acquisition of TNK-BP, it was reported in Russian state media that the move would add greater transparency and efficiency to Rosneft (Ria Novosti, October 25, 2012).
However, Sechin’s actions since the deal have been questionable. Since the Rosneft takeover, over 90% of the employees from TNK BP’s head office have resigned from their jobs, apparently due to Sechin’s poor management (Aslund, June 21, 2013), depriving Rosneft of much of the talent that contributed to TNK BP’s superior performance. Furthermore, despite the continual need for investment capital in the Russian energy sector, Sechin has denied TNK BP’s minority shareholders equal value for their shares within the company, claiming that Rosneft is “not a charity fund” (Soldatkin, April 23, 2013). Sechin has also attacked the former management of TNK BP for having paid dividends that were too large and investing too little, an argument that Aslund dismisses on the grounds that it is actually indicative of good performance which is attractive to would-be investors (Aslund, June 21, 2013).

Sechin has vowed to invest more than $20 billion annually in capital expenditure (Aslund, June 21, 2013). As with Gazprom, much of this is in non-core assets of questionable profitability. Thane Gustafson argues that Russian firms should be focusing on “tight oil” in Western Siberia by utilizing new technologies that require extensive capital investment from smaller foreign partners (Gustafson, 2013, p. 497). Nonetheless, Sechin is planning to invest in Arctic exploration with large foreign companies, which will have a much longer time span in terms of delivering production yields (Aslund, June 21, 2013) at a time when many existing fields are now believed to have surpassed their peak in terms of current production with existing technology and are now going into decline (Aris, November 27, 2012). In this sense, Russian production is under serious threat in the short term as there is a serious gap in the time for delivery. The extensive amount of infrastructure investment in Arctic development will create many possibilities for would-be rent seekers.
Like Gazprom in the 1990s, Rosneft has been using an intermediary to get its products to market. In 2003, the Swiss-based oil trading intermediary Gunvor won the contract to trade Rosneft’s oil and by 2007 it handled as much as one third of all of Russia’s seaborne oil exports (Hoffman, et. al., March 21, 2014). The firm, which was co-founded by President Putin’s close friend and former associate from the St. Petersburg mayor’s office Gennady Timchenko, is suspected by the United States of having direct ties with President Putin through ownership of shares and has been targeted by recent sanctions (Luhn, March 21, 2014). Proof of Putin’s direct involvement in Gunvor would explain much: the company’s revenues grew from $5 billion in 2005 to $43 billion in 2007 following the breakup of Yukos, which was initiated by the Putin administration (Ibid). Such proof would only add to the validity of Kang’s theory of the “predatory state” wherein large amounts of money are appropriated by political elites, typically for the primary purpose of buying loyalty and the secondary purpose of personal enrichment (Kang, 2002, p. 141). Although there is no definitive proof of the president’s involvement, the fact remains that Grundor is reaping substantial rents from Russia’s oil sector, and like the Florida-based ITERA, is doing so from outside Russia’s borders.

Gazprom, with ever increasing reports of mismanagement since its founding at the end of the Soviet era, offers considerable insight as to the future of Russia’s oil sector under the status quo. These problems include:

- A state budget heavily dependent on oil revenue: it is estimated that a balanced state budget requires the global price of crude to be above $120 per barrel (Schuman, July 5, 2012) and prices have not reached that level since 2009.

- A wasteful and ailing transport network: environmental groups estimate that Russia’s pipelines spill at least 1% of annual crude production and the Russian Transport Ministry conservatively estimates that 20 million tons are spilled each year (The St. Petersburg Times, December, 2011).
• A severe lack of foreign investment that hinders the productivity and profitability of firms, mainly due to an unfriendly investor climate affected by rent-seekers. This adversely affects not only production but also transport and the exploration for new fields (Ernst and Young, 2011).
• The alarming number of depleted fields in use and the insufficient exploration for new ones (Ernst and Young, 2011).

With challenges as great as these, Kang’s matrix offers us some insight into how effectively they may be handled in the future: this will be explored in the next chapter.

4.3 Reforms and Outcomes in the Gas Sector

Given the systemic problems outlined in the previous chapter, Putin faced a considerable challenge in reforming Gazprom into his ideal of a ‘national champion’. Despite this, he produced significant initial results in changing the (at least nominal) leadership structure at Gazprom; the issue is whether these changes resulted in meaningful reform. Moreover, Russia’s gas industry is heavily dependent on the country’s foreign policy. For this reason, this section will also examine the implications for Russia’s gas export capacity.

Reforming Gazprom was a formidable task. In addition to the widespread asset stripping noted in the previous chapter, Gazprom executives became very accustomed to the lifestyle their positions afforded them. Goldman notes the company’s “Taj Mahal-like” headquarters, and the executives’ penchant for paying large bonuses to themselves and building extravagant resorts for their exclusive use. These extravagances should also be viewed in light of major financial inefficiencies: in 1999 Gazprom reported a profit of $1.3 billion, but according to Western accounting practices this should have been posted as a loss of $3.2 billion (Goldman, 2008, p. 140). Removing Chernomyrdin as chairman of the board proved a relatively easy task: Putin’s
former associate from the St. Petersburg mayor’s office, Dmitry Medvedev, replaced him in 2000 (Viktor, 2008, p. 50). However, Gazprom had a history of formidable yet failed attempts to change its leadership structure.

In 1999 board member and former Minister of Finance Boris Fedorov attempted to bring in a new auditor to examine the company’s relationship with the Florida-based Itera, and openly called for the dismissal of CEO Rem Vyakhirev. Vyakhirev did not take kindly to this criticism and Fedorov began to fear for his safety: more than fifty articles denouncing him appeared in Moscow’s Gazprom-dominated press, he was visited by representatives of the ‘Russian Mafia’, and even discovered that ‘someone’ had poisoned his dog. It was only when Putin dismissed Vyakhirev and replaced him with another associate from St. Petersburg, Alexei Miller, in July 2001 that these attacks suddenly ceased (Goldman, 2008, p. 141).

Unlike Yeltsin, Putin had no hesitation in wielding executive authority in enforcing his goals on state-owned corporations; however, there were considerable trade-offs. Early in his presidency, Putin began to decimate the ranks of the ‘oligarchs’. By the time Gazprom reforms were underway, contentious figures like Berezovksy and Gusinsky had already been exiled and the infamous Yukos affair saw most of the company’s management jailed just five years later. Very few of those who had emerged outside of the traditional bureaucracy would have much influence in the hydrocarbon sector and many were removed with considerable harshness. As with the compliant Roman Abramovich of Sibneft, Putin completely ignored past abuses from the likes of Chernomyrdin and Vyakhirev, and rewarded them handsomely. Chernomyrdin, whom The Moscow Times reported as having a net worth of only $46,000 in 1997 (The Moscow Times, July, 1997), was appointed ambassador to Ukraine following his dismissal from Gazprom; official media now describes him as being one of the wealthiest men in the country at
the time of his death in 2010 (RT, Accessed Feb. 15, 2014). Former CEO Rem Vyakhirev is also said to have amassed a fortune of $1.5 billion at the time of his ousting as CEO in 2001 (The Moscow Times, February 13, 2013).

The fact that both Chernomyrdin and Vyakhirev, with strong evidence linking them to rent-seeking, violence, and extortion, were given such honours by the state is indicative of a special relationship between them and the Kremlin. Though a national champion is indeed meant to be compliant with the state, it is also meant to be globally competitive. In this sense, Yukos and Gazprom were different sides of the same coin: Yukos defied state authority and Gazprom’s competitiveness was hindered by deep systemic problems within. In this sense it stands to reason that the Gazprom leadership should also be punished, given the well-documented cases of mismanagement in the decade prior. Because Chernomyrdin and Vyakhirev were treated so well compared to the draconian measures taken against the Yukos leadership, it seems clear that the Putin government values compliance over performance and that authoritarian measures to enforce compliance were not applied evenly, with the oligarchs receiving the harshest treatment. More importantly for the purposes of this study is that these measures significantly limited competition within the industry.

Medvedev and Miller were first tasked with bringing a halt to asset stripping and well as reclaiming those assets stripped from Gazprom in the previous decade. As CEO, Miller’s first move was to stop the bleeding of money through the Florida-based Itera. This had been purchasing Gazprom gas at a fraction of its market value and selling it to foreign buyers at an inflated rate at a cost of billions annually in lost revenue. In 2004 Itera was denied access to Gazprom’s pipelines, forcing it into near bankruptcy; by 2006 it was persuaded to sell its controlling interest in Sibneftegaz, a key asset that had been previously stripped, back to
Gazprom bank for a deflated price of $130 million (Goldman, 2008, p. 142). In 2005, Gazprom’s board purchased an additional 10.7% of Gazprom shares for $7 billion -- which Western analysts believe to be a heavily devalued price -- solidifying a state-held majority at just above 50% (BBC, June 16, 2005). Despite the new leadership’s success at recovering assets, stopping the haemorrhaging of wealth to the rent-seekers at Itera, and regaining state control, Gazprom would remain quite opaque. This opacity would lend itself to further asset stripping in the years to come.

As gas prices and foreign demand rose in the 2000s, Gazprom emerged as an even greater source of revenue and power for the state; however, it became apparent to observers that Putin prioritized the latter over the former. Beginning in 2000, Gazprom benefitted greatly from a steadily increased gas demand in Europe, dwindling European gas production, and Europe’s preference for gas as an alternative to less environmentally friendly fuel sources like oil and coal. Partly as result of these conditions, the value of Gazprom’s exports tripled between 2002 and 2006 (Aslund, 2010, p. 154). However, this growth in export revenue resulted in little investment in productivity: gas production declined in the five years leading up to 2002 and levelled off at roughly 550 billion cubic meters per year between 2003 and 2008 (Astrov, 2010, p. 15). Additionally, Russia’s oil producers continued to flare between 50 and 60 billion cubic meters (roughly 10% of Gazprom’s total production), primarily due to poor infrastructure and discriminatory access to Gazprom’s pipeline network (Ibid, p. 22): the former of which, Karl argues, is an indicator of internal corruption (Karl, 2007, p. 119). Aslund argues that “(Gazprom) sales seemed to be on autopilot, and the perception was that Russia could double its gas exports to Europe between 2006 and 2015” (Aslund, 2010, p. 155). In his 2006 state of the nation speech, Vladimir Putin boasted that Gazprom had become the world’s third largest corporation
with a market capitalization of over $300 billion (Goldman, 2008, p. 142). At the time, some of its executives even predicted that Gazprom would soon surpass ExxonMobil and General Electric to become the world’s most valuable corporation with a market capitalization exceeding $1 trillion (Aslund, 2010, p. 157). With this sense of confidence, officials utilized Gazprom’s immense resources to suit purposes with little relation to the firm’s long-term viability.

4.4 Gazprom: Foreign Activities

A proper examination of Gazprom requires looking at its activities beyond Russia’s borders. The necessity of this section is to demonstrate the effects of rent seeking and corruption in Gazprom’s foreign activities, and that these have contributed to hindrances to the company’s long-term viability. Furthermore, it has been made apparent that the firm operates often as a tool of Russian foreign policy, indicating a particularly close relationship between it and the political regime.

As had been done during the Soviet and Yeltsin eras, the Russian government regulated gas sales prices within the former Soviet Union, and as such they were kept artificially low. This has a dual advantage for the political elite domestically: it stimulated industrial growth, and made gas more affordable to a society where many struggle economically on a daily basis. As a tool of foreign policy, gas sales also had the effect of strengthening relationships with important allies and could be used to punish those states that balked at Moscow’s influence. This became quite apparent in 2005 when Ukraine’s Orange Revolution produced a leadership that decidedly favoured the west. At the time Ukraine was being sold gas for as low as $50 per 1000 cubic meters, a third of the price, which was paid by other European buyers. Following the pro-western Orange Revolution, Goldman notes that Russia decided that Ukraine should then be made to pay for gas at the same prices as western buyers (Goldman, 2008, p. 144). The result would be years
of gas disputes that would affect not only Ukraine’s gas supply, but also that of Russia’s largest
gas consumers in Europe.

Like Russia, Ukraine’s gas transport system is incredibly antiquated and deeply corrupt. Just as Itera had been stripping wealth from Gazprom through sales to Ukraine, Ukraine’s elite (along with their Russian partners) were siphoning large amounts of Russian and Turkmen gas (transported exclusively through Gazprom pipelines) and enriching themselves in the process. This is an issue that goes much deeper than Ukraine’s socio-political divisions: in the 1990s the former Prime Minister and key figure in the Orange Revolution, Yulia Timoshenko, was known as Ukraine’s ‘gas princess’ and at one point controlled one third of Ukraine’s gas industry, or 20% of her country’s GDP. In the 1990s she and her former business partner, Pavlo Lazarenko, are alleged to have siphoned over $20 billion in public funds to overseas bank accounts (Ioffe, February 23, 2014). Furthermore, the network of intermediaries used to transport gas through Ukraine is convoluted and of questionable repute: the United States Department of Justice and FBI have investigated numerous allegations that Ukrainian and Russian organized crime syndicates are involved in Ukraine’s gas transport sector (Goldman, 2008, p. 147). When one considers this volatility, the fact that Russia continued to rely on Ukraine as its primary conduit to the European market is troubling.

Ukraine and Russia had numerous disputes over theft of and non-payment for imported gas in the 1990s that resulted in brief supply cut-offs on several occasions. When Kiev refused to pay Moscow’s higher gas prices in January 2006, claiming a breach of contract, Gazprom claimed that the contract had expired and was null and void. That year Gazprom cut off Russian/Turkmen gas shipments to Ukraine; however, Ukraine was able to divert sufficient
supplies from that which was intended for domestic use to Europe and supplies were not greatly affected.

Moscow and Kiev came to an agreement in 2008 wherein the Ukrainian state-owned oil and gas company, Naftogaz, would purchase gas from Gazprom and repay $1.52 billion in outstanding fees for gas deliveries. After Rosukreenergo (RUE), the Gazprom-controlled intermediary, received payment from Naftogaz on December 30, 2008, Gazprom insisted that the company owed an additional $614 million in fines and penalties, and on January 1, 2009 it cut off all shipments to Ukraine while continuing those to other European customers (Pirani et. al, 2009, p. 17). Pirani, Stern and Yafimava offer three possible reasons as to why Gazprom allowed Kiev to accumulate such a high amount of debt that necessitated a supply cut-off in the first place:

1. Gazprom assumed that Moscow and Kiev would come to an agreement and did not want to upset its European customers. By not cutting off gas supplies as a sign of good faith, Russia would reassure its European customers that there would not be a repeat of the 2006 dispute. Furthermore, because declining prices severely strained revenue, Gazprom was keen to have Ukraine sign a ‘transition contract’ (a step by step increase in the price of gas sold to Ukraine to eventually reach parity with those of the EU) that was made conditional on Ukraine’s full repayment of its debt (Pirani et al., 2009, p. 17). Given Ukraine’s unreliability and lack of funds in the past, this could be seen as either a reckless wager or wishful thinking.

2. The Gazprom-controlled intermediary, RUE (to which most of the money was owing) may have simply failed to adequately monitor the situation. However, they note that this was unlikely, given Gazprom’s control of the company (Ibid, p. 18)

3. A lack of oversight could have caused both parties to overlook the standard practice of having contracts run out in October, rather than in the middle of winter at year’s end (Ibid).
With Ukraine as an increasingly unreliable transport conduit, Russia has opted to construct alternative pipeline routes to Europe. Gazprom’s Nord Stream Pipeline, which runs under the Baltic Sea to Germany, was commissioned in November 2011. The South Stream Pipeline, running beneath the Black Sea to the Balkans and Southern Italy into the European Market is expected to open in 2015 (Gazprom) and Gazprom has also discussed the possible expansion of the Nord Stream route (Natural Gas Europe, February 7, 2014). However, as of February 2014 Ukraine remains the conduit for 50% of Russian natural gas exports to Europe and 15% of Europe’s total gas imports (House of Commons Library, February 28, 2014). With mounting tensions following the ousting of Viktor Yanukovich (who himself had issues with Gazprom and Russian natural gas imports), a pro-Western government has now emerged that dominates the geographic area where most gas pipelines are located (Globe and Mail, February 28, 2014). Though Gazprom spokesman Sergei Kupriyanov has recently stated that Kiev will have “zero role” in Russian gas exports after the completion of these two pipelines (Ria Novosti, February 22, 2014), Russia’s current reliance on Ukraine as a transit route for at least as long as is necessary to complete construction could result in a major gas crisis in Europe which in turn could severely affect revenue for the Russian state. Moscow ultimately bears the responsibility for relying so heavily on a partner that has proven highly unreliable over the course of the past three decades. Though this reliance may have been understandable under different circumstances, Gazprom’s large influx of squandered wealth due to favourable gas prices in the 2000s may have financed the exploration of such alternatives much sooner.

Maintaining a monopoly on the western transit of Central Asian natural gas through Russian territory is of primary concern to Russia and Gazprom. The region has three major gas producers: Turkmenistan with 7.5 trillion cubic meters of proven gas reserves, Kazakhstan with
2.4 trillion, and Uzbekistan with 1.8 trillion. Though these three countries possess among the world’s largest reserves, they do not compare with Russia’s 49 trillion cubic meters (CIA World Factbook). Should these countries’ rich gas fields have access to a pipeline that bypasses those of Gazprom to Europe, they would be a major competitor for Gazprom in a market with an increasing demand for a more reliable seller. Though Moscow largely ignored the region in the 1990s, it has been paid particular attention to it since 2000, largely in an effort to maintain its transport monopoly.

The primary threat to Russia’s natural gas transit dominance is the Nabucco pipeline, which was originally proposed in 2002. Some have stated that it could be operational by 2018 (UPI, May 11, 2012). At present, the proposed line would carry gas from Azerbaijan and northern Iraq through Turkey to Europe via the Balkans.

Though the influx of Azeri and Iraqi gas to Europe certainly threatens Russia’s cornering of the market, the additional threat looms that the pipeline may reach across the Caspian to the Central Asian producers. Though there have been a number of treaties regarding the status of the Caspian since 1813, none of these has led to a consensus on border demarcation. The seabed beyond the ten-mile coastal radius remains an international zone in which all parties must agree to any pipeline construction. Because it is not in the interest of all parties involved (particularly Russia), such a consensus has not been reached and thus little progress has been made on a proposed trans-Caspian pipeline connecting Turkmenistan to the Nabucco pipeline in Azerbaijan (Journal of Energy Security, 2010).

However, an additional possibility exists that the easing of tensions between Tehran and Washington could revitalize the United States-backed Nabucco pipeline. In 2009 the White House appointed Richard Morningstar as Envoy for Eurasian Energy. At a conference in
Bulgaria in April of that year, he suggested that opening Iran’s energy sector could be a “carrot” for Iran to improve its relations with the United States (Kucera, 2009). Having been appointed to the key role of Ambassador to Azerbaijan in 2012, Morningstar has continued to discuss issues related to the role of Central Asian gas in European energy security. On February 20, 2014, in addition to stressing Azerbaijan’s relationship with the United States, he also discussed the possibility of Iran’s role in regional energy projects (AzerNews, February 21, 2014). Iran possesses the world’s second largest proven gas reserves after Russia, at nearly 33 trillion cubic meters (CIA Factbook), so a pipeline carrying Iranian gas to Europe would pose a major threat to Russia’s dominance in that market. Furthermore, with Iran’s territory running along the south Caspian coast into Central Asia, the possibility exists that Nabucco may be extended to the gas producers of that region as well. If this line were to open concurrently with the increased in LNG exports to Europe, Russia would face serious threats to accessing its largest gas market.

It must first be stated that the recent events in Ukraine have demonstrated the necessity for Russia’s plans to build the Nord Stream and South Stream pipelines: combined, their total capacity matches the volume of gas in transit via Ukraine, effectively bypassing it (Korchemkin, August 21, 2009). Though the crisis in Ukraine has certainly created an impetus, there have been numerous legal issues with the countries over which the South Stream line will pass: Austria, Greece, Hungary and Serbia. As a result of this, the project was declared “illegal” by the European Union last year and its construction is currently halted (Ekathimerini, February 21, 2014).

With Russia having proven to be an unreliable partner, Europe has increasingly looked for alternate means to achieve energy security: in 2003 Europe imported 45% of its gas from Russia, but it currently imports just over one third (Financial Post, March 5, 2014). In addition to
the proposed Nabucco route, the European Union has increasingly looked to overseas providers for shipments of liquefied natural gas (LNG). In December 2013, Qatar announced that it expected to ship 22% more gas than it is currently under contract to deliver Europe in 2014, the largest increase since 2009 (Gulf Times, December 24, 2013). Furthermore, the ‘shale revolution’ has allowed the United States to dramatically increase production for export purposes, and in the wake of the crisis in Ukraine, senior congressional Republicans have called on the president to further reduce barriers to gas exports (Bloomberg, March 4, 2014). Additionally, in March 2014 a spokeswoman for the European Commission has stated that the EU currently has 40 billion cubic meters of gas in reserves, accounting for 10% of total annual demand at present (Financial Post, March 5, 2014). Finally, though the infrastructural needs are not in place at present, Europe is looking to increase its domestic shale gas production. Poland has recently successfully tested a natural gas well project worth an estimated 60,000 cubic meters per day in a project backed by American billionaire George Soros and Blackrock, Inc. The United Kingdom, Romania, and Ukraine have also expressed an interest in shale gas exploration (Bloomberg, January 23, 2014). As tensions with the West rise over the annexation of Crimea and other events in Ukraine, it can reasonably be expected that Europe will continue to explore ways to wean itself off Russian gas. This means that Russia must look to either LNG production or seek buyers through alternative pipeline routes.

In addition to these challenges, perhaps the greatest issue before Russia’s gas industry is the lower global demand and prices that have not fully recovered since the 2009 financial crisis. In the years leading up to the market crash, Gazprom’s market capitalization was the third highest of any company in the world at $360 billion. In 2007 CEO Alexei Miller promised to boost this to $1 trillion in the next decade. However, as global commodities prices collapsed,
Gazprom’s value decreased substantially: by June 2013 its market capitalization had fallen to just $77 billion (Soldatkin, June 28, 2013). In the wake of the crisis in Ukraine, Gazprom shares fell by 17.68% and the company lost $15 billion of its market capitalization over a few days in February/March 2014 (ITAR-TASS, March 3, 2014).

With its present model, Gazprom’s prospects appear to be dwindling. Traditionally, Gazprom has insisted on long-term service contracts at fixed prices through regional pipelines. This worked well for consumers when gas prices were on the rise, but when they are in decline they create the impetus among customers to seek alternatives. Now that Russia has missed the ‘shale revolution’ and has invested little in LNG development, Gazprom’s share of the European market is being slashed by shipments from Qatar and possibly soon the United States. This impetus for change is merely a matter of economics.

However, Gazprom’s political activities have created much more alarm among consumers who are now seeking alternative fuel sources. A study by the Swedish Defense Research Agency showed that Russia used “coercive” energy policies such as coercive pricing, supply cuts, and sabotage 55 times from 1991 to 2006. Of these incidents, the authors wrote that 36 had political and 48 economic underpinnings. They also found that the post-Soviet countries of Moldova, Ukraine, Belarus, Lithuania, and Georgia were the most targeted. While this clearly points to the exercise of state power, Gazprom was found to be involved in 16 of the cases and its closely-allied trader, Itera, in an additional 9: thus it is clear that Gazprom has been involved in Moscow’s political machinations (Aslund, 2010, p. 159). It was through this system that Gazprom sought its power and profitability, but it appears that this model’s efficacy is failing.

The state and Gazprom have colluded regularly in manipulating the economic and political systems of their customers. Aslund notes: “Gazprom justified its multiple cuts in supply
with payment arrears and resistance to higher prices, but often they have been accompanied by loud political polemics by Russian officials” (Aslund, 2010, p. 159). While Gazprom initially kept prices low for former Soviet countries, the prices were still as such that large and unregulated debts were permitted to accumulate in order to be traded for debt-equity swaps in an effort to gain control over these countries’ pipeline systems. Though it had long touted itself as a reliable energy provider, Gazprom continued to disrupt supply flows even after the pipelines were acquired in countries like Ukraine, Moldova, and Belarus (Ibid). While Gazprom certainly damaged its reputation with its post-Soviet consumers, the supply disruptions to Ukraine were as such that it led to major fears among its consumers in the west as well.

As we have also seen, intermediaries like Itera and Eural Trans Gas, with numerous ties to organized crime (Goldman, 2008, p. 147), have benefitted immensely at the expense of both consumers and Gazprom itself. The practices of these intermediaries have also contributed to Gazprom’s unreliability as a provider. With low consumer confidence and competition from emerging LNG producers, Gazprom faces major obstacles to its long-term viability.

Despite troubles in Europe, Russia has managed to secure a deal to sell gas to China, albeit with a number of concessions. Moscow and Beijing began to develop plans to sell Russian gas to China when Gazprom and China National Petroleum Corporation (CNPC) signed the Agreement of Strategic Cooperation on October 14, 2004 (Gazprom Website). On May 21, 2014 Gazprom signed a deal to provide China with some $400 billion worth of gas over a ten-year period (BBC, May 21, 2014). Despite this breakthrough, the deal is not as profitable as it would appear. A recent study by Merrill Lynch estimates that it will cost some $55 billion to develop the gas fields and pipelines necessary to supply China. China has pledged $25 billion to develop the fields, meaning the project will require an additional $30 billion from either Gazprom or the
Russian government to develop the pipelines (Treagold, May 28, 2014): as we have seen, pipeline expenditures tend to run over cost estimates as rent seekers take advantage through padded construction costs. In addition to this, Gazprom will need to recover unpaid bills from the new government in Ukraine, which could take a considerable amount of time with current tensions (Ibid.) Finally, the threats to Russia’s market in Europe are still of great importance: the 38 billion cubic meters to be sold to China annually is small compared to the 161.5 billion sold to Europe in 2013 (Lain, May 26, 2014). For these reasons, the China deal, though necessary in light of Gazprom’s fall in European sales, comes at a significant cost to the company and with diminished long-term benefits.

As we have seen, Gazprom’s foreign activities have not produced optimal results. Like with other aspects of the company, rent seeking and corruption are major problems with the stripping of assets through Ukrainian intermediaries and the legal problems associated with the South Stream pipeline standing out as notable examples. These factors, and the subsequent capital outflow, appear to be factors in why Gazprom has not put more resources into new technologies such as Liquefied Natural Gas, which would have allowed it to diversify its market.

Aside from being very interesting, the reason for including these foreign activities is to first demonstrate that rent seeking within Russia’s gas sector extends beyond Russia’s borders by conferring rents on intermediaries as well as enabling corruption on pipeline projects. It is demonstrative of the ways in which capital flows out of Gazprom and how inefficient the firm is at getting its product to market. This inefficiency and waste, in addition to an antagonistic foreign policy that is deeply linked to Gazprom, is demonstrative of the prioritization of rent seeking activities over efficiency and long-term viability. Now the Russia faces serious threats to its share of foreign gas markets, the flaws of this strategy are becoming increasingly apparent.
4.5 Dysfunctional Business Model and Internal Rent Seeking

Though external factors are certainly at play, Gazprom’s mismanagement during nearly a decade of high profits has also led to serious issues at present. CEO and trusted Putin ally Alexei Miller was once touted as one of Russia’s great business leaders and economic reformers. However, he is now largely credited as leading Gazprom into one of the greatest missed opportunities of the 21st century. While the United States undertook massive energy reforms in the exploration for and exploitation of shale gas, Miller dismissed this as a “myth” (The Economist, June 19, 2013). These developments have not only proven to be real, but now Russia is facing serious competition from the United States in this regard. Furthermore, despite the available capital, Gazprom invested very little in easily transported Liquefied Natural Gas (LNG) and is now competing with emerging producers like Qatar which are capable of transporting large quantities of liquid gas into Europe’s ports. Presently, Russia’s market share of European gas is diminishing, major shale producers like the United States are expected to emerge as greater competitors in the future, and European countries have been increasingly looking toward domestic production.

In addition to these major threats to its viability, Gazprom faces a much more insidious threat: wasteful internal spending that enables widespread rent seeking. Russia’s Hermitage Capital Management has written a report accusing Gazprom of spending well above market prices on pipeline projects (The Moscow Times, June 16, 2005). Coincidentally, in December 2013 Gazprom announced that the South Stream pipeline project would cost 45% above the initial estimate and it claims the additional $23 billion is needed for upgrades to its domestic gas system (Reuters, December 9, 2013). This would allow local rent-seekers to take full advantage of the purportedly padded costs. An exposé from Kremlin opposition leader Boris Nemtsev has shed light on a number of other cases of overspending at Gazprom. Among other things, he notes
a project in Russia’s Far East that is to create a gas corridor to China by linking it to a gas field north of Lake Baikal at a cost just above $38 billion: the report notes that not only does Russia have an existing pipeline in the region to fulfill that function, and it does not have enough gas to fill it to capacity. Finally, the report sheds light on the actual beneficiaries of these projects: among their strongest advocates are Ziyad Manasir and Arkady Rotenberg, “old friends of Putin” who control the two major subcontractors for Gazprom’s pipeline projects. This kind of spending not only cuts into Gazprom’s profit margins, it also hurts the ordinary Russian consumer: the enormous cost of such endeavours will be paid by raising the domestic price of gas over the next few years, increasing the cost of living for millions of people living in a now-struggling economy (The Moscow Times, February 5, 2014). However, this kind of corruption and inefficiency serves only to benefit Gazprom’s major subcontractors.

Despite having built a headquarters that critics likened to the Taj Mahal in the 1990s and now facing major financial difficulties, Gazprom is constructing an 86-floor 456-meter tower to serve as its new headquarters in St. Petersburg, to be completed in 2018 (The Globe and Mail, January 19, 2014) at an estimated cost of $1.87 billion (The Moscow Times, September 4, 2012). It would not be surprising to see this cost rise exponentially in the coming years. In 2008, as a testament to the lifestyle of those within Gazprom, the company listed a request to purchase, among other things, a horse-bathing facility, a solarium, a laser physiotherapy complex, a cosmetologist’s chair, and a new whirlpool hot tub for one of its luxury resorts outside Moscow (Vishnevsky, November 5, 2008) – all during the same month as the worst crash in global financial markets since the Great Depression. In 2013 CEO Alexey Miller ordered a $3.7 million tablet (a top of the line iPad retails for roughly $1000) that he claims is required for “decision making on raising Gazprom’s efficiency” (The Telegraph, July 16, 2013). A report by
independent investment bankers states that 70% of Gazprom’s $50 billion in capital investments in 2011 were lost to “value destruction”, or what Aslund terms ‘waste and corruption’ (Aslund, February 28, 2012). Miller is also widely believed to have been the intended occupant of a $30 million 3200 square meter mock-18th century palace reportedly commissioned by Gazprom for “official and semi-official events” in 2004 and constructed by Gazprom construction subcontractor and reported “friend of Putin”, Ziyad Manasir. Unfortunately for him, the palace was deemed too extravagant following the financial crisis and the contract was cancelled: it now apparently sits empty (The Telegraph, December 29, 2010). It is also important to note that these extravagances were all recorded in a period when Gazprom’s market capitalization plunged by more than 75%.

Despite its precarious financial position, Gazprom’s leadership appears to have no intention of scaling back expenses. In 2013, during a year when Gazprom saw a 9% fall in net profit (The Moscow Times, February 17, 2014), calculated by local accounting standards, the 17-member board of directors saw its compensation grow by 67%, with many members holding additional lucrative positions at the company’s numerous subsidiaries.

Though the largesse of its executives and subcontractors is certainly well known, the primary beneficiary of Gazprom rents is the Russian state itself. As a company, Gazprom contributes some 20% of Russia’s annual budget (Financial Times, June 5, 2013): though the oil industry contributes more as a whole, Gazprom is the single largest contributor. With Gazprom’s major challenges and the precarious state of Russian oil, the status quo for these economic actors could have major consequences for the Russian state and society if it is permitted to continue.
4.6 Gazprom: Challenges for the Future

By enabling rent-seekers and focusing on an out-dated business model, Gazprom has missed three important opportunities that would ensure its long-term viability:

1. **Shale Gas**: Famously dismissed as a ‘myth’ by CEO Alexey Miller, this new source is enabling new competitors in the world market, particularly the United States. As its current fields deplete, Gazprom must develop new ways to reach new gas for export.

2. **Liquefied Natural Gas (LNG)**: Countries like Qatar and the United States have undertaken to construct facilities capable of converting large amounts of gas to liquid for shipping. Though costly, the benefit is an unprecedented ability to access a gas market that is now global: gas may be liquefied at a 600:1 ratio in a state ready for transport. To put this into perspective, Russia shipped about 167 billion cubic meters of gas to Europe in 2013 (Forbes, March 5, 2014). However, a QMax LNG Container Ship can carry 226,000 cubic meters (1.35 billion in conventional form) of natural gas to market in a single shipment (Oil and Gas Journal, July 16, 2008); Qatar shipped more than 45 million cubic meters of LNG (27 billion cubic meters in conventional gas) in August 2012 alone (Lloyds List Intelligence, 2012). If Russia is to make the most of its gas exports, it must develop this technology to a much greater extent in order to diversify its consumer base and become more competitive in the global market.

3. **Investment**: With dated technology and dwindling finances, the aforementioned challenges cannot be overcome without substantial foreign capital and technological investment. For this reason, Russia’s and Gazprom’s ability to attract foreign investment is also crucial in facing these challenges.

4.7 Hydrocarbons: Conclusion

The social programs, pension benefits, and other funding that hydrocarbon revenue has provided to the Russian state have been essential to the stability of the Putin regime. Just as
Gazprom sought to keep prices low only in the pursuit of capital assets and eventual higher prices in post-Soviet Europe, the same appears to be happening in Russia as domestic prices are driven up to fund mostly unnecessary endeavours for the enrichment of Gazprom’s elite inner circle of executives, subcontractors and other ‘friends of Putin’.

Through his protégé Igor Sechin, it appears that Putin is attempting to reform Rosneft into the ‘national champion’ he had hoped Gazprom would be. Ironically however, he is doing this in precisely the way he empowered his other protégé, Alexey Miller of Gazprom, in the past: enabling a bureaucratic state-controlled corporation to dominate the industry. By whatever means, it is now imperative that meaningful reform is made to Russia’s oil and gas industries as the state faces a major crisis.

Though the Russian state was able to wield power coherently and effectively against the private sector at the turn of the 21st century, as in the Soviet era before, it still lacked means to curb corruption within its own bureaucratic ranks. Despite the state growing more powerful and coherent by increasing cohesion between the executive and legislative branches of government, its unchecked corporate management continues to undermine this coherence by enabling corrupt actors to divert capital and make questionable decisions, generally with impunity. With dwindling foreign opportunities, Gazprom’s actors - like their Soviet bureaucratic forbears - are now turning their predatory behaviour on the public. As budgetary pressures mount and fuel prices rise, the Russian people could experience a deteriorating quality of life in clear view of an apparently parasitic elite and an authoritarian state offering fewer of the benefits it employed to justify its own existence.
4.8 Russia’s Emerging Nuclear Sector

With extensive technological, human, and resource capital, Russia is poised to be a dominant actor in the global civilian nuclear industry. On the surface, this appears lucrative: the global civilian nuclear energy market is estimated to be worth roughly $850 billion by 2020 (ITA, October 30, 2013). However, with funding for these projects supplied extensively by the state, limited returns on investments, high risk, and widespread corruption, Russia’s ability to capitalize on this industry is questionable. Furthermore Rosatom, Russia’s state-owned nuclear corporation, is receiving this increased funding with little oversight, not only permitting the possibility of waste and inefficiency, but also of significant environmental degradation.

Russia’s has renewed its interest in nuclear energy. In 2003 Russia had 19 civilian power reactors operating at nine sites (Josephson, 2003, p. 278); as of March 2014 there are 33 operational reactors with 10 more under construction (European Nuclear Society, 2014). However, even at an early stage of redevelopment there were troubling concerns. Paul Josephson notes that in addition to developing new reactors under questionable oversight, extending the life of old reactors is particularly risky as it involves sites where “incidents” occur frequently and extensive unresolved toxic waste issues persist. He concludes that Russia’s renewed interest in nuclear power is the same kind of “technological hubris” found in the Soviet era, when nuclear power was believed to be the potential source of the country’s total energy needs (Josephson, 2003, pp. 277-278). With such potential risks, the resulting reaction should a major incident occur could also seriously affect Russia’s ability to market its technology globally. This could have serious ramifications for the Russian state as it is so heavily invested in these overseas projects.
At present, global demand for Russian civilian nuclear technology is high: Rosatom’s foreign contracts have increased by 60% since 2011 despite widespread concerns since the Fukushima Daichi disaster of that year. Of the 68 nuclear reactors being built worldwide, Rosatom is building 28 – 9 within Russia and 19 abroad – making it the single largest player in the global market (Reuters, July 22, 2013). Part of the reason for this interest is the services Rosatom provides to prospective customers through its “build, own, operate” (BOO) offer, under which Rosatom (or a local subsidiary thereof) will control every aspect of the power plant while producing electricity for domestic consumption (Rosatom Group).

Furthermore, the company is developing technologies that are quite attractive to prospective buyers; however, this too has a number of drawbacks. Perhaps the most noteworthy of these technologies are the floating nuclear power plant (FNPP) and a new generation of breeder reactors. Going one step further than Rosatom’s “BOO” program, the FNPP is not only built, owned, and operated by Rosatom but is actually shipped in on a barge and anchored in a location for local use. Rosatom hopes to export these units to countries for electricity and seawater desalinization, operating them on a 15-year basis before returning them to Russia for maintenance and defueling. China, Malaysia, Indonesia, Algeria, Namibia, Cape Verde, and Argentina have all expressed an interest in pursuing such purchases (World Nuclear News, August 11, 2008). The breeder reactors, for which Rosatom has been allocated $3.6 billion for research, are said to produce less waste than traditional reactors and cost less to operate (Medetsky, 2010). Though Russia is said to be the leader in this technology (Ibid.), there are a number of concerns as to its safety and its costly development. Indeed the construction of new reactors in Russia has been shown to be a costly and potentially hazardous endeavour with questionable long-term benefits.
Despite this interest, there are two particular risks associated with such endeavours: the potential for ‘incidents’ as a result of corruption, and the high long-term cost to the Russian budget. While the potential market for Rosatom’s turnkey, breeder and other facilities is tremendous, there are numerous concerns surrounding them. In nearly all cases, these issues have arisen as a result of blatant rent-seeking. Though Rosatom has undergone reforms, there are a number of incidents that point to deep corruption within its ranks. Furthermore, in a corporation that manages the entirety of one of the world’s largest nuclear power industries and the world’s single largest nuclear arsenal, such instances of corruption are deeply disturbing.

Firstly, it must be said that the Russian authorities and Rosatom have taken steps to fight corruption within the nuclear agency’s ranks, at least from what can be ascertained from the available information. At the end of 2005, signalling the beginning of reforms, President Putin appointed former Prime Minister and reputedly reform-minded Sergey Kiriyenko as head of Rosatom. Like Alexey Miller of Gazprom before him, Kiriyenko was young at the time of his appointment and had no experience in the nuclear sector; however, he was also known to be loyal to the Kremlin’s interests (Bellona, November 6, 2007). Since his appointment, a number of incidents of a disturbing nature have come to light within the state nuclear corporation.

Prior to Kiriyenko’s appointment, Yevgeny Adamov, who served Russia’s Nuclear Energy Minister from 1998 to 2001 was arrested in Switzerland in May 2005, at the request of the United States. He and two other Russian nationals were charged with embezzling over $100 million from the national budget as well as embezzling an additional $9 million issued to Russia by the United States for nuclear safety projects (World Nuclear News, September 28, 2011). Though acquitted of money-laundering charges in a Monaco court, Adamov was extradited to Russia in 2006 and was found guilty of fraud and abuse of authority by a Moscow court in 2008.
Though sentenced to five and a half years in prison, he was released on a suspended sentence after serving a mere two months and returned to his former post as scientific advisor at the Dollezhal Institute (Ria Novosti, September 27, 2011), one of Russia’s largest nuclear research centers and a division of Rosatom (Nuclear Threat Initiative, 2013). Given Russia’s notorious lack of an independent judiciary (Pomy, April 28, 2013), Adamov’s lax treatment by the Russian authorities, as well as his reappointment to a comfortable position within the Rosatom corporation, is indicative of deep systemic problems within Russia’s nuclear sector.

Rent seeking and corruption have not ceased with Kiriyenko’s appointment. In July 2011, Rosatom’s former Deputy Director General, Yevgeny Yevstratov, was arrested along with his team of radiation technicians for embezzling $1.8 million in funds allocated for safety research in relation to waste disposal: Yevstratov and his team were found guilty of downloading scientific material from the internet and claiming it as their own. What is perhaps most surprising is Rosatom’s reaction: spokesman Sergei Novikov was quoted as saying “none of this is very surprising”. (Nuclear Power Daily, July 20, 2011). This is particularly troubling, given Russia’s poor record of nuclear waste disposal (Josephson, 2003, p. 277). Perhaps less surprising is that, though Yevstratov faced a maximum sentence of ten years imprisonment, his time in prison was eventually reduced to a mere two months (Raspi, September 9, 2012). In the cases of Adamov and Yevstratov, the rule of law in Russia appears to be open to significant interpretation with regard to Rosatom executives.

Though the Adamov and Yevstratov cases may involve relatively small amounts of money, corruption within Rosatom has significant costs to the company and the Russian state. With 10 reactors under construction, Russia is building more reactors than any other country in the world at this time (World Nuclear Association, March, 2013). According to former Minatom
Deputy Minister Bulat Nigmatulin, corruption accounts for no less than 40% of total construction costs for nuclear facilities within Russia (Andreev, 2011, p. 11). When one considers that Rosatom itself estimates that the cost of two reactors at the Novovoronezh Power Plant to be just over $6 billion (Rosatom, April 23, 2014) and there are currently 10 reactors under active construction in the Russian Federation, the potential financial cost of corruption is staggering.

Not only do Rosatom projects have the added financial burden associated with corruption, but there is also significant evidence indicating that corruption has led to the purchase of inferior materials. As a result of a 2012 Russian Federal Security Bureau (FSB) investigation, Sergei Shutov, the procurement director of Rosatom’s Zia-Podolsk machine plant, was arrested for purchasing low-grade raw materials and pocketing the difference. Though it remains unknown how many facilities were affected, it is possible that new reactors in Russia, China, India, Bulgaria, and Iran, as well as several reactor construction and repair projects in Russia may have been affected by the sub-standard material (Bellona, February 27, 2012). In another incident, Alexander Murach, the deputy head of Rosatom’s Research Institute for Complex Testing of Optoelectronic Devices and Systems (NIIKI OEP), was sentenced to three years in prison for selling counterfeit testing equipment used in nuclear power stations. The danger of faulty testing equipment is very serious: in a 1994 incident in India, faulty turbine detection equipment failed to detect two blades that had broken off. This caused the turbine to vibrate and led to a fire that destroyed the reactor’s secondary cooling system, resulting in India’s most serious nuclear accident to date. What is more astounding is that Alexander Murach was willing to jeopardize the lives of countless individuals for a mere $49,000 (Tanter, 2013, p. 483). Such incidents have not gone unnoticed by foreign buyers: there are reports that Chinese authorities have come to Rosatom with more than 3,000 grievances concerning low-quality
materials supplied to the Tianwan Nuclear Power Plant alone (Ibid, p. 485). In 2013, sixty of India’s top scientists (including nuclear specialists) wrote to ministers in Kerela and Tamil Nadu expressing safety concerns over Rosatom’s Kudankulum Nuclear Power Plant. In their three page petition they expressed doubts “particularly with reference to possible sub-standard components” that were shown to have been supplied to the plant (NDTV, May 14, 2013).

In addition to the real potential for ecological disaster and the subsequent public outcry that could result in loss of foreign revenue due to fines and/or cancelled work orders, there are a number of questions about Rosatom’s actual profitability. Speaking for Ecodefense, Russian nuclear physicist Andrei Ozharavosky concluded that “Rosatom is fast becoming, as before, a ‘state within a state’, a powerful and secretive dominion with an almost limitless access to government funds and no accountability to either the state or the public” (Tanter, 2013, p. 487). Indeed the Russian government offers substantial support to Rosatom: as of 2013 it has earmarked $37.5 billion over the next eight years (Reuters, July 22, 2013). While much this money is expected to be paid back by foreign buyers, the risk of non-repayment is quite high.

As of year-end 2013, Rosatom’s foreign orders amounted to $74 billion; however, the manner in which these projects are funded is a dubious one. Sergey Kiriyenko has insisted that “we want to make profits out of nuclear energy, we want to power the world” (Reuters, July 22, 2013); however, for Russia the emphasis appears to be on the latter. While the amount of money Rosatom will take in foreign orders is staggering, many of these projects are to be funded by the Russian state in the form of export credits over long periods, often with little interest (Bellona, January 22, 2011). The Akkuyu plant in Turkey alone will cost the Russian budget $20 billion with a timeline for return-on-investment exceeding 20 years (Bellona, March 2, 2011). Though Russia will reap profits as a result of its “BOO” program, the long timeline of repayment,
coupled with a high probability of error in forecasting electricity prices, will not only cut into potential profits but will also make it difficult to find investors for the project (Akkuyu NPP). Thus, with questionable profitability and a massive capital outflow for extended periods of time, it is risky to project that Rosatom’s foreign sales will have a positive impact on a state budget that continues to suffer from the effects of low foreign demand for hydrocarbon resources. It appears more likely that the state is handing this money to Rosatom while simultaneously assuming the liability for the loan: with strong evidence of wealth being siphoned off by Rosatom during such projects, it appears likely that this resource allocation is state-sanctioned rent procurement.

In addition to large government subsidies, the potential for excessive rent-seeking with Rosatom is very high, as it now effectively has the power to oversee its own regulation. Under Medvedev’s presidency in 2011, Rosatom became authorized to issue itself licenses to build and operate facilities within the Russian Federation – a mandate previously held by the Federal Agency for Ecological, Industrial, and Economic Supervision, “Rostekhnador” (Bellona, January 22, 2011). Vladimir Slivyak, co-chairman of the environmental group EcoDefence, an environmental group that has collaborated with Transparency International over abuses within Russia’s nuclear sector, notes: “Formally, they (Rosatom) are responsible for ensuring safety. In practice, Rosatom is essentially self-regulating” (Oliphant, April 11, 2011). As mentioned previously, Rosatom’s domestic projects feature questionable materials and offer strong evidence of padded costs: now that it may regulate itself without oversight and mandate its own projects, there are many opportunities for those seeking to exploit large systemic loopholes. This may also explain the relatively recent uptake in Russia’s domestic reactor production and refurbishment. Though export of power may be a long-term strategy, a lack of guarantees of sales or stable
electricity prices demonstrate that these projects are both costly to the Russian state and feature excessive opportunities for career rent-seekers.

As mentioned previously, the operation of foreign facilities is one that is high risk for little reward at present. Russia may gain influence in the foreign countries that become dependent on their power generation, but as we have seen with the situation in Europe in relation to natural gas exports and pipeline ownership, excessive corruption and political disagreements can lead to buyers to seek alternative means to satisfy their energy demands. As the world continues to seek new forms of renewable and non-renewable energy, the cost of offsetting the power provided by Rosatom may simply be one its future buyers could be willing to bear.

With evidence of padded costs, the reaping of billions of dollars of state money with little reciprocity, and the permission to regulate itself, Rosatom is emerging as more of a liability than an asset for the Russian state. If Aslund is correct in asserting that Gazprom is “the state’s foremost rent-seeking machine” (Aslund, 2007, p. 142), Rosatom is emerging as a strong contender and is doing so with a mixture of legal and illegal means with the use of state-approved funding. Though the superficial benefits it offers buyers has resulted in a major influx in foreign orders, Rosatom is almost entirely subsidized by the Kremlin at present. The opportunity to reap profit from the operation of its foreign facilities or the export of electricity from Russia is questionable and offers nothing tangible in the short term. With Russia’s budgetary problems and the cost of foreign sanctions, money is what the state requires more than anything else at present. When one considers the potential of a nuclear disaster, the potential social costs of subsidizing Rosatom are high for the world at large.
To summarize, the following factors must be considered when examining Rosatom’s behaviour:

1. **Systemic Corruption**
   Corruption is clearly rampant in the industry. This has been shown to be a hindrance both to profitability, as well as safety that could affect foreign demand.

2. **Lack of oversight**
   More than any other sector, the nuclear industry has the full authority to regulate itself without oversight. This must be taken into account as it casts doubt as to whether the systemic problems identified could possibly be alleviated.

3. **High cost to the state**
   High expenditures with little reward could mean that the nuclear sector not only fails to add revenue to Russia’s budget, but could also detract from it substantially. The legal means through which rents are attained include padded construction costs and little accountability as to how state funds are allocated. This is in some ways worse than illegal corruption in that it is, at least superficially, achieved through legal means.

4. **Potential loss of business over political and safety concerns**
   As mentioned previously, with the high levels of corruption and subsequent use of sub-standard technology and materiel, this is a very real issue. Though it is impossible to predict the future, this factor must certainly be taken into account.

   The state’s behaviour toward the nuclear sector mirrors that of the oil and gas sectors. By utilizing the political system, it has substantially increased funding and enacted reforms that have turned the Ministry of Atomic Energy into a state-owned corporation capable of entering a growing global marketplace. However, like Gazprom, the same systemic problems associated with value destruction and general rent-seeking continue to undermine the organization’s
effectiveness in delivering long-term benefits to the state. By allowing the firm to effectively regulate itself, the state is pursuing anti-corruption in a very incoherent manner by enabling those who have permitted corruption within their ranks to attempt to curb corruption with virtually no state oversight. Essentially, through self-regulation the firm’s elite may pursue a plethora of rent-seeking opportunities, as they are only accountable to themselves.
Chapter Five: Analysis

Each of the three sectors examined has a well-established culture of corruption; however, as we have seen previously corruption is not necessarily a hindrance to economic development. If the business and state sectors are able to counterbalance each other, in Kang’s argument an economy can thrive under the circumstance of widespread corruption.

Figure 4.1: The Four Types of Corruption

<table>
<thead>
<tr>
<th>State</th>
<th>Coherent</th>
<th>Fractured</th>
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<tbody>
<tr>
<td></td>
<td>I: Mutual Hostages (Optimal)</td>
<td>II: Rent Seeking</td>
</tr>
</tbody>
</table>
| Concentrated   | Type: PD
                 | Rent Amount: Medium          |
| (Strong)       | Type: bottom-up            | Rent Amount: Large    |
| Business       | III: Predatory State       | IV: Laissez-faire     |
| Dispersed      | Type: top-down             | (Optimal)             |
| (Weak)         | Rent Amount: Large         | Type: residual        |
|                |                            | Rent Amount: Small    |

Table 5.1 The four types of corruption

The one constant seen throughout the turmoil in the Russian economy over the past three decades is the role of the state bureaucracy. Though Lenin referred to his country’s economic system as that of “state capitalism,” wherein state bureaucrats would be entrusted with the means

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of production, today’s bureaucrats are perhaps best referred to as ‘state capitalists’ in their own right. While corruption and inefficiency were certainly rampant in the Soviet Union, the excesses of the bureaucracy were kept in check by a powerful police state to which none were immune: accordingly, the strong state’s preoccupation with quotas over innovation and efficiency led to the model resembling something akin to the ‘predatory state’, albeit with a much smaller amount of rent-seeking than seen in Kang’s example of the Philippines under Marcos. By contrast, there are fewer constraints on leaders in the energy sector today, and as we have seen, fewer still on their individual excesses. This has understandably led to more rent seeking with fewer restrictions; however, the question is whether a ‘mutual hostages’ scenario has arisen wherein economic development can exist in spite of this fact.

5.1 Russia through the lens of Kang’s Matrix

Kang’s case studies demonstrate a remarkable degree of similarity between Russia and the Philippines, and conversely, stark contrasts between it and the economically successful South Korea. First is the composition of the bureaucracy. Regarding the formation of a bureaucracy in South Korea under President Syngman Rhee, Kang notes “Rhee was creating a nation and filling an entire bureaucratic apparatus from scratch, and the few bureaucrats who had worked under the previous Japanese administration tended to be low-level functionaries” (Kang, 2002, p. 66). He further notes that, in part because this bureaucracy was built through the prerogative of the executive, there was little “agency slack:” because the bureaucrats were dependent on the state for their appointment, extensive internal monitoring occurred that reduced their ability to act and seek rents independently (Kang, 2002, p. 73). Conversely, Kang states that the Philippines’ lawmakers had been trying to reform the bureaucracy, which has been rife with patronage and corruption, for nearly a century. Thus leaders inherited the problems that persisted in the colonial
era in the post-independence era (Ibid, p. 75). Though Russia was not colonized, the similarity between it and the Philippines in this regard is quite palpable: the bureaucrats of the Soviet era were notoriously corrupt and, as noted previously, once the constraints of the communist party were removed they had full agency to pursue rent-seeking and other corrupt activities. With the bureaucracy controlling the vast majority of the capital in the sectors in question, this has significant consequences for Russia’s economy.

Prior to the rise of authoritarianism in the Philippines, Kang characterizes the bureaucracy as largely corrupt and ineffective due to the influence of the country’s oligarchs on the functions of the state. The difference between the Philippines and Russia in the Yeltsin era in this regard is that Russia’s bureaucrats, though left to their own devices, were in control of a significant portion of the country’s economy. However, the similarity is found within the Yeltsin administration itself. In fact the regime of the time could be characterized as two largely separate administrations: the president and the oligarchs, and the bureaucrats and their state-controlled corporations. The two largely kept to themselves, and thus acted largely autonomously of each other.

Bureaucrats having a large stake in the country’s economy is not unique to Russia: bureaucrats in India and China both play major roles in their countries’ economy by controlling large state-owned conglomerates. Indeed this is also true of Norway, whose state-owned oil company, Statoil, is widely lauded as being one of the best run in the world. However, as Anders Aslund notes, the corruption of the Soviet bureaucrats was kept in check by a powerful state: when the relative power of the state shrank with the fall of the Soviet Union, we find a bifurcation of state power between major bureaucratic institutions (most notably Gazprom) and the executive branch under the Yeltsin administration. With the lack of an independent judicial
system or powerful state, Russia’s bureaucrats have an enormous amount of power to seek rents with impunity.

The system in Russia differs notably from Kang’s example of South Korea’s bifurcated bureaucracy wherein some bureaucrats were politicized and used for the purposes of patronage while others ran the day-to-day functions of the state (Kang, 2002, p. 87): Russia’s management of its resources was split between bureaucrats and oligarchs, and patronage was doled out separately between the legislative and executive branches respectively. In essence, the state-owned corporations (primarily Gazprom) were patronized by Prime Minister Chernomyrdin, whereas the oligarchs in the oil sector were patronized by President Yeltsin, with the two sides having relatively little interaction.

What makes this particularly interesting, and differentiating it from the examples provided by Kang, is that Russia’s bureaucracy had a very capitalist function within this system. In addition to being systemically corrupt, these actors, like their Soviet-era predecessors also controlled a substantial portion of the country’s means of production. With this wealth and influence at their disposal, it can be said that Russia’s bureaucratic elite are a hybrid of the state and business sectors.

With two sets of actors (bureaucrats and oligarchs) having rents conferred on them by separate state institutions (the legislative and executive, respectively) we find two examples of a ‘rent seeking’ scenario found in Cell II. However, as the next section will show, relations between the oligarchs and the executive were much more approximate to the ‘mutual hostages’ scenario found in Cell I than were the bureaucrats and the legislative branch.

When Vladimir Putin ascended to the presidency, he developed much closer ties to bureaucratically-run economic institutions like Gazprom, and later Rosneft and
Minatom/Rosatom. The way in which this was achieved is similar to Kang’s analysis of the Philippines under the presidency of Ferdinand Marcos. Like Marcos, Putin has been able to limit the power of the legislative branch (though not going so far as to disband it), concentrating the bulk of the political power in the country under him personally. It is here that we find Russia moving closer to the ‘predatory state’ scenario found in Cell III. Kang describes Marcos’ machinations in much the same way as later commentators discussing Putin’s actions: “Marcos created new oligarchs who were dependent on him for their success and he also rewarded traditional elites who cooperated with him” (Kang, 2002, p. 137). In Putin’s case, this can be found in his installation of close associates in key positions in Gazprom, Rosneft, and Rosatom and eliminating threatening oligarchs while rewarding those who cooperated, like Roman Abramovich, who was persuaded to sell his controlling interest in Sibneft to the state in 2005.

The similarities between Putin and Marcos, at least with regard to the sectors examined in this study, have persisted into the second decade of Putin’s presidency. Like Russia, the Filipino economy began to struggle after a decade of Marcos’ rule. Unlike the Philippines, the effects of a global financial crisis triggered Russia’s economic faltering; however, the overall effect has been similar. When the Marcos regime began to falter, the country’s economic elite began to squabble among themselves (Kang, 2002, p. 144). Similarly, we are seeing a significant amount of competition among Russia’s state-owned energy giants: Rosneft and Gazprom are openly quarrelling over access to Russia’s lucrative gas export industry (Reuters, April 25, 2014), and Rosneft has similarly openly challenged Transneft over its oil pipeline monopoly (Farchy, February 20, 2014). As mentioned previously, Igor Sechin, who maintains very close ties to the president, runs Rosneft.
A major difference between Kang’s Philippines example and Russia, at least from what may be surmised from the evidence available, is that there is proof that Ferdinand Marcos benefitted personally from his cronyism whereas this has not been proven in Russia with respect to Putin. Despite the lack of definitive evidence, the cases of Putin and Marcos are similar and at the very least, with both eliminating all major threats to their leadership through the use of state power, both being strongmen who organized the economy in a way that is meant to subordinate it to their leadership, and both would presiding over an economy severely hindered by excessive corruption. The conditions are thus in place that make it possible for the Russian president to personally taking part in the rent seeking occurring under his leadership.

The primary difference between Russia and Kang’s examples of South Korea, and the Philippines, is the relative power of the Russian bureaucracy. Though the bureaucracies featured in Kang’s analysis played a substantial role in their respective economies, Russia’s bureaucracy carries with it the legacy of its role in the Soviet Union, which makes it quite unique in this regard. Even after the fall of the Soviet Union, these institutions managed a substantial portion of the country’s wealth and now control the vast majority of the capital in the sectors in question.

What Kang does not fully account for is the possibility that bureaucrats may engage in ‘state capture’, taking power from both the political establishment and the private sector. In the case of Russia, as we will see, the bureaucrats have managed to gain an upper hand in all three of the identified sectors and are now engaging in widespread corruption. There is much to indicate that the political leadership is complicit in this corruption and the close ties the president has enjoyed to the bureaucracy throughout his career at the very least indicates a high likelihood of his personal involvement in this state capture. The evidence thus far indicates that this is not
sustainable and as we will see, Kang’s matrix offers much to illuminate the precariousness of the current regime’s power at present.

5.2 Analysis of Russia’s Oil Sector

Russia’s oil sector has seen the most dramatic systemic changes since the fall of the Soviet Union and for this reason it has received the most attention in this analysis. Though there was motion towards a private sector in oil, it is once again dominated by the state, with the two remaining large producers (LukOil and Surgutneftgaz) remaining under the control of their Soviet-era management. Though the sector has seen enormous growth in the past decade, low prices relative to the high production costs, and a lack of investment in new technologies are key vulnerabilities it faces at present. Though problematic and rife with conflict, the state’s relationship with the new ‘oligarchs’ in the 1990s offered perhaps the best possibility for a ‘mutual hostages’ scenario to emerge among the three sectors examined in this study. The fact that a state-owned corporation is the dominant actor in production need not be a hindrance at present (Norway’s state-owned Statoil is consistently ranked among the best performing in the world); however, the way in which the state has managed the oil sector does little to inspire optimism for the future.

5.2.1 Coherent/ Incoherent State Behaviour in relation the Oil Sector

With the Russian state entering into an immediate economic and political crisis after the fall of the Soviet Union, it is difficult to characterize the 1990s as a period in which the state behaved coherently. However, with major reforms decisively made to the oil sector during this period, it can be said that there was an emergence of coherence with regard to the state’s behaviour toward the privatized oil sector.
As mentioned previously, the Russian state in many ways bifurcated in the 1990s leaving Gazprom and other state-controlled interests under the patronage of the Duma while oil was eventually brought under the purview of the executive branch of government. The institution of the ‘loans for shares’ auctions perhaps best demonstrates the incoherent context in which the move to privatize oil was born. In an effort to circumvent the legislative branch’s ban on privatization, the executive branch auctioned off tranches of oil companies to be held as collateral in exchange for loans which in all likelihood would not be repaid (Treisman, 2010, p. 14). However, by enabling new actors outside of state bureaucrats to enter the oil sector, both branches of government were able to interact with the oil industry in a way that was not permitted in the gas and nuclear energy sectors.

This is not to say that the executive branch’s behaviour was particularly coherent with regard to oil once actors in the private sector were enabled to emerge, nor were the bifurcated parts of the state mutually exclusive in managing their sectors of the economy. Indeed the new actors of the oil sector later took full advantage of the lack of state coherence by oscillating between actors in the executive and legislative branches of government. However, the instances of collaboration between both branches of government and the oil sector are indicative of a relationship that simply did not exist between the executive branch and the gas and nuclear sectors. It is from this that we find the possible early foundations for a ‘mutual hostages’ scenario to emerge.

With the emergence of the privatized oil sector, there was something of a ‘give and take’ relationship between the state and these new tycoons. The beneficiaries of the loans for shares auctions won their tranches with the tacit agreement that they would have to support Yeltsin’s 1996 election campaign in order to avoid having their assets appropriated by the state. In writing
on the emergence of ‘mutual hostages’ in South Korea, Kang notes that the regime under Park Chung Hee required substantial funding from private sources to maintain its locus of control and this came primarily from businessmen who often referred to their donations as “quasi-taxes” due to their understood necessity (Kang, 2002, p. 104).

A major difference between Yeltsin’s relations with the ‘oligarchs’ and that of the South Korean state with the leaders of the chaebols is the superior strength of the South Korean state. Kang attributes much of this to the power of the Korean state to loan money to businesses, thus keeping them in line with its interests. To illustrate this power, he notes an incident where the Kukje Group refused to make a ‘voluntary donation’ to a foundation of the state’s choosing in 1985: its cheques were no longer honoured, it was refused further loans and, due to its inability to service its debt, it was forced into bankruptcy within weeks (Kang, 2002, pp. 102-104). This is in stark contrast to Yeltsin’s ability to handle the oligarchs which his administration effectively created: they ran their own financial institutions, had access to foreign capital and were thus much less beholden to the Russian state once they had been empowered by it through the loans for shares arrangement. Kang describes Filippino oligarchs in the democratic era with similar independent banking means of their own (Ibid, 2002, p. 136). However, in the case of Yeltsin and his oligarchs not only was the state incapable of offering further loans to business conglomerates, but also it actually required loans from them, and on which it later defaulted.

In general, the Yeltsin administration was quite powerless in dealing with the oligarchs after it had facilitated their rise and was instead forced to play on divisions within the group. With their own access to capital and even private militias, the oligarchs generally acted with impunity. In this sense, the situation resembles Kang’s description of the Philippines in the democratic era: corrupt political elites purchased by business sector actors for their own benefit.
(Kang, 2002, p. 126). However, because this situation was as such that the oligarchs purchased only the executive branch and not the legislature (though attempts were made), the alliance was much more volatile and precarious because each was competing for influence in a much smaller group. The result was a series of volatile coalitions between the state and the oligarchs that culminated in the ‘Banker War’ of 1997-1998. It was through this volatility that certain compromises were forced.

The issue of tax compliance is a good example in this regard. Though it is true that the oil producers were largely tax exempt, they achieved this by increasingly finding loopholes in the changing legal framework. This was true, especially in the case of Yukos, due to a desire to embrace transparency in order to gain foreign partnerships and investment. With the executive branch and the oligarchs possessing the means to harm each other, it is conceivable that a compromise could have been reached over time that would have seen the private firms submitting to some form of taxation, as was later achieved under the Putin regime.

The obvious challenge to this hypothesis is the possibility that the oligarchs could once again collaborate with actors in the Duma in blocking such reforms: this is highly conceivable, given the legislative branch’s proven ability to protect state-owned firms from similar compliance. Nonetheless, by embracing transparency the private sector was begrudgingly dragging itself into the rule of law. By contrast, Gazprom did not embrace transparency and was simply exempt from taxation throughout the 1990s due to its protection by Chernomyrdin and his allies in the Duma, with little regard to the question of legal compliance.

Though state-oil sector relations were messy in the 1990s, it is clear that both sets of actors possessed some ability to harm and enforce their will on the other. Though it most closely approximates Kang’s ‘rent-seeking’ scenario, it is conceivable that over time a ‘mutual hostages’
type of relationship could emerge. This is due to the oligarchs’ reliance on state patronage for their own protection against those who would revert their holdings to state control. However, the prospects for the emergence of a mutual hostages scenario were minimal: with most of the power of the Soviet legacy in the hands of the legislative and bureaucratic arms of the state, the position of the executive and its oligarchs was a precarious one at best. Putin, who was initially thought to be an ally of the oligarchs, would initiate the emergence of the “predatory state”.

Vladimir Putin was effective in reining in the troublesome oligarchs by wielding state power in a concerted and coherent manner. As mentioned previously, this is consistent with Kang’s description of the Marcos regime (Kang, 2002, p. 137). The obvious example of this was the Yukos affair, which saw the country’s most profitable and transparent oil company broken down and parceled off to state-controlled interests (primarily Rosneft). The subsequent use of police and tax investigators against Sibneft as a means of convincing Roman Abramovich to sell his shares to the state is further indicative of Putin’s effectiveness in the use of state power. This show of force would help solidify Putin’s image as a paragon of state capitalism for nearly a decade.

Rosneft’s recent acquisition of TNK-BP is indicative that, when the interests of state-led corporations and the political institutions (at least nominally) do not align, the state political establishment appears quite weak in this regard. In addition to the fact that the leaders of the legislative and executive branches have called for a selloff of the state’s shares in Rosneft, which has not occurred, Rosneft’s $55 billion acquisition of TNK-BP has come up against the very public statements of both the President and the Prime Minister. This is interesting. While in the 1990s the oil oligarchs would have had to carefully manoeuvre between the executive and legislative branches of government, Rosneft (now in control of just over half the country’s oil
production) is able to overtly contradict both branches of government with apparent impunity. First it must be said that Russia’s political situation has changed significantly during this time in that the executive and legislative branches are much more closely aligned, and thus it would be much more difficult to play one branch off the other. However, this does not negate the apparent weakness of the state in this regard. Kang describes a similar weakness of the state emerging in late-Marcos era Philippines wherein the President became increasingly weak, creating a power vacuum for competing oligarchs (Kang, 2002, p. 144). Given the infighting among those the President previously appointed to lead state-owned corporations, this is a strong possibility.

The TNK BP example fits perfectly into Kang’s example of the “predatory state”. He writes: “political elites often pursue outright expropriation; they also solicit ‘donations’ from businessmen who in turn are either ‘shaken down’ by the regime or who volunteer bribes in return for favours” (Kang, 2002, p. 16). The example of the Russian owners of TNK BP collaborating with the state for a large purchase price while its American CEO Robert Dudley was repeatedly harassed by the state until his work permit expired, forcing him to leave the country, fits well into this characterization. What is interesting is that though all of this was occurring, political elites like Putin and Medvedev spoke against the deal publically. As mentioned previously, this is indicative of either a very high level of state capture or their complicity in the matter.

The latter explanation (or perhaps a complementary one) is that the President, the Prime Minister, or both were actually in favour of the deal (perhaps with substantial rents to be gained). This is a very real possibility and indeed would mirror the Marcos regime’s plundering of the Filipino economy as described by Kang (Kang, 2002, p. 138). However, without sufficient evidence we must take them at their word and simply pronounce their leadership as ineffective in
this regard. In either case, this is demonstrative of the state becoming increasingly less coherent, indicating a move from the ‘predatory state’ scenario back to that of ‘rent seeking’. If actors in the political establishment were acting secretly on Rosneft’s behalf, they were doing so as private individuals and in direct contradiction of their public pronouncement. Thus it is clear that these actors are either individually corrupt or incapable of imposing their will: both are indicative of state capture on the part of those who stand to benefit from the questionable deal within Rosneft.

Though the state’s relationship with the oil sector in the 1990s was a difficult one, it is clear that the state was at the very least able to influence the sector’s direction. Initially, the Putin regime gave a much stronger show of force against the oil sector; however, this authority seems to have weakened in just a few short years with the country’s largest producer able to effectively contradict the apparent will of the state. Thus with regard to state coherence, it can be said that the Putin regime has brought the state further away from Kang’s ideal of a powerful and coherent governing structure in relation to the oil industry. Similarly the oil sector has become much more concentrated under Putin’s leadership: the only large producers left are those run by the state or former Soviet bureaucrats. Thus with regard to their relationship dynamic, the state has moved further away from Kang’s idea of the “mutual hostages” category, into that of “predatory state”, and is now moving back toward the “rent seeking category”. To be clear, the situation was far from that of “mutual hostages”, however, it is further from this ideal now than ever before.

5.2.2 The State of Investment in the Oil Sector

The way in which money is invested in Russia’s oil sector has changed significantly over time. Following privatization, money that was stripped away from the large oil producers was reinvested in ways aimed at increasing the efficiency and profitability of the firms. Since Putin
has limited the competition in the sector to firms that are state-owned or controlled by their Soviet-era management, this model has changed significantly.

From the information surveyed, it is clear that the oligarchs invested heavily in the efficiency and profitability of their firms. Though tranches were sold at discounted prices at the loans for shares auctions, there were substantial risks in doing so. However, these risks were not acquired evenly: as mentioned, the risks associated with those who already managed their firms (Lukoil and Surgutneftgaz) were far fewer than for those ‘oligarchs’ who purchased their tranches with no prior industry experience or insider connections to the existing management structures. In any case, it is clear that those firms that took on the risks of acquisition far outpaced state-controlled firms like Gazprom in terms of meaningful investment in productivity.

As Treisman notes, capital spending grew significantly in the private sector once oil prices began to rise. Furthermore, the firms controlled by the ‘oligarchs’ (Yukos and Sibneft) were much better at attracting foreign investment and capital by embracing transparency (Treisman, 2010, p. 223). By comparison, much of Rosneft’s capital acquisitions have been done with a considerable degree of opacity, particularly with regard to acquiring Yukos assets through rigged auctions and with the use of shell corporations. The firm has also shown hostility toward its western partnerships, demonstrated by the fact that nearly all of the staff at the TNK BP headquarters either resigned or was fired following the Rosneft acquisition. With regard to transparency and foreign partnerships, it is clear that Rosneft stands in stark contrast to its predecessors in the private sector.

The positive results of this investment are demonstrated through a comparison of the amount of revenue dollars generated per worker that indicates that it was indeed those firms controlled by the oligarchs that outperformed those owned by the state and their former Soviet
management. Thus even though prices rose during this period, it is clear that private firms proved more successful in terms of revenue than their state-owned counterparts; furthermore it is apparent that those firms under the control of ‘oligarchs’ performed far better than those that remained under their Soviet-era management in this regard.

The dismantling of Yukos arguably had the double effect of effectively nationalizing Russia’s largest and most profitable oil producer and convincing Roman Abramovich to sell his shares of Sibneft to Gazprom while at the same time severely restricting the number of actors in the market. With the 2013 sale of TNK-BP to Rosneft for $55 billion, more than half of Russia’s oil production is under state control. However, there are a number of concerns as to how the state-owned corporation manages its capital expenditures.

Rosneft’s current capital expenditures are very high and its debt of $70 billion is roughly equivalent to its market capitalization (Reuters, June 25, 2013). When he announced the purchase of TNK-BP in 2012, Igor Sechin stated that Rosneft would be looking to sell its non-core and less-profitable assets; however, the company appears to be doing the exact opposite as it continues to acquire substantial non-core assets and is investing heavily in large construction projects as opposed to tight oil development. As Terry-Lynn Karl notes, large-scale investment in construction spending has offered considerable opportunities for large-scale rent seeking and this further constrains the amount of money put toward core production (Karl, 2007, p. 119).

In terms of actual core production, Rosneft’s investment is questionable. As mentioned previously, Thane Gustafson and others have argued that the future of Russian oil lies in “tight oil” in existing fields; however with the use of existing technology, production in more than half of these fields is in decline. Instead of moving to claim more tight oil from existing fields, Rosneft has instead chosen to invest heavily in Arctic offshore projects through joint projects.
with large foreign producers, which will not deliver production for a number of years. This will also come at a considerable cost: in October 2013 the Russian government committed $63 billion for Arctic regional oil and gas development (Daly, February 10, 2014). On February 8, 2014 the state approved Rosneft’s plans to begin production of seagoing vessels at two separate facilities, with one of the shipyards to be built by Rosneft (Ria Novosti, February 8, 2014). Again, such projects could prove very lucrative for rent-seekers, but will come at great expense to the state and Rosneft’s core production prospects in the short- to medium-term.

Rosneft appears intent on entering the natural gas market, with the stated ambition of producing 100 million cubic meters of gas annually by 2020. Though this could be viewed as the Putin administration looking to remedy the failings of Gazprom, it also comes at a tremendous financial burden to the already debt-laden Rosneft: after securing a 51% ownership stake in the gas trader Itera, it secured the remaining 49% in 2013 for $2.9 billion, making the acquisition its second largest of the year after the purchase of TNK-BP (Reuters, July 2, 2013). With oil prices having not recovered since the crash in commodities prices in 2009, Rosneft’s market capitalization has fallen to roughly a third what it was. Because it is difficult to tell if oil prices will return to a level that is optimal for Rosneft, the company faces the serious threat of over-investment.

On the whole, there are major constrictions on investment in key areas for Russia’s oil sector. James Henderson cites the lack of small servicing companies, an unfavourable foreign investment climate, and a punitive export tax regime all as factors of constraint against Russia’s state-owned and private producers’ investment in tight oil and other exploration and development endeavours (Henderson, 2013 p. 21). With the country’s largest oil company investing in a number of noncore holdings that offer substantial opportunities for rent-seekers at
the potential expense of its already poor financial situation, investment on the part of Russia’s oil industry appears misguided at best.

The 1990s showed tremendous potential in terms of investment in production, particularly among those firms held by oligarchs: rising oil prices fuelled investment in equipment upgrades and partnerships with small-scale servicing companies that greatly expanded production in a way that disproportionately favoured the private over the public sector. With the state’s role in production dramatically increased, Russia is missing out on its most important production potential in the pursuit of projects that will likely not deliver substantially in the short- to mid-term and which offer substantial opportunities to rent-seekers through lucrative construction contracts that will further detract from meaningful investment.

In a mutual hostages scenario, rent-seekers are forced to invest in production and efficiency as a matter of pure self-interest: the state and business sector must do so in order to reap the rewards of profit as their ability to collect rents from each other is reduced by their equal ability to inflict harm on the other. In the 1990s, though substantial rents were handed out by the state in terms of discounted auction pricing with preferential bidding and election kickbacks, the oligarchs had a vested interest in their companies’ profitability for two reasons: 1) they had to recoup the cost associated with acquisition and consolidation of control (including employing ‘private security’ to ‘take care of’ uncooperative criminals and management and managing the ‘greenmail’ associated with minority shareholders); 2) Rising oil prices encouraged the sale of non-core assets and capital investment in those assets that would improve production and efficiency for the owners, who were the primary beneficiaries of their firms’ efficiency and profitability. For these reasons, capital expenditures in the oligarch-owned private firms (and those owned by their former management to a lesser extent) resembled those aimed at efficiency
and profitability, with reduced opportunities for rent-seekers to cut into the bottom line. These investments made sense as the firms they owned and the profits derived therefrom were the source of their power relative to the state, and as we later saw in the Putin era, these ‘oligarchs’ were highly vulnerable to the effective wielding of state power.

Conversely, it also explains the extensive asset stripping that occurred in state-owned firms in the 1990s. Regardless of foreign pricing, firms like Gazprom engaged in extensive asset stripping. The management of these firms, unlike those who acquired their firms in the loans for shares auctions, had little interest in profitability as their personal income was derived from elsewhere. Furthermore, with the paralysis of the state following the collapse of the Soviet Union, there were few mechanisms to regulate their behaviour or set enforceable directives, however misguided they had been previously. The result was minimal capital investment in production when prices began to rise, with Gazprom being a fine example of this. The primary exception to this rule is the construction of the first portion of the Baltic Pipeline System by the state-owned oil pipeline corporation Transneft; however, this was also done in partnership with the private sector and foreign investors (Leningrad Region Official Website).

Now that all of the private producers previously controlled by the ‘oligarchs’ are under state control, the future of Russian investment in oil production is both misguided and likely to be constrained by rent seeking. Firstly, Rosneft’s extensive noncore investments and investment in long-term projects puts it in a precarious position, given that its debt matches its total value and there are no guarantees of rising revenues due to a relatively anaemic global demand. Furthermore, the heavy constraints on tight oil production associated with taxation and an unfavourable foreign investment climate make it difficult for Rosneft or the private sector to invest in these projects.
With heavy investment in production and efficiency among the private producers in the 1990s, Russia appeared to have a possible emergence of a “mutual hostages” scenario. Motivated by limited ability to collect rents through asset stripping relative to their state-owned managerial counterparts, Russia’s private producers had many incentives to invest in the means to achieve greater profits. With Rosneft’s emergence as the dominant producer, investment has been inordinately high, seemingly misguided, and comes with significant costs to the state through new budget allocations: this is also consistent with Karl’s example of rent seekers taking advantage of such projects for the purposes of enriching themselves at the expense of their firms and/or country as a whole (Karl, 2007, p. 119). The opportunities this creates will be explored in the following section.

5.2.3 Opportunities for Rent Collection in the Oil Sector

Throughout the post-Soviet era, there has been extensive rent collection within Russia’s oil industry within both the state-owned and the private sectors. However, it is apparent that these opportunities were and are not evenly dispersed, with those in the state-owned corporations enjoying the greatest possibilities for rent collection in the Putin era.

Firstly, the beneficiaries of the loans for shares auctions certainly reaped substantial rents through discounted pricing. However, as Figure 2.1 demonstrates, this discounted pricing tended to favour the existing Soviet era management over the oligarchs: Lukoil and Surgutneftgaz were discounted by 89% and 69%, respectively whereas Yukos and Sibneft were discounted by 45% and 16%, respectively. When one further considers the uneven costs associated with consolidating control over these enterprises (the existing management had virtually none whereas the oligarchs faced a number of major obstacles), we further see that the costs associated with acquisition overwhelmingly favoured those already in charge of their firms. From this, we
can gather that there was a major reduction of rent size doled out by the state to the oligarchs versus their Soviet-era managerial counterparts.

Furthermore, there were many more (virtually cost-free) opportunities to reap rents from asset-stripping within state-owned firms like Gazprom, particularly through its intermediary, Itera. Though the private producers engaged in asset-stripping initially, it is reasonable to assume that, given the later capital expenditures, this was done to free up cash for future investment (Treisman, 2010, p. 224). Again, the result in this regard is a reduced ability to reap rents through asset-stripping among the private oil producers, especially in comparison to Gazprom.

As mentioned in the methodology portion of the first chapter, Alberto Ades and Rafael Di Tella argue that a wider distribution of the rents available tends to limit corruption on the whole. However, this appears to have had a negligible effect on the oil industry. Though it is true that investment in production increased and the oligarchs adopted new methods aimed at improving efficiency, their group was perhaps too small to constitute the kind of competition that would limit corruption in the way Ades and Di Tella identify (Ades and Di Tella, 1999, p. 982). Rather, by dispersing the rents among at least a small group of actors, they were naturally more reduced than if they had been sold entirely to one firm.

Now that Rosneft has emerged as the dominant force in Russian oil production, many opportunities for rent collection are emerging as well. As mentioned previously, the company is investing heavily in non-core and costly capital expenditures that offer opportunities to reap rents through padded construction costs as well as opportunities for future asset-stripping of these non-core assets should the firm engage in the privatization reforms both the management and the state have stated it will undergo. Though these projects are new and details have yet to come to light, the possibilities for substantial rent collection exist nonetheless: this is why the
methodological criteria examine the *opportunities* for rent seekers as an indication. In this sense, the reduced rents among the oligarchs in the ‘90s somewhat resembled a ‘mutual hostages’ scenario, whereas the current opportunities for rent collection within contemporary Rosneft shows that the tide is moving toward a mixture of a “predatory state” and “rent seeking” scenario.

### 5.2.4 Oil Sector Conclusion

Development in Russia’s oil sector and the way in which it relates to the state has undergone significant changes since the fall of the Soviet Union. This analysis argues that Russia has shifted from a situation in which there were some signs of a “mutual hostages” situation potentially emerging within the private oil sector, though the overall situation of the time must be categorized as “rent seeking”. Under the Putin administration, Russia’s oil sector moved into the “predatory state” category as the political, legal, and when necessary, police arms of the state were employed to limit competition in the market and bring the majority of production under state control. Now that Rosneft has been empowered by the state, there are signs that it is able to flout government pronouncements while still receiving substantial amounts of government funding. Though Rosneft is a state-owned entity, it is now entirely possible that it is moving Russia’s oil sector into the “rent seeking” category wherein it takes advantage of the state. In this way the use of the state for the purposes of appropriation may be seen as a reversion to the Soviet model; however, it is clear now that the state lacks either the means or the will to curb egregious corruption, unlike what was the case in the Soviet Union.

In summation, it may be said that the Soviet era may be characterized as a “predatory state” wherein a rent-seeking bureaucracy was tempered by a political system backed by a powerful police state. Interestingly, this is a kind of reversal of Count Ernst Friederich Herbert
von Muenster’s observation of the bottom-up nature of Russian politics in the Russia’s 19th century where the country’s version of a constitution was “absolutism tempered by assassination” (Bartlett, 1892, p. 807). In the Yeltsin era, the bureaucratic rent seeking occurring within the oil sector was curbed only by handing it over to other rent seekers with a vested interest in profits: at the very least, this limited the kind of deliberate value destruction found in other state-owned enterprises: it was not “mutual hostages”, but the separation of state and private actors with some ability to harm one another more closely approximated it than any other time examined in this study.

Under Putin, the state has preyed on the private oil sector in a way that has restored the majority of ownership under state bureaucrats in a way that is institutionally akin to the Soviet Union. The difference is that the state political establishment is at best incapable and at worst implicit in the kind of corruption that the Soviet establishment was able to curb through coercion. The result is current mismanagement and a strong possibility of future mass plunder as both bureaucratic and political elites indicate a long term plan for privatization, likely through rigged auctions in favour of preferred cronies or perhaps even the elites themselves. If this is the case, what we are seeing is a kind of reversion from the “predatory state” back to “rent seeking” as individual actors prey on the state in a bottom-up kind of corruption: particularly through lucrative construction contracts and future privatization plans for the benefit private actors.
Table 5.2 Oil sector metamorphosis

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<td><strong>Late Soviet Period</strong></td>
<td>&quot;Predatory State&quot; -&gt; &quot;Rent-Seeking&quot;</td>
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<tr>
<td><strong>Yeltsin Period</strong></td>
<td>&quot;Rent-Seeking&quot; -&gt; &quot;Mutual Hostages&quot; (possibility)</td>
</tr>
<tr>
<td><strong>Early Putin Period</strong></td>
<td>&quot;Rent-Seeking&quot; -&gt; &quot;Predatory State&quot;</td>
</tr>
<tr>
<td><strong>Late Putin Period</strong></td>
<td>&quot;Predatory State&quot; -&gt; &quot;Rent Seeking&quot; (strong possibility)</td>
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Table 5.1 illustrates the metamorphosis of Russia’s oil sector over time, relative to Kang’s matrix. Under Yeltsin, there were a few minor signs that a “mutual hostages” situation could emerge over time; however, the prevailing forces of the time were indicative of a “rent seeking” scenario wherein private actors generally prey on the state with relative impunity. Under Putin, the situation reflected the “predatory state” scenario as the full power of the state was employed against the oligarchs to bring their holdings under state control. However, now that actors within the bureaucracy appear to be acting against the will of the state and are turning toward activities shown to have a high likelihood of corruption, we are finding a strong indication that the situation as a whole is reverting to the kind of bottom-up corruption found in the “rent-seeking” scenario. As we will see with the other two sectors, the fact that the firm’s bureaucratic management has initiated this offers a variation on Kang’s matrix.

5.3 Analysis of the Gas Sector

The changes undergone within Russia’s natural gas sector, for at least as long as Gazprom holds dominance over the market, have been primarily superficial. In terms of Kang’s model, the sector has completely failed to move out of the “rent-seeking” category and is now on
the brink of self-destruction as it faces over-investment, falling revenues, and a plummeting market capitalization. To understand this evolution over time, we need only examine Gazprom’s activities over the period of time identified in this study.

5.3.1 Coherent/ Incoherent Behavior relative to the Gas Sector

Throughout Gazprom’s existence it has operated as almost a state within a state. During the Yeltsin years it operated with near-complete autonomy from state goals and objectives, largely with the help of Prime Minister Victor Chernomyrdin who sheltered it through his influence over the legislative branch. During the Putin years, Gazprom often acted as an arm of state power and its revenue heavily contributed to the federal budget; however, as we have seen from the company’s recent troubles, bringing it into compliance with collaborative legislative and executive branches of government has done little to curb rent-seeking and poor management. Despite being a cohesive structure that is evidently capable of behaving coherently in tandem with state policy (especially foreign policy), Gazprom has become deeply mismanaged and it is evident that rent seekers are preying on it from the bottom up in spite of this coherence.

Despite numerous attempts at making reforms, Gazprom remained under state management throughout the 1990s. This was achieved through the uninterrupted protection by the state Duma, primarily under the leadership of Prime Minister Viktor Chernomyrdin. By its very nature, this is the exploitation of state incoherence and the result allowed those associated with the firm to strip assets and seek rents with impunity. Thus, within the bifurcated state it appears that the political and bureaucratic elite associated with Gazprom play bifurcated roles themselves: publically they function to run the institution while privately preying on it from the bottom-up either themselves or at the very least by blatantly permitting their cronies to do so. In this sense, despite being under state control, the firm may be categorized as “rent seeking”
relative to Kang’s matrix. Arguably this is because, unlike oil during the early years of Putin’s presidency, there was little for the state-owned firm to prey upon and thus it was permitted to exist within a vacuum wherein its actors could prey on the firm’s wealth with impunity.

When Putin took office, the powerful actors of the day were amenable to reforming Gazprom. This was arguably due to a greater level of state coherence, particularly between the executive and legislative branches. Putin’s thesis on “national champions” was demonstrative of the new president’s desire to have Gazprom remain a single entity under state control, the very thing the Duma sought to uphold throughout the 1990s. The new management under the young Putin associates Dmitry Medvedev and CEO Alexei Miller made important moves to curb asset-stripping by causing the near-bankruptcy of Itera, the intermediary responsible for siphoning off billions in potential revenue. Despite such measures, the incidents surrounding reform are indicative of more systemic issues.

In stark contrast to the ‘oligarchs’ in the private sector, Viktor Chernomyrdin and CEO Rem Vyakhirev were both sacked, with neither facing investigation for corruption charges and the former even receiving the important ambassadorship to Ukraine. If corruption was a motivating factor for the attack on Yukos, by comparison it is interesting that these two men were permitted to enjoy comfortable retirements. When Chernomyrdin returned to chair Gazprom following his dismissal as Prime Minister, the company stripped away billions in assets accumulated throughout the 1990s for its executives, their families, and other known associates. If such blatant corruption was permitted, it is impossible to refute that the state behaved coherently; however, it is indicative of much deeper problems.

Despite these issues, the state-Gazprom relationship has been a highly coherent one. With evidence that the firm has been used in matters of foreign policy and its revenue used to bankroll
a substantial portion of the growing state budget, Marshall Goldman was correct in asserting that “it is difficult to tell where Putin begins and Gazprom ends” (Goldman, 2008, p. 143).

5.3.2 The State of Investment at Gazprom

With the examples given, it is difficult to categorize Gazprom’s capital investment as anything other than mismanaged. With a shrinking market capitalization, falling profits, and an ailing infrastructure network, the results of this have been disastrous.

Throughout the 1990s, Gazprom’s extensive capital expenditures included resort hotels, farms, and substantial media holdings. Not only were non-core investments often unprofitable, but Gazprom executives later stripped many of them away at heavily-discounted prices for their personal gain in the late 1990s. When one considers the bleeding of profits through intermediaries like Itera and the deplorable state of the firm’s infrastructure network, this is highly suggestive that the firm existed (perhaps primarily) as a tool for rent-seekers.

Despite Putin’s early reforms, rent seeking has not been curbed at Gazprom. Though not as blatant as selling gas to intermediaries at absurdly low prices or clear examples of asset-stripping, the exorbitant costs of construction by contractors closely associated with the president is causing wealth to flow away from the company at enormous rates: not surprisingly, an independent report has shown that some 70% of Gazprom’s $50 billion capital expenditures have been lost due to “value destruction” (Aslund, February 28, 2012). Furthermore, this “value destruction” has come at an enormous cost: having completely overlooked LNG exports and shale gas, the company is left with ailing pipelines and heavily-depleted gas fields with drastically-reduced cash available to invest in such endeavors at present (Ahrend and Thompson, 2004, p. 8).
It is arguable that the most important investment Gazprom has made was the Nord Stream pipeline that bypasses Ukraine via the Baltic Sea to Germany. However, the South Stream, which has been plagued with corruption charges and rising costs within Russia, is faced with many delays at a time when Russian gas shipments through Ukraine are under serious threat due to rising international tensions. Gazprom’s inability to adequately invest in LNG facilities has cut Russia off from potentially lucrative markets; however, as seen previously, large infrastructure works like new pipelines offer many opportunities to rent-seekers regardless of their actual value. This offers a possible explanation as to why greater attention was paid to the latter than to the former.

The way in which the firm invests in large infrastructure projects which enrich construction contractors is consistent with both Karl’s notions of megaprojects as a vehicle to enable rent seeking, as well as Kang’s example of the “rent seeking” scenario in which individual actors in the business sector take advantage of state wealth. With capital expenditures like these, Gazprom offers a near-flawless example of the ‘rent-seeking’ category with regard to investment.

5.3.3 Opportunities for Rent Collection within Gazprom

The opportunity to collect large and unfettered rents within Gazprom has been widespread since its inception. The 1990s offer two primary examples: the stripping of billions in profits through intermediaries like Itera, and the accumulation of non-core assets that were later stripped by senior management at the end of the decade. The fact that the leadership of the time has gone unpunished for such blatant mismanagement was a harbinger of things to come in Russia’s largest corporation.
Despite attempts at reform (real or feigned) the ability for rent-seekers to collect has not abated and this has had a detrimental effect on Gazprom’s long-term viability as an institution, as evidenced by the blatant value destruction shown as of late. Troubling still is the fact that the primary contractors reaping profit from Gazprom’s numerous unnecessary ventures are Ziyad Manasir and Arkady Rotenberg, two men closely associated with President Putin (The Moscow Times, February 5, 2014). Furthermore, the largesse of Gazprom’s executives is well known and there are many signs that this has not abated. With this in mind, it is difficult to say that there is much in the way to stop rent-seekers from continuing to reap substantial amounts of wealth from Russia’s gas sector. It is difficult to refute that the sector falls decidedly into Kang’s “Rent-Seeking” category.

5.3.4 Gazprom Conclusion:

From the criteria examined, Gazprom best fits into Kang’s ‘rent seeking’ scenario with regard to investment and opportunities for unfettered rent collection. The discrepant factor here is with regard to state coherence: though incoherent in the 1990s due to the bifurcation of the presidency and what appears to have been a captured legislative branch, the state has become increasingly coherent in its behaviour toward Gazprom. This is indicative of either the state’s inability to rein in this behaviour or the state’s complicity in it. Though it is impossible to prove that the latter is true, if one is prone to believing that power tends to be abused, it is certainly plausible. Figure 5.3 illustrates the sector’s metamorphosis over time.
Table 5.3 Gas sector metamorphosis

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<th>Gas Sector Metamorphosis</th>
<th>&quot;Predatory State&quot;</th>
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<td>Late Soviet Period</td>
<td>&quot;Predatory State&quot;</td>
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<tr>
<td>Yeltsin Period</td>
<td>&quot;Predatory State&quot; -&quot;Rent-Seeking&quot;</td>
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<tr>
<td>Early Putin Period</td>
<td>&quot;Rent-Seeking&quot; -&quot;Predatory State&quot;</td>
</tr>
<tr>
<td>Late Putin Period</td>
<td>&quot;Predatory State&quot; - &quot;Rent Seeking&quot;</td>
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Through the lens of this analysis it is clear that Gazprom began and remains a mixture of Kang’s “rent-seeking” and “predatory state” categories. Though initial reforms in the Putin era stopped the outflow of wealth through asset stripping and the diversion of profits through intermediaries, Gazprom has instead moved to enable rent-seekers through over-inflated construction costs. With a market capitalization a fraction of its former worth just five years ago, and major threats to its primary market in Europe, the high costs incurred by this behaviour may be more than the firm is capable of bearing in the long term.

Though initially powerless to initiate reforms in the 1990s, the state in Putin’s Russia has taken a much more collaborative approach with Gazprom. It may be said that it was ‘colonized’ by close associated with the president, Dmitry Medvedev and Alexey Miller: much of the rent seeking of the 1990s was put to an end due to their efforts. Though Gazprom was expected to pay a much higher portion of its revenue to the state, opportunities for the collection of large rents have proliferated through the firm’s investment in highly inflated construction projects. Though the very opaque nature of the sector makes it difficult to ascertain many of the finer details, it is clear from this relationship that Gazprom has not achieved economic optimization through a ‘mutual hostages’ model. In the early 2000s the president initiated a transfer of power
from one set of bureaucrats to another: not only has this resulted in continued corruption, but now the firm’s long term viability is threatened.

With Rosneft moving to increase gas production and develop LNG export, the real possibility exists that Gazprom could be absorbed by this new favoured ‘national champion’. However, as we have seen, if Kang’s model of economic optimization through ‘mutual hostages’ is correct, Rosneft leaves much to be desired: the firm’s high debt to value ratio and possibilities for its own over-inflated construction costs are strong indicators that it, too, is moving toward a rent-seeking categorization like Gazprom.

Kang argues that a “predatory state” category, as was the case in Marcos’ Philippines requires substantial rents to pay off subordinates in order to form a kind of governing coalition of rent-seekers (Kang, 2002, p. 154). As a tool of achieving this end, Gazprom appears to share many characteristics of this. Karl’s example of megaprojects fits well into Gazprom’s multiple highly expensive and questionably useful large-scale investments, the rents from which could be used to pay off members of such a coalition. However, as mentioned previously, without sufficient evidence this is impossible to qualify.

With Gazprom being a state-owned corporation staffed with high-level Putin associates like Alexei Miller, as well as being the beneficiary of the utilization of state power to convince the sale of Sibneft to it, Gazprom exemplifies Kang’s notion of top-down “predatory state” behaviour. However, by wasting such substantial portions of its capital investment on ‘value destruction’, the beneficiaries of which are private construction contractors, the firm also appears the victim of bottom up “rent seeking” category behaviour. Though impossible to determine exactly where the money is going (at least at present) we are still able to see that the firm is
caught somewhere between top-down and bottom-up rent seeking, with its management likely complicit in both cases.

5.4 Analysis of Russia’s Nuclear Sector

It is in Russia’s nuclear sector that we find some of the more blatant examples of rent-seeking behaviour. This is primarily due to the recent anti-corruption measures taken within the firm, demonstrative of a disturbing lack of regulation and oversight which have uncovered many cases, demonstrative of a disturbing lack of regulation and oversight. What is most interesting, however, is that though measures have been taken against corruption, the mechanisms to regulate Rosatom with any kind of transparency have been stripped away. In this sense, the firm is emerging as another major rent-seeker in Russia’s energy sector.

What is most troubling about Rosatom is the high likelihood of state involvement in abetting its opacity and corruption. Unlike oil and gas, Rosatom is not a net profit generator at present and thus requires extensive state patronage to conduct its regular operations. That it has received so much funding in recent years and is slated to receive more in upcoming earmarks is indicative that Rosatom will likely continue to be a significant cost to the state coupled with a questionable ability to be a source of revenue in the future.

5.4.1 Coherent/ Incoherent State Behavior relative to the Nuclear Sector

It is difficult to determine the state’s actual goals for Rosatom. Though it claims it wishes to turn the firm into a transparent revenue generator, the state has made Rosatom more opaque and costly than before. The culture of corruption within Rosatom is a disturbing one and the
measures taken against this do not appeared to have resulted in more than the arrest of certain established functionaries within the firm.

From an outside perspective, the state’s attempts to crack down on corruption within Rosatom appear paradoxical. On one hand, a number of middle- and high-ranking officials have been arrested over the past decade. However, the evidence shows that in the cases of the most high profile and egregious abuses, the perpetrators tend to receive incredibly lax punishments even for those crimes that significantly endanger human life. Recently, anti-corruption measures against the firm have increased, but again these are quite problematic. In 2012, it was announced that internal perpetrators of corruption within Rosatom would face criminal liability for their actions (Ria Novosti, March 5, 2012). Furthermore in the president’s 2014-2015 anti-corruption campaign, Rosatom is the only firm in this study that will be inspected by officials (ITAR, April 11, 2014). However, Rosatom’s recently gained ability to “effectively self-regulate” (Oliphant, April 11, 2011) gives it considerable sway in deciding which offenses are investigated and which are overlooked. One could easily see that such circumstances would simply make it more possible for those at the top of the hierarchy to remove some through these anti-corruption mechanisms, while shielding others.

In this sense, we are left with inconclusive results. The government has been able to enact major reforms at Rosatom that have turned the state’s nuclear sector into a commercial venture. Conversely, the stated goal of curbing corruption within the firm has proven deeply problematic, given the number of potential loopholes available for exploitation. This leaves us with two possibilities: 1) the state has been largely incoherent in its efforts to curb potential corruption within the firm due to a number of egregious regulatory oversights, or 2) state actors have purposely created these considerable loopholes for their own benefit, indicating something
entirely different than what the matrix offers. Both of these possibilities are indicative of a ‘rent-seeking’ scenario; however, the latter is indicative of state coherence whereas the former is not.

It is entirely possible that the culture of corruption within Rosatom is too great to be curbed by any government. However, by instituting criminal liability against perpetrators of corruption in an effectively self-regulating body, the state has empowered Rosatom’s leadership to target specific actors with harsher punishments while leaving others untouched. Given that Rosatom’s restructuring was entirely state-initiated, it is possible that the state actors involved may be directly benefitting from these corruption-enabling loopholes. The fact that Rosatom’s ability to issue its own construction licenses was given by presidential decree by President Medvedev in 2011 (Bellona, January 21, 2011) is a troubling indication of this possibility. Additionally, it should also be noted that Russia’s nuclear sector is dependent on federal funds and would not possess the necessary means to ‘colonize the state’ in the same way that the oil and gas sectors could, given their immense resources derived from their profits. This further indicates the possibility that state actors are taking an active rather than passive role in enabling this corruption.

Without sufficient evidence it is impossible to tell if this notion is true. Thus it may only be said that the attempts at curbing corruption within Rosatom are misguided and will likely be ineffective, given the profound lack of oversight. With Rosatom’s ability to contradict the government’s stated goal of curbing corruption within it, it may be said that the state is behaving incoherently toward one of its major corporations. We can at the very least surmise that this incoherence is indicative of a “rent-seeking” scenario. If the state is complicit, it is still indicative of unfettered rent seeking, but suggests something different from Kang’s model entirely.
5.4.2 The State of Investment at Rosatom

Like Gazprom, Rosneft has the tendency to invest heavily in large construction projects with easily padded costs. However the primary difference is that while Gazprom uses its own generated wealth to fund these endeavors, Rosatom does so at the direct expense of the state. While Gazprom’s viability as a primary contributor to the federal budget is now threatened, Rosatom is currently serving as a major expenditure with few guarantees it will be a net contributor any time soon. Thus Rosatom’s investments are not only costly and questionable, their cost comes at the direct expense of the Russian public.

Rosatom’s technological development and overseas projects, though impressive, are coming at a tremendous budgetary expense, at least in the short- to medium-term. This is because many of the company’s foreign orders are being financed through low-interest loans from the Kremlin that go directly to Rosatom, while the state receives payment installments from the foreign buyer. As discussed previously, there are a number of problems associated with this payment model, including not paying owed money and the long term of the loan agreements. Furthermore, there is strong evidence to demonstrate that this money is not being effectively handled: a joint investigation by Transparency International and EcoDefence found multiple violations of standards in 40 percent of the 200 procurement deals studied (Oliphant, April 11, 2011). For these reasons, the risk of these investments being unprofitable and a net drain on the federal budget is quite high.

Russia’s experimentation with breeder-style reactors is reminiscent of another of Karl’s statements on “megaprojects”. In addition to new domestic and overseas construction fitting into this category, she also notes that “highly capital-intensive and specialized one-of-a-kind designs may be favored so that there are no reliable cost benchmarks” (Karl, 2004, p. 667). Though the breeder reactor is not a new thing, Rosatom’s new designs are. If this is true, the fact that $3.6
billion was invested just into research indicates that the costs associated with breeder reactors will continue to grow as more are constructed.

Rosatom has invested heavily in a number of questionable megaprojects that may easily enable rent-seekers and have questionable profit delivering ability. The process for procurement is deeply flawed: there have been numerous examples of substandard equipment and materials being used with the cost differences pocketed by officials, and other reports have shown heavily bloated construction costs for reactors. As noted previously, the potential money generated from nuclear power exports is difficult to determine due to fluctuating prices and demand. Additionally, the long-term drain on the federal budget incurred by overseas projects will not deliver a net financial gain for the state in the near future. Thus Rosatom’s investments in the last decade resemble of those in a “rent-seeking” model wherein rents are collected from the bottom-up at the expense of the state. The fact that it is a state-owned corporation further complicates the matter, with the possibility that some of these rents are being used to buy the loyalties of a governing coalition, indicative of a “predatory state”. This curious mixture appears to indicate that the case falls somewhat askew of Kang’s matrix.

### 5.4.3 Opportunities for Rent Collection within the Nuclear Sector

The aforementioned megaprojects have been shown to offer substantial opportunities to rent-seekers within Rosatom. Firstly, it has been shown that widespread corruption has occurred in the company’s procurement process, wherein the perpetrators pocket the difference by purchasing substandard materials, a form of rent seeking. This, in addition to the greatly over-valued costs associated with reactor construction in a manner similar to what we have seen in
Gazprom’s construction endeavors, offers rent-seekers tremendous opportunities at the expense of the state.

Most interestingly, the state has announced that it plans to eventually privatize the commercial assets Rosatom in a manner similar to its long-term plans for Rosneft (World Nuclear News, February 2, 2012). Like Rosneft, Rosatom continues to accumulate vast capital assets as it expands, with little apparent regard to its own profitability. If this privatization is to occur in much the same way as it has in Russia’s recent history, we can assume that an even greater opportunity might arise for rent-seekers with the means and connections to acquire these vast assets at greatly devalued rates. Additionally, the current commercial operations of Rosatom require extensive state patronage to function and the evidence presented in this study does not indicate that they would become commercially viable in the foreseeable future: if they were to be privatized, it is possible that the state would be handing over large amounts of wealth to private actors for their direct expropriation.

With the oil sector and even gas (though to a lesser extent) there remains some competition. In the case of the nuclear sector, this is completely non-existent within the country. This means that the entirety of the rents available for reaping is doled out by one vertically integrated state-owned conglomerate. With corruption as high as it is in the sector, it is clear that Ades and Di Tella are correct in this assertion that this breeds corruption, as Rosatom has seemingly been given more autonomy than any other sector due to its ability to functionally self-regulate.
5.4.4 Nuclear Sector Conclusion:

Russia’s nuclear sector undoubtedly best fits into Kang’s rent-seeking model. It is able to flout state goals (at least those stated publicly), and repeatedly makes large-scale investments that do much more to enable rent-seekers than add to the firm’s efficiency or profitability. However, more than oil and gas, Russia’s nuclear sector demonstrates the strong possibility that the state itself may be purposefully enabling this internal corruption. Figure 5.4 indicates the sector’s change over time:

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<th>Nuclear Sector Metamorphosis</th>
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<td><strong>Yeltsin Period</strong></td>
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<td>&quot;Predatory State&quot; -&gt; &quot;Rent Seeking&quot;</td>
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Table 5.4 Nuclear sector metamorphosis

Under the Soviet era the sector was under the domination of the state, albeit with considerable opacity. When the Soviet Union fell, the Yeltsin government was incapable of reining in corruption within the firm’s ranks as its members preyed on the firm from the bottom-up, mostly in the form of petty corruption. As with the oil and gas sectors, bureaucrats take on the dual role of public managers and private rent seekers as they prey on their firms with general impunity. Under Vladimir Putin and CEO Sergey Kiriyenko, the firm did much to combat the smaller abuses of corruption from within, but as we have seen, extensive rent seeking in the form of large-scale projects and questionable overseas deals has led to the firm becoming a powerful
vehicle for those reaping these rents at a high level. Though state power has been used to purge many abusers, it is apparent that those in charge stand to gain significantly from these larger dealings.

For these reasons, we find the firm in a curious mixture of the “predatory state” and “rent seeking” categories. While those lower level functionaries who are caught appear to be punished, little is being done to counter the apparent abuses on the whole and it appears that less is being done to question the actual profitability of the model.

The primary factor for Rosatom is its ability to generate profit long-term. This study has shown serious doubts in this regard; however, the possibility of future privatization may persuade the upper management to curb subordinate rent-seeking in the pursuit of greater rents for themselves. If the current management is to own, or is in the employ of future owners, it is entirely possible that they may curb the most egregious and dangerous forms of rent-seeking in order to improve the value of the assets in the future, when they would require these to be profitable. In this sense, there would also be great incentive to curb the kind of egregious corruption that comes at a potential cost to public safety as this would make future buyers rightly wary of Russia’s nuclear energy industry; however, this too is merely a possibility and there are currently no mechanisms to adequately curb such abuses.

Regardless of such possible underlying factors, it is clear that Rosatom fits well into Kang’s “rent seeking” category in that it operates virtually free of state oversight, makes numerous large investments of questionable profitability with multiple opportunities for rent-seekers, which indicates of a kind of bottom-up kind of corruption. The fact that Rosatom is a state-owned corporation appears to be irrelevant as there were no competing non-state institutions on which the state could prey as per the “predatory state” category. Though the other
sectors straddle the line of top-down and bottom-up corruption to some extent, Rosatom has existed as a generally autonomous entity that swallows large amounts of state resources for questionable payoffs. The only evidence that the firm is part of a “predatory state” model is if this wealth outflow is going in part to construction contractors that in some way serve the political elite: without this evidence, Rosatom may be only categorized as fitting into the “rent seeking” model.

5.5 Russia and ‘The Resource Curse’

As mentioned previously, the very fact that Russia has gone from being a manufacturing economy in the Soviet era to one which is primarily resource based at present is likely to result in a number of issues. With regard to the resource curse as a phenomenon, it is apparent that Russia is experiencing the prominent symptoms outlined in this study. As mentioned previously, the goal of this final portion of the analysis is not to test a hypothesis, but rather to offer an area for further study into this matter. Given the sheer depth of writing on the ‘resource curse’ phenomenon, a full examination into such a matter would warrant another study altogether.

Firstly, it must be said that Russia very much fits the profile of a rentier state. This categorization is demonstrated quite succinctly earlier in this work by noting that oil and gas revenues account for 70% of Russia’s export revenue and 52% of its annual budget (Hargreaves, March 3, 2014). Karl’s contention that rentier states emerge from weak institutional frameworks seems to apply here: with the state bureaucracy becoming disjointed from the executive branch of government in the 1980s and 1990s, coupled with the state’s lackluster ability to enforce policy reforms under Yeltsin, it may be said that the institutional context in which Putin found
himself in 1999 was a relatively weak one with regard to these sectors. Simply put: there was little constraining them.

From an institutional perspective, empowering the state-owned corporations marks the Putin presidency. However, it is also clear that these institutions function with a high degree of autonomy with little restraint on the behaviour of actors within. In this instance, both Ross and Karl are correct in their assertions. Firstly, Ross’s argument that increased revenue serves to empower the state offers a good explanation as to why, as this revenue rose in the early 2000s, the Putin administration was so able to ‘rein in’ the oligarchs so effectively through legal and other institutions and allow for their assets to be purchased by state-owned corporations. Secondly, Karl’s assertion that the state’s institutions become ‘hollow’ and ineffective is also appropriate, given the state’s inability to reign in corruption and push for changes within its state-owned firms.

Though it is beyond the scope of this study to say definitively, it is clear from this analysis that Russia is experiencing two prominent symptoms of ‘resource curse’: being a rentier state, and having a large and unruly institutional framework. The implications of this warrant further study. Particularly, it is worthy of note that Russia’s emerging nuclear sector is being, in one way or another, subsidized by oil and gas rents as it emerges as a major source of elite rents trough, among other things, corruption. Regardless of these implications, the fact that Russia fits well into these two prominent symptoms of resource curse, in addition to struggling economically, offers possible explanations worthy of future inquiry.
Chapter Six: Conclusion

“Those who fight corruption must be crystal clean themselves, otherwise they just engage in political self-promotion”

– Vladimir Putin, April 25, 2013

Though David Kang’s theory and analysis demonstrate that corruption need not be an inhibitor to economic optimization, this is not the case in Russia at present with regard to the industries examined. This study has shown that the three energy sectors in question consist of both top-down and bottom-up corruption, constituting a mixture of Kang’s “predatory state” and “rent seeking” scenarios: in many ways, Russia resembles the example of the Philippines given in his work.

Like the Philippines, Russia’s bureaucracy is the successor to an administration from a previous regime, with both being comprised of a number of well-educated professionals. The difference here is that though the Philippines’ democratic era saw significant amounts of bureaucratic corruption that permitted the predatory behaviour of private economic actors in the country, Russia’s bureaucracy had significantly more sway over its national economy. As mentioned in chapter 2, this is largely the remnant of Lenin’s concept of state-capitalism, in which a large bureaucracy was given control over the entirety of Soviet economic production in the post-revolutionary era. When the Soviet Union fell, vertically integrated conglomerates like Gazprom, Lukoil, and Surgutneftgas had already been carved out and were ready to function as both public and private entities. Furthermore, without the restrictions of a centralized economy and repressive state, the post-Soviet bureaucrats in firms like Gazprom were able to take full advantage of their positions by skimming profits and stripping assets by doling them out to a number of private intermediaries. As we have seen, this plunder has not abated, but rather has
accelerated over the past three decades and there is reason to suspect that the system in place will face severe challenges moving forward.

Under Boris Yeltsin, the political branches of the Russian federal state became bifurcated, with oil falling under the purview of the executive and its favoured patrons, the oligarchs, while the gas sector fell under that of the legislative branch as a state-owned entity with extensive state patronage. In both cases, the state was preyed upon: the oligarchs were doled out substantial tranches by the state in fraudulent auctions while Gazprom was permitted to skim the profits and strip the assets of their state-owned entity and neither were subjected to any kind of taxation. Meanwhile the nuclear sector was permitted to engage in its own corrupt behavior with virtually no state oversight. Thus in all three instances, we find the kind of state incoherence and bottom-up corruption Kang describes in the Philippines during the democratic era.

Like Ferdinand Marcos, Putin is a populist and authoritarian leader. Just as Marcos used state wealth and power to bring an enhanced infrastructure and other social benefits to his people during the initial years of his rule, the income of ordinary Russians and their access to social programs have expanded during the initial Putin years. Most importantly, however, both leaders presided over a system of systemic corruption.

In Kang’s example, one of the reasons for the unraveling of the Marcos regime came when the state lost its access to foreign credit, causing a lending crisis in the country that slowed the economy and turned the regime cronies against each other as they scrambled for fewer collectable rents (Kang, 2002, p. 145). Similarly, Russia faces problems with attaining the revenue needed for payoffs for all of the reasons mentioned in this study. Most importantly, in Kang’s example Marcos’ cronies began infighting and weakening the regime -- something that
appears to be happening now in Russia in the very public battles between the state-owned oil and gas conglomerates.

It is well known that the Marcos regime plundered much of the Filipino economy to enrich both the presidential family and its supporters. In Russia, there are a number of signs that the Putin regime is doing the same: the amount of corruption identified in this study indicates it may very well be occurring in the oil, gas, and nuclear sectors of the economy. A recent series of articles by Reuters, entitled “Comrade Capitalism,” has uncovered a scheme where close associates of the President sold medical equipment to the government for $195 million and sent a total of $84 million to Swiss bank accounts: records have shown that $48 million from those accounts were funneled to a company that helped construct what is known as “Putin’s palace” near the Black Sea (Gray, et al. May 21, 2014). In 2011, documents revealed that the Kremlin property chief approved the construction, despite his previous denial of any involvement. The privately owned site is alleged to be worth $1 billion. Activists taking photos of the property have been taken away and detained by officers of the Federal Guard Service (Bratersky, February 15, 2011). Indeed foreign officials have also suspected the Russian president of profiting personally at the expense of his country: leaked documents from 2008 reveal that the United States Ambassador to Russia, John Beryle suspected the president of skimming wealth from the oil sector through a Swiss-based intermediary (The Guardian, December 1, 2010). If these allegations are true, the similarities between the Putin regime and Marcos’ “predatory state” are palpable. At present, the only definitive hint of corruption on the part of the president has been found on his physical person: from examining videos and photos of the president, the Russian opposition group ‘Solidarity’ has noted that the different watches he has been seen
wearing are collectively worth nearly $700,000, roughly six times his annual salary (Radia, June 8, 2012).

With public battles between Rosneft, Transneft, and Gazprom, it is difficult to determine whether these differences are legitimate or contrived as a mode of distraction. When Marcos’ influence began to wane, infighting among his supporters became commonplace and there is reason to suspect that exactly this is occurring within the Putin regime as the income that caused Russia’s GDP to grow immensely in the 2000s has diminished significantly.

Though the similarities between the two cases are demonstrable, Kang’s theory does not account for a crucial aspect in Putin’s Russia: the mixture of top-down and bottom-up corruption. In Kang’s example of the Philippines under Marcos, state power was wielded against a corrupt and fragmented private sector in much the same way Putin did with the corrupt and fragmented oligarchs of the oil sector. However, once the wealth of these firms was appropriated in Russia, the result has been systemic bottom-up corruption, which from what can be seen is outside the oversight of the political elite. Though the possibility exists that the entirety of the political elite is complicit in this, I suspect it is a mixture of the two. If this is indeed the case it may be said that when the “predatory state” begins to falter economically, at least in the case of Russia, it reverts somewhat to the “rent-seeking category” that is exemplified by bottom-up corruption. This is because bureaucrats engage in or permit rent seeking by private outside interests (particularly construction firms and trading intermediaries), which in essence gives them the dual role of behaving as bureaucrats and private actors in their own right. Neither top-down nor bottom-up corruption is optimal for economic growth, which is blatantly made clear by the state of the Russian economy today.
The systemic problems in Russia are arguably the culmination of two factors in the country: the legacy of Leninist ‘state capitalism’ and the fall of the Soviet Union. As we have seen, Russia’s state-owned corporations that are managed by the successors to the Soviet-era bureaucracy are plagued by massive capital outflows indicative of systemic corruption. Under the Soviet system such plunder would have been met with harsh penalties, but it appears that the state today is, at best ineffective in curbing these activities and, at worst, complicit in them. Furthermore, in the Soviet system, much of the demonstrable inefficiency was attributable to bureaucratic mismanagement, which has only accelerated over time and has arguably culminated in a bureaucratic-led kleptocracy.

Though this study contains an underlying critique of Leninist state capitalism, the title of a 1913 article by V.I. Lenin is particularly illuminating: “Who Stands to Gain?”. Ironically, it has been actors within Lenin’s bureaucratic economic model and its successors who have stood to gain the most over the past fifty years. These are the people who use pension funds to purchase private oil companies and permit the stripping of billions of dollars in assets away from state-owned firms to their preferred cronies. The fact that Vladimir Putin has stated that he “fancies himself more of a bureaucrat than a politician” (Jack, 2005, p. 45) is illuminating in this regard. Perhaps more than any other, he has stood to gain the most since his ascent to the presidency: determining one’s opinion on whether he is complicit is merely a question of the man’s character.

However, the question of Putin’s culpability is not the only matter at hand. Indeed there are those in the country who see him as a “victim of circumstance”. Indeed a former political advisor from the President’s 2000 campaign Gleb Pavlovsky stated in an interview with Rolling Stone that Putin is “a functionary of a machine that sucked him in, and it broke him. We have
built a government that buys loyalty from its functionaries and the population, but nobody actually manages the country” (Reitman, April 30, 2014). Regardless of the validity of Pavlovsky’s assessment of his former boss, the question that must be raised is: what is the ‘machine that sucked him in’?

From the evidence presented in this study it appears that those in charge of the sectors in question, despite being technically in the employ of the state, are engaging in widespread rent seeking and general corruption. Furthermore, this is coming at great expense to the profitability of the state-owned firms and indeed the Russian people. In this sense, it is apparent that the state bureaucratic and political actors complicit in this behavior are the ones who have colonized the state. Now that there are no more private institutions on which these state actors can prey, their deliberate plunder of the state’s assets is becoming increasingly apparent and comes at the expense of their long-term viability. In this sense, a situation has emerged that falls outside Kang’s matrix wherein the actors within the state’s largest conglomerates are plundering them of their wealth at an alarming rate. I call this scenario mutual predators, as this describes both the political and bureaucratic actors preying on the state wealth under their stewardship at a rate that is neither economically optimal or even tenable in the long term.

After examining the institutions in this study, the ‘machine’ Pavlovsky refers to is likely the successors to Soviet-era bureaucrats: those in state corporations and their cronies who function as intermediaries and construction contractors. It is a machine that has survived attempts at reform in the Soviet and post-Soviet eras and, given its current influence, is unlikely to be reformed in a meaningful way any time soon. If Russia is to seek economic optimization, it must do so with this consideration in mind.
It is clear that the very foundations of Russia’s energy economy are faltering and that reform is necessary. With a mix of top-down and bottom-up corruption in Russia, it is difficult to know where to start in such an undertaking. Given that the state was able to halt much of the asset-stripping within Gazprom in the early 2000s, it is conceivable that the state could assert itself once more in this regard; however, the likelihood of this occurring is dependent on the will of the current elites or the ability of another group to replace them.
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